

OUTBOUND ACQUISITIONS:  
TAX PLANNING FOR EUROPEAN EXPANSION  
IN A CHANGING LANDSCAPE  
(2019)

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## CHART

The following chart is a summary of several of the most common tax regimes that are covered in detail in this text. Below is a brief explanation of what information is shown in each row.

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

	<u><b>Austria</b></u>	<u><b>Belgium</b></u>	<u><b>Cyprus</b></u>
<b>C.I.T.</b>	25% <sup>1</sup>	29.58% <sup>2</sup>	12.5%
<b>P/E (Div./C.G.)</b>	Full / Full <sup>3</sup>	Full / Full <sup>4</sup>	Full / Full <sup>5</sup>
<b>Dividends Paid</b>	0% / 27.5% / treaty rate <sup>6</sup>	0% / 30% / treaty rate	0%
<b>Dividends Received</b>	Full / 25%	Full / 29.58%	Generally exempt <sup>7</sup>
<b>Capital Gains</b>	P/E / 25%	P/E / 29.58 / 25. 5% <sup>8</sup>	Full / 20% <sup>9</sup>
<b>Double Tax Relief</b>	D.T.T.; Credit <sup>10</sup>	D.T.T.; Credit <sup>11</sup>	D.T.T.; Credit <sup>12</sup>
<b>Tax Treaties</b>	88	95	65
<b>V.A.T.</b>	20%	21%	19%
<b>Cap. Tax / Stamp Duty</b>	No / Yes	No / Yes	Yes <sup>13</sup> / Yes <sup>14</sup>
<b>D.P.T.</b>	No	No	No <sup>15</sup>
<b>C.F.C. Rules</b>	Yes	Yes <sup>16</sup>	No <sup>17</sup>
<b>Debt vs. Equity</b>	No thin cap. / Gen. limit <sup>18</sup>	5:1 / Gen. Limit <sup>19</sup>	No thin cap. rules
<b>Transfer Pricing</b>	Based on O.E.C.D. rules	Based on O.E.C.D. rules	Based on O.E.C.D. rules <sup>20</sup>
<b>Patent Box</b>	No	Yes	Yes <sup>21</sup>
<b>C.R.S.</b>	Adopted	Early Adopter	Early Adopter
<b>B.E.P.S. Action Plan</b>	Active	Active	Planned <sup>22</sup>

<b>F.A.T.C.A. I.G.A.</b>	Model 2	Model 1	Model 1
	<b><u>Denmark</u></b>	<b><u>France</u></b>	<b><u>Germany</u></b>
<b>C.I.T.</b>	22%	31% or 32.02% <sup>23</sup>	~30% <sup>24</sup>
<b>P/E (Div./C.G.)</b>	Full / Full	Partial / Partial	Partial / Partial
<b>Dividends Paid</b>	0% / 22% / treaty rate <sup>25</sup>	0% / 30% / treaty rate <sup>26</sup>	0% / 26.38% / treaty rate <sup>27</sup>
<b>Dividends Received</b>	Full / 16.5% <sup>28</sup>	1.6% / 31%+ <sup>29</sup>	95% / ~30%
<b>Capital Gains</b>	Full / 22% <sup>30</sup>	3.7% / 31%+ <sup>31</sup>	95% / ~30%
<b>Double Tax Relief</b>	D.T.T.; Credit	D.T.T.; Deduction <sup>32</sup>	D.T.T.; Credit; Deduction
<b>Tax Treaties</b>	86	120+	97
<b>V.A.T.</b>	25%	20%	19% <sup>33</sup>
<b>Cap. Tax / Stamp Duty</b>	No / No	Yes / Yes	No / No <sup>34</sup>
<b>D.P.T.</b>	No	No	No
<b>C.F.C. Rules</b>	Yes	Yes <sup>35</sup>	Yes
<b>Debt vs. Equity</b>	4:1 / Asset Basis / Tax E.B.I.T. <sup>36</sup>	Gen. limit <sup>37</sup> 1.5:1 Thin-cap ratio	Gen. limit on interest <sup>38</sup>
<b>Transfer Pricing</b>	Based on O.E.C.D. rules	Based on O.E.C.D. rules	Based on O.E.C.D. rules
<b>Patent Box</b>	No	Yes <sup>39</sup>	No <sup>40</sup>
<b>C.R.S.</b>	Early Adopter	Early Adopter	Early Adopter

<b>B.E.P.S. Action Plan</b>	Active	Active	Active
<b>F.A.T.C.A. I.G.A.</b>	Model 1	Model 1	Model 1
	<b><u>Ireland</u></b>	<b><u>Italy</u></b>	<b><u>Luxembourg</u></b>
<b>C.I.T.</b>	12.5% or 25%	24%	24.94% <sup>41</sup>
<b>P/E (Div./C.G.)</b>	Full / Full	Partial / Partial <sup>42</sup>	Full / Full
<b>Dividends Paid</b>	0% / 20% / treaty rate	0% <sup>43</sup> / 26% / treaty rate	0% / 15% / treaty rate
<b>Dividends Received</b>	Full / 12.5% or 25% <sup>44</sup>	95% Exempt / 24%	Full / 17%+ <sup>45</sup>
<b>Capital Gains</b>	Full / 33%	95% Exempt / 24%	Full / 17%+ <sup>46</sup>
<b>Double Tax Relief</b>	D.T.T.; Credit; Deduction	D.T.T.; Credit <sup>47</sup>	D.T.T.; Credit; Deduction <sup>48</sup>
<b>Tax Treaties</b>	74	99	83
<b>V.A.T.</b>	23%	22%	17%
<b>Cap. Tax / Stamp Duty</b>	No / Yes	Yes / Yes	Yes / Yes
<b>D.P.T.</b>	No	No	No
<b>C.F.C. Rules</b>	Yes	Yes	No
<b>Debt vs. Equity</b>	No thin cap. / Gen. limit <sup>49</sup>	Gen. limit on interest <sup>50</sup>	No thin cap. rules <sup>51</sup>
<b>Transfer Pricing</b>	Limited <sup>52</sup>	Based on O.E.C.D. rules	Based on O.E.C.D. rules
<b>Patent Box</b>	Yes <sup>53</sup>	Yes <sup>54</sup>	Yes <sup>55</sup>

<b>C.R.S.</b>	Early Adopter	Early Adopter	Early Adopter
<b>B.E.P.S. Action Plan</b>	Active	Active	Active
<b>F.A.T.C.A. I.G.A.</b>	Model 1	Model 1	Model 1
	<u>Malta</u>	<u>Netherlands</u>	<u>Spain</u>
<b>C.I.T.</b>	35%	25%/19% over € 200,000	25%
<b>P/E (Div./C.G.)</b>	Full / Full	Full / Full	Full / Full
<b>Dividends Paid</b>	0% / none / treaty rate	0% / 15% / treaty rate <sup>56</sup>	0% / 19% / treaty rate <sup>57</sup>
<b>Dividends Received</b>	Full / 35%	Full / 25%/19%	0% / 25%
<b>Capital Gains</b>	Full / 35%	Full / 25%/19%	0% / 19%
<b>Double Tax Relief</b>	D.T.T.; Credits	D.T.T.; Credit; Exemption <sup>58</sup>	D.T.T.; Credit; Exemption <sup>59</sup>
<b>Tax Treaties</b>	76	97	93 <sup>60</sup>
<b>V.A.T.</b>	18%	21%/9%	21%/4%/10%
<b>Cap. Tax / Stamp Duty</b>	No <sup>61</sup> / Yes	No / No	Yes / Yes
<b>D.P.T.</b>	No	No	No
<b>C.F.C. Rules</b>	Yes (A.T.A.D.)	Yes	Yes
<b>Debt vs. Equity</b>	No thin cap. rules	No thin cap. / Gen. limit <sup>62</sup>	Gen. limit on interest <sup>63</sup>
<b>Transfer Pricing</b>	No	Based on O.E.C.D. rules	Based on O.E.C.D. rules

<b>Patent Box</b>	Yes <sup>64</sup>	Yes <sup>65</sup>	Yes <sup>66</sup>
<b>C.R.S.</b>	Early Adopter	Early Adopter	Early Adopter
<b>B.E.P.S. Action Plan</b>	Active	Active	Active
<b>F.A.T.C.A. I.G.A.</b>	Model 1	Model 1	Model 1
	<u><b>Sweden</b></u>	<u><b>Switzerland</b></u>	<u><b>U.K.</b></u>
<b>C.I.T.</b>	21.4%	11.9% to 21.6% <sup>67</sup>	19% <sup>68</sup>
<b>P/E (Div./C.G.)</b>	Full / Full	Partial / Partial <sup>69</sup>	Full / Full <sup>70</sup>
<b>Dividends Paid</b>	0% / 30% / treaty rate <sup>71</sup>	n/a / 35% / treaty rate <sup>72</sup>	0% / none / treaty rate <sup>73</sup>
<b>Dividends Received</b>	Full / 30%	P/E / 11.9% to 21.6%	Full / 19% <sup>74</sup>
<b>Capital Gains</b>	Full / 21.4%	P/E / 11.9% to 21.6%	Full / 19% <sup>75</sup>
<b>Double Tax Relief</b>	D.T.T.; Credit; Deduction	D.T.T.; Exempt; Deduction	D.T.T.; Credit; Deduction
<b>Tax Treaties</b>	92	107	131
<b>V.A.T.</b>	25% <sup>76</sup>	7.7% <sup>77</sup>	20%
<b>Cap. Tax / Stamp Duty</b>	No / Yes <sup>78</sup>	Yes / Yes	No / Yes
<b>D.P.T.</b>	No	No	25%
<b>C.F.C. Rules</b>	Yes	No	Yes
<b>Debt vs. Equity</b>	No thin cap. rules <sup>79</sup>	Generally, 70-85% of debt	Gen. limit on interest <sup>80</sup>

<b>Transfer Pricing</b>	Based on O.E.C.D. rules	Based on O.E.C.D. rules	Based on O.E.C.D. rules
<b>Patent Box</b>	No	Yes <sup>81</sup>	Yes <sup>82</sup>
<b>C.R.S.</b>	Early Adopter	Adopted	Early Adopter
<b>B.E.P.S. Action Plan</b>	Active <sup>83</sup>	Planned	Active <sup>84</sup>
<b>F.A.T.C.A. I.G.A.</b>	Model 1	Model 2	Model 1

A. Notes

<sup>1</sup> *Austria (C.I.T.)*. A minimum corporate income tax is levied.

<sup>2</sup> *Belgium (C.I.T.)*. The 29.58% rate includes a 2% austerity surcharge, which is obtained by multiplying the basic corporate tax rate of 29% by 2%.

<sup>3</sup> *Austria (P/E)*. Additionally, under the International Portfolio Participation Exemption dividends (but not capital gains) are tax exempt, with minimum ownership or minimum holding period requirement.

<sup>4</sup> *Belgium (P/E)*. Capital gains: see note **Error! Bookmark not defined..**

<sup>5</sup> *Cyprus (P/E)*. The exemption does not apply where the company paying the dividend engages directly or indirectly more than 50% in activities which lead to investment income and the foreign tax burden on such income is substantially lower than the Cyprus tax burden. The exemption does not apply also to the extent that such dividends are deductible for purposes of calculating the taxable income of the dividend paying company.

<sup>6</sup> *Austria (Dividends Paid)*. Under most tax treaties, withholding tax is ordinarily reduced to 15% for portfolio dividends and 5% for non-portfolio dividends. In some cases, withholding tax may be eliminated entirely.

- <sup>7</sup> *Cyprus (Dividends Received)*. A 30% special defense contribution applies to Cypriot individuals.
- <sup>8</sup> *Belgium (Capital Gains)*. In summary, for 2018 and 2019, capital gains on shares are exempt provided that all conditions (participation or acquisition value, holding period, and subject to tax) are met. Capital gains are taxed at 25.5% if the one-year holding period requirement is not met and at 29.58% if the participation condition or taxation condition is not met. From 2020 onwards, capital gains on shares are either taxed at the standard rate (25%) if one or more of the conditions are not met, or exempt if all conditions are met.
- <sup>9</sup> *Cyprus (Capital Gains)*. A 20% tax rate applies for real estate situated in Cyprus.
- <sup>10</sup> *Austria (Double Tax Relief)*. Varies by treaty. See "Tax Treaty Network" for a list of countries that have a tax treaty with Austria. Unilateral relief exemption by progression, foreign tax credit.
- <sup>11</sup> *Belgium (Double Tax Relief)*. Varies by treaty. See "Tax Treaty Network" for a list of countries that have a tax treaty with Belgium. Treaty relief is mandatory. For unilateral relief, fixed credit is generally offered.
- <sup>12</sup> *Cyprus (Double Tax Relief)*. Treaty relief varies by treaty. See "Tax Treaty Network" for a list of countries that have a tax treaty with Cyprus. Unilateral relief is based on a foreign tax credit, credit against income tax, and the Special Defense Contribution for foreign taxes paid.
- <sup>13</sup> *Cyprus (Capital Tax)*. Capital tax is only applied on issue of share capital 0.6% on authorized share capital.
- <sup>14</sup> *Cyprus (Stamp Duty)*. Stamp duty does not apply to transactions that are effected abroad or assets outside of Cyprus.
- <sup>15</sup> *Cyprus (D.P.T.)*. Implementation of a diverted profits tax is under discussion.

- <sup>16</sup> *Belgium (C.F.C.)*. A C.F.C. regime entered into effect as of January 1, 2019.
- <sup>17</sup> *Cyprus (C.F.C. Rules)*. Implementation of C.F.C. legislation is under discussion.
- <sup>18</sup> *Austria (Debt vs. Equity)*. None in Place.
- <sup>19</sup> *Belgium (Debt vs. Equity)*. Under new legislation of December 25, 2017, there is no deduction for net interest in excess of 30% of E.B.I.T.D.A. (as specifically defined in the new legislation); effective as of January 1, 2019.
- <sup>20</sup> *Cyprus (Transfer Pricing)*. Circular No. 3, which was issued in 2017, introduced detailed transfer pricing rules concerning intragroup back-to-back financing arrangements.
- <sup>21</sup> *Cyprus (Patent Box)*. Cyprus has aligned its Patent Box regime with the B.E.P.S. Action Plan to reach full compliance with the “nexus approach.” Benefits under the prior Cypriot Patent Box regime phase out by 2021.
- <sup>22</sup> *Cyprus (B.E.P.S. Action Plan)*. Implementation of the B.E.P.S. Action Plan is ongoing, and all transactions in Cyprus now undergo stricter scrutiny.
- <sup>23</sup> *France (C.I.T.)*. A 3.3% additional social contribution may apply on the portion of the C.I.T. that exceeds €763,000.
- <sup>24</sup> *Germany (C.I.T.)*. While the regular C.I.T. rate is 15%, the effective rate is approximately 30%. This rate is obtained by multiplying the regular corporate tax rate of 15% by a 5.5% solidarity surcharge and by adding a municipal trade tax that may vary from 7% to 17%.
- <sup>25</sup> *Denmark (Dividends Paid)*. If a dividend is not covered by the P.S.D., it is subject to 22% withholding. However, a refund will be provided if this rate is reduced by a treaty or if a tax information exchange treaty has been entered into between Denmark and the jurisdiction in which the recipient resides for tax purposes, in which case a 15% rate applies.

- <sup>26</sup> *France (Dividends Paid)*. Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax, generally ranging from 25% to 5%, and in some cases allow for zero withholding. The rate of withholding is 75% for payments made to persons resident in countries on France's list of non-cooperative countries and territories.
- <sup>27</sup> *Germany (Dividends Paid)*. The statutory rate of German withholding tax is 25% (plus a 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). Germany has also enacted anti-treaty shopping and anti-directive-shopping rules regarding the use of intermediate holding companies. These anti-abuse rules may deny reduced withholding tax rates under certain circumstances.
- <sup>28</sup> *Denmark (Dividends Received)*. Dividends may be exempt even if below the 10% participation exemption ownership requirement for consolidated groups.
- <sup>29</sup> *France (Dividends Received)*. The first rate corresponds to the application of the D.R.D. regime (95% exemption). Interest on a debt-financed acquisition of shareholdings is deductible.
- <sup>30</sup> *Denmark (Capital Gains)*. Exemptions also apply to consolidated groups and unlisted companies that are not part of a consolidated group and not covered by the participation exemption.
- <sup>31</sup> *France (Capital Gains)*. The first rate corresponds to the application of the C.G.T. regime (88% exemption). *Supra* note **Error! Bookmark not defined..**
- <sup>32</sup> *France (Double Tax Relief)*. Treaty relief generally includes exemptions or a foreign tax credit. Unilateral relief is available under the territoriality principle or a deduction.
- <sup>33</sup> *Germany (V.A.T.)*. A reduced rate of 7% applies in some areas.

- <sup>34</sup> *Germany (Capital Tax / Stamp Duty)*. No capital tax or stamp duty as such are levied. Registration fees may however apply.
- <sup>35</sup> *France (C.F.C. Rules)*. Trusts are among the targeted foreign structures.
- <sup>36</sup> *Denmark (Debt vs. Equity)*. Under the Asset Limitation Rule, net financing expenses exceeding DKK 21,300,000 are capped at 2.9% of the tax basis of operating assets. Under the E.B.I.T.D.A. Limitation Rule, net excess debt funding costs exceeding DKK 22,313,400 are capped at 30% of E.B.I.T.D.A. A higher percentage can be elected if the consolidated group excess debt funding costs exceed 30% in which case a corresponding percentage can apply.
- <sup>37</sup> *France (Debt vs. Equity)*. The deductibility of interest expense is limited to the higher of 30% of adjusted tax E.B.I.T.D.A and €3 million. Thin-capitalization applies if related debts exceeds 1.5 equity.
- <sup>38</sup> *Germany (Debt vs. Equity)*. No deduction applies for interest payments in excess of 30% of E.B.I.T.D.A. In Germany, this is also known as the “interest deduction ceiling.”
- <sup>39</sup> *France (Patent Box)*. However, 10% tax on net I.P. income, subject to O.E.C.D.’s nexus approach.
- <sup>40</sup> *Germany (Patent Box)*. A license barrier rule applies to expenses arising from the year 2018 onward. The legislation 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 (*i.e.*, patent box) that is not compliant with the O.E.C.D. nexus approach and (ii) effectively taxed at a rate below 25%.
- <sup>41</sup> *Luxembourg (C.I.T.)*. This the rate applicable in Luxembourg City. The general corporate rate is 17%. A 7% surcharge applies, which results in an overall rate of 18.19%. Luxembourg City adds a 6.75% municipal business tax, which results in a 24.94% Luxembourg City rate.

- <sup>42</sup> *Italy (P/E)*. Classified as financial fixed assets, the subsidiary must be resident in a country which is not considered as black listed and must be engaged in an active business
- <sup>43</sup> *Italy (Dividends Paid)*. In order to qualify for the P.S.D. exemption, a minimum holding period of one year and a minimum shareholding of 10% is required. E.U. companies not covered by the P.S.D. are subject to a withholding rate of 1.20%.
- <sup>44</sup> *Ireland (Dividends Received)*. Dividend distributions received from another Irish company are generally exempt. However, dividends received from foreign subsidiaries do not qualify for a participation exemption. 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 from certain foreign shareholdings. The tax rate on dividends received from a non-Irish corporation is either 12.5% (for dividends paid out of trading profits by certain companies) or 25%.
- <sup>45</sup> *Luxembourg (Dividends Received)*. There is a 50% exemption for certain dividends not qualifying under the participation exemption which are then subject to tax under general corporate rates.
- <sup>46</sup> *Luxembourg (Capital Gains)*. Capital gains are taxable up to the amount of previously deductible expenses that are linked to the exempt participation. Such taxable amount can be offset against available losses (carried forward).
- <sup>47</sup> *Italy (Double Tax Relief)*. Excess credits may be carried back and carried forward over an eight-year period.
- <sup>48</sup> *Luxembourg (Double Tax Relief)*. Treaties supersede domestic law, unless domestic law is more favorable.
- <sup>49</sup> *Ireland (Debt vs. Equity)*. Under proposals, no deduction for net interest in excess of 30% of E.B.I.T.D.A. deferred until January 1, 2020.
- <sup>50</sup> *Italy (Debt vs. Equity)*. The general limitation applies on the amount of the payment in excess of earned interest, if any.

The excess amount is only deductible up to 30% of E.B.I.T.D.A.

<sup>51</sup> *Luxembourg (Debt vs. Equity)*. In practice, a ratio of 85:15 is applied to the financing of qualifying subsidiaries.

<sup>52</sup> *Ireland (Transfer Pricing)*. Irish transfer pricing legislation does not apply to S.M.E's. It is based on O.E.C.D. recommendations.

<sup>53</sup> *Ireland (Patent Box)*. The Knowledge Development Box ("K.D.B.") was introduced in Ireland in 2015. Qualifying income is taxed at an effective reduced corporate tax rate of 6.25%. The K.D.B. is in line with the B.E.P.S. Action Plan.

<sup>54</sup> *Italy (Patent Box)*. A 50% exemption is granted (reduced to 30% for 2015 and 40% for 2016) from corporation income tax on income derived from certain intangible assets. I.P. income is determined using a ratio of qualifying expenses to overall expenses. An exemption also exists for capital gains arising from the disposal of such assets if certain qualifications are met. The Patent Box regime is aligned with the B.E.P.S. Action Plan.

<sup>55</sup> *Luxembourg (Patent Box)*. The former Patent Box regime has been abolished as of July 1, 2016. The benefits under the former regime will phase out by 2021. A new I.P. regime was introduced and is applicable as of January 1, 2018. The new regime is in line with the B.E.P.S. Action Plan.

<sup>56</sup> *Netherlands (Dividends Paid)*. Under certain conditions, the dividend withholding tax may be reduced by 3% to compensate for foreign withholding taxes that cannot be claimed as a credit by the holding company by virtue of the participation exemption.

<sup>57</sup> *Spain (Dividends Paid)*. Dividends distributed out of qualified exempt income (*i.e.*, dividends and capital gains that were exempt from tax at the level of the Spanish holding company) are not subject to withholding tax unless the recipient is resident in a country or territory that is considered a tax haven by Spain.

- <sup>58</sup> *Netherlands (Double Tax Relief)*. Tax treaties take priority over domestic law. Foreign taxes may be deductible as expenses if no other method applies.
- <sup>59</sup> *Spain (Double Tax Relief)*. Foreign tax credits on non-exempt foreign-source income may be credited against the 25% corporation income tax, limited to the Spanish corporation income tax payable on the foreign-source income. However, the application of foreign tax credits by taxpayers with an annual turnover exceeding €20 million will be limited to 50% of the tax due before the deduction of the foreign tax credit. Foreign tax credits not deducted may be carried forward and deducted in subsequent tax years.
- <sup>60</sup> *Spain (Tax Treaties)*. 33 countries are on Spain's blacklist.
- <sup>61</sup> *Malta (Capital Tax)*. 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. Lower fees apply if the incorporation documents are filed electronically.
- <sup>62</sup> *Netherlands (Debt vs. Equity)*. Interest paid on base erosion loans is not deductible and as a consequence of the earnings stripping rule included in A.T.A.D.1, from 2019 onwards, interest payments will be limited to the highest of (i) 30% of the taxpayer's E.B.I.T.D.A. or (ii) €1 million.
- <sup>63</sup> *Spain (Debt vs. Equity)*. No deduction applies for net interest expense in excess of 30% of E.B.I.T.D.A. Interest derived from intragroup P.P.L. qualify as return on equity.
- <sup>64</sup> *Malta (Patent Box)*. No determinations under the current Patent Box regime will be issued after June 30, 2016, and benefits will phase out by June 30, 2021.
- <sup>65</sup> *Netherlands (Patent Box)*. A 7% effective tax rate may apply to income generated by qualifying intangibles. As of January 1, 2017, legislation became effective bringing the

existing Dutch Patent Box regime in line with the B.E.P.S. Action Plan.

<sup>66</sup> *Spain (Patent Box)*. 60% of income derived from the use of a qualified intangible asset is exempt from corporation income tax, provided that several conditions are met. The patent box regime is aligned with the B.E.P.S. Action Plan.

<sup>67</sup> *Switzerland (C.I.T.)*. The general federal corporate tax rate is 8.5%. Considering that this tax is deductible, the effective federal corporate rate is brought down to 7.8%. However, cantonal and communal taxes also apply. Lucerne has an overall 12.3% rate; Appenzell Ausserrhoden has a 13.0% rate; Obwalden has a 12.7% rate; Nidwalden has a 12.7% rate; Zug has a 14.4% rate; Zürich has a 21.2% rate; and Geneva has a 24.2% rate.

Under the tax reform that has been approved by a public vote, reduced income tax rates will come into effect as of 2020 in many Swiss cantons. The new rates will be: Lucerne: 12.3%; Appenzell Ausserrhoden: 13.0%; Obwalden: 12.7%; Nidwalden: 12.7%; Zug: 11.9%; Zürich: 18.2%; Geneva: 14.0%.

<sup>68</sup> *United Kingdom (C.I.T.)*. The rate is due to be reduced to 17% in April 2020.

<sup>69</sup> *Switzerland (P/E)*. Corporate tax is reduced proportionally to dividend over total income.

<sup>70</sup> *United Kingdom (P/E)*. Known as the “Substantial Shareholding Exemption.”

<sup>71</sup> *Sweden (Dividends Paid)*. 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. Further, when the recipient of the dividend is a company in a E.U. member state that holds at least 10% of the capital in the Swedish company and fulfills the terms in Article two of the Directive 2011/96/EU, Parent Subsidiary

Directive, the dividend is exempt from withholding tax. Exemption also applies to foreign contractual funds. In addition, certain funds within the E.E.A. and within countries with which Sweden has in force an income tax treaty or a treaty for exchange of information relating to tax matters are exempt from withholding tax.

<sup>72</sup> *Switzerland (Dividends Paid)*. In many cases, a full or partial refund of Swiss withholding tax is available by following notification procedures. The Swiss tax authorities must be notified in advance of the distribution and grant permission for relief. Under the Swiss-E.U. Savings Tax Agreement, dividends paid to any E.U. parent company may follow the notification procedures and receive a full refund of withholding tax if the parent controls at least 20% of the Swiss subsidiary (or a lesser percentage, as provided by an applicable tax treaty). For shareholders resident in other countries, dividend distributions may be subject to reduced Swiss withholding tax. The notification procedures should be available if the requirements of the relevant double tax treaty are met and permission for partial relief at the source has been obtained prior to distribution.

<sup>73</sup> *United Kingdom (Dividends Paid)*. The U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law. The U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law. However, U.K. withholding tax at 20% applies to property income distributions ("P.I.D.'s") paid in relation to certain qualifying activities by R.E.I.T.'s to shareholders who are not within the charge to corporation tax (which can include companies not resident in the U.K). This may be reduced by an applicable U.K. income tax treaty. Since a company will not be able to qualify as a R.E.I.T. if it has corporate shareholders with a 10% or greater participation, treaty relief will be at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20%

withholding that applies to P.I.D.'s made by property-authorized investment funds.

<sup>74</sup> *United Kingdom (Dividends Received).* In principle, dividends received by U.K. holding companies are subject to tax unless specifically exempt. However, the exemptions available are broad, and in practice most distributions received will fall under one of them.

<sup>75</sup> *United Kingdom (Capital Gains).* Note that significant changes have recently been introduced in relation to the taxation of gains realized on disposals of U.K. real estate by non-UK resident companies.

<sup>76</sup> *Sweden (V.A.T.).* A lower V.A.T. rate may apply depending on the type of goods or service.

<sup>77</sup> *Switzerland (V.A.T.).* A Swiss holding company may be subject to V.A.T. at the standard rate 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.

<sup>78</sup> *Sweden (Stamp Duty).* Stamp duty applies only to real estate.

<sup>79</sup> *Sweden (Debt vs. Equity).* There is a general limitation of interest deductibility (net interest) to 30 % of E.B.I.T.D.A. There is also an intercompany interest deduction limitation based on commercial justification for borrowing.

<sup>80</sup> *United Kingdom (Debt vs. Equity).* The thin capitalization rules are part of the U.K.'s transfer pricing legislation. No deduction applies for net interest expense in excess of 30% of E.B.I.T.D.A.

<sup>81</sup> *Switzerland (Patent Box).* Regime in place in some cantons. Based on the public vote of May 19, 2019, all Swiss cantons must introduce a patent box regime with a 90% exclusion allowed for qualifying income. The new regime is in line with the B.E.P.S. Action Plan.

- <sup>82</sup> *United Kingdom (Patent Box)*. The prior Patent Box regime is being phased out. As of July 1, 2016, a new Patent Box became available that is aligned with the B.E.P.S. Action Plan.
- <sup>83</sup> *Sweden (B.E.P.S. Action Plan)*. The Swedish government has implemented several Actions. For further discussion, see page 195 in *Outbound Acquisitions*.
- <sup>84</sup> *United Kingdom (B.E.P.S. Action Plan)*. On January 1, 2017, the U.K. introduced new anti-hybrid rules in response to Action Item 2 of the B.E.P.S. Project. A new restriction on the tax deductibility of corporate interest payments is also expected to be introduced in 2017, which broadly follows the recommendation of Action Item 4 of the B.E.P.S. Project.

## INTRODUCTION<sup>1</sup>

### A. Global Tax Planning in a Pre-2018 World

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

#### i. 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.

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<sup>1</sup> This portion of the article was written by Stanley C. Ruchelman of Ruchelman P.L.L.C., New York.

All of the authors acknowledge the assistance of Jennifer Lapper and Denisse Lopez at Ruchelman P.L.L.C., for converting 18 separate submissions prepared by persons having a multitude of birth languages into a cohesive and accurate monograph.

- 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 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.

## **ii. 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>2</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

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<sup>2</sup> Section 904(a) of the Internal Revenue Code of 1986 (hereinafter, the “Code”).

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.

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>3</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.

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

U.S. income tax regulations required expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.<sup>4</sup> The allocation and apportionment procedures set forth in the regulations were exhaustive and tended to maximize the apportionment of expenses to foreign-source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group were allocated and apportioned under a set of rules that allocated interest

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<sup>3</sup> Code §§1(h)(11)(C)(iv) and 904(b)(2)(B).

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

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

The problem was worsened by carryovers of overall foreign loss accounts.<sup>10</sup> These were “off-book” accounts that arose when expenses incurred in a particular prior year that were allocable and apportionable to foreign-source income exceeded the amount of foreign-source gross income 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.

#### **iv. 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

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

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

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

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

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

<sup>10</sup> Code §904(f).

relatively low values) often eliminated actual tax exposure in the U.S. Thereafter, the foreign subsidiaries were owned directly or indirectly by a foreign parent corporation organized in a tax-favored jurisdiction and the foreign tax credit problems disappeared.

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

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

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

Broad regulatory authority has been granted to the I.R.S. to carry out the purposes of Code §7874. By 2017, 12 regulations were

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<sup>11</sup> Code §7874(a)(1).

<sup>12</sup> Code §7874(a)(2)(B).

<sup>13</sup> Code §7878(b).

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 examples:

- Identifying circumstances where the minimum stock ownership requirement ostensibly is not met, but the foreign acquiring corporation holds a significant amount of passive assets, suggesting the existence of an asset-stuffing transaction intended to avoid a trigger for application of the anti-inversion provisions<sup>14</sup>
- Combining prior acquisitions of U.S. targets by the foreign acquirer when used to bolster a much larger single acquisition of a target<sup>15</sup>
- Combining prior acquisitions of foreign targets by the foreign acquirer when used to bolster a much larger single acquisition of a target<sup>16</sup>
- Addressing certain transfers of stock of a foreign acquiring corporation, through a spin-off or otherwise, following an acquisition
- Identifying the occurrence of certain distributions that are not made in the ordinary course of businesses by the U.S. entity, suggesting an intent to avoid a trigger for application of the anti-inversion provisions<sup>17</sup>
- Identifying the acquisition by a C.F.C. of obligations of or equity investments in the new foreign parent corporation or certain foreign affiliates suggesting an intent to avoid taxable investments in U.S. property when such

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<sup>14</sup> Treas. Reg. §1.7874-7T.

<sup>15</sup> Treas. Reg. §1.7874-8T.

<sup>16</sup> Treas. Reg. §1.7874-9T.

<sup>17</sup> Treas. Reg. §1.7874-10T.

investments were taxable in the hands of a U.S. parent corporation<sup>18</sup>

- Addressing the investment of pre-inversion earnings and profits of a C.F.C. through a post-inversion transaction that terminates the C.F.C. status of foreign subsidiaries or substantially dilutes a U.S. shareholder's interest in those earnings and profits<sup>19</sup>
- Related-party stock sales subject to Code §304 (which converts a stock sale of controlled stock into a dividend payment) that are intended to remove untaxed foreign earnings and profits of a C.F.C.<sup>20</sup>

In 2016, the Treasury Department adopted updates to the U.S. Model Income Tax Convention (the “2016 U.S. Model”), which serves as the basic document that the U.S. submits when negotiating an income tax treaty. The draft provisions propose, *inter alia*, to reduce the tax benefits that may be enjoyed by an expatriated group by imposing full withholding taxes on key payments such as dividends,<sup>21</sup> interest,<sup>22</sup> and royalties<sup>23</sup> made to connected persons that are residents of a treaty country by “expatriated entities” as defined under the Code. This 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.

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

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

<sup>20</sup> Treas. Reg. §1.304-7T.

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

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

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

## **B. Global Tax Planning in a Post-2017 World**

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

By the end of 2017, too many barriers were in place to continue on with established planning strategies. First in line were the actions taken by the Organization for Economic Cooperation and Development (“O.E.C.D.”) to curtail base erosion and profit shifting through 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. 1” and “A.T.A.D. 2”),
- 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.

### **i. 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.

#### **a. 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.<sup>24</sup> 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.

#### **b. 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

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

published by the O.E.C.D. The reports were commissioned by the G-20 and reflect findings that a disparity often exists between (i) the location of actual business activities and investment, and (ii) the jurisdiction where the resulting profits are reported for tax purposes.

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

- International mismatches in entity and instrument characterization
- The application of treaty concepts to profits derived from the delivery of digital goods and services
- The tax treatment of related party debt-financing
- 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.<sup>25</sup>

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

### **c. Attacks Based on State Aid**

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

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

- Exit taxation

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<sup>25</sup> See also the Danish Cases discussed at note 24, where the C.J.E.U. adopted B.E.P.S. concepts as part of European Law.

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

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

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

- Hybrid financial instrument mismatches
- Hybrid entity mismatches
- 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.

**ii. 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>26</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

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<sup>26</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.

- imposed a Base Erosion and Anti-Abuse Tax (“B.E.A.T.”) on large U.S. companies making deductible payments to foreign related parties.

**a. 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 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.

In 2018, the I.R.S. announced that it would not impose a reporting obligation on the U.S. entity in these circumstances, provided that no U.S. entity owns stock in such C.F.C., either directly or indirectly through a foreign subsidiary, and the foreign corporation is a C.F.C. solely because a U.S. entity constructively owns stock in the corporation through a foreign parent.

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.

**b. 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>27</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>28</sup> None of the exceptions to taxation under Subpart F are applicable.

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<sup>27</sup> Code §245A.

<sup>28</sup> Code §245A(e)(2).

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>29</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>30</sup>

**c. 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>31</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>32</sup>

The rate of U.S. tax on the amount included in income is reduced by means of a notional deduction.<sup>33</sup> For U.S. corporations, the rate is 15.5% to the extent that the earnings have been invested in cash or cash equivalents, based on the balance sheet of the C.F.C. The

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<sup>29</sup> Code §245A(e)(3).

<sup>30</sup> Code §904(d)(1)(B).

<sup>31</sup> Code §965.

<sup>32</sup> Code §965(e).

<sup>33</sup> Code §965(c).

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>34</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>35</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>36</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.

**d. 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>37</sup>

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<sup>34</sup> Code §965(g).

<sup>35</sup> Code §965(h).

<sup>36</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>37</sup> Code §951A.

### **1) 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>38</sup> These include the following items of income:

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

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

### **2) 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>39</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.

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<sup>38</sup> Code §951A(c)(2)(A)(i).

<sup>39</sup> Code §951A(b)(1).

The investment in tangible depreciable property is deemed to generate a 10% yield computed with reference to the adjusted basis of the property.<sup>40</sup> The amount so determined is reduced by interest expense allocated against the tangible depreciable property.<sup>41</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.

### **3) 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.

### **4) 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>42</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.

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<sup>40</sup> Code §951(b)(2)(A).

<sup>41</sup> Code §951(b)(2)(B).

<sup>42</sup> Code §960(d).

What remains are Tested Foreign Tax Credits attributable to G.I.L.T.I.

Because the foreign tax credit in this scenario relates to taxes actually paid by the C.F.C. but attributed to the corporate U.S. Shareholder – sometimes called a deemed-paid or indirect credit – the taxes for which the credit is claimed must be added to the amount otherwise reported as taxable. This is referred to as a gross-up.<sup>43</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>44</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.

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<sup>43</sup> Code §78.

<sup>44</sup> Code §960(d)(1).

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.

#### **5) 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>45</sup> Because the rate of corporate tax in the U.S. is 21%, a corporate U.S. Shareholder's effective tax rate on G.I.L.T.I. will be 10.5%. If foreign taxes are available to be claimed as a credit, the effective rate of tax must take into account the 20% of deemed paid taxes that are not available for any credit. This makes the effective rate of U.S. tax 13.125%.

The deduction is not available to individuals. However, individuals may elect to create a silo of income and taxes with regard to G.I.L.T.I. Income in the silo can be taxed as if earned by a corporation.<sup>46</sup> The income in the silo is entitled to the 50% deduction,<sup>47</sup> as the legislative history of the T.C.J.A. describes the

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<sup>45</sup> Code §250.

<sup>46</sup> Code §962.

<sup>47</sup> Prop Treas. Reg §1.962-1(b)(3)

deduction as a “reduced rates” mechanism.<sup>48</sup> This characterization is important because an individual making the election to be taxed at corporate rates generally is not entitled to deductions, except as allowed in the provision allowing for the election.

**e. 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>49</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

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<sup>48</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>49</sup> Code §250.

trade or business and of a type for which a depreciation deduction is allowed.

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

A U.S. corporation may claim a 37.5% deduction for the foreign-derived deduction eligible income when computing taxable income. The intent is to impose a 13.125% rate of tax on these profits.<sup>50</sup> This deduction is not available to individuals who operate a business through a limited liability company.

#### **f. 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>51</sup> Known as the

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<sup>50</sup> Code §250(a)(1)(A).

<sup>51</sup> Code §59A.

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>52</sup> paid to 25% foreign related persons.<sup>53</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>54</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>55</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

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<sup>52</sup> Code §59A(d).

<sup>53</sup> Code §59A(g).

<sup>54</sup> Code §59A(e)(1).

<sup>55</sup> Code §59A(c).

- Depreciation and amortization deductions related to property purchased from 25% foreign related parties
- A specified portion of net operating losses from earlier years

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

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

Certain payments that reduce U.S. tax are expressly removed from coverage under the B.E.A.T. Regime. These include the purchase price for inventory<sup>56</sup> and certain services that are generally of a kind that can be charged to a related party without a mark-up over costs without running afoul of the arm's length transfer pricing rules of U.S. tax law.<sup>57</sup> The I.R.S. is authorized to issue regulations that are necessary to prevent the avoidance of the B.E.A.T. Regime. Examples of abusive transactions include the use of unrelated persons, conduit transactions, or other intermediaries, or transactions or arrangements in ways that are designed, in whole or in part, to improperly recharacterize payments for the purpose of avoiding the B.E.A.T. Regime.

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<sup>56</sup> Preamble to REG-104259-18, Section III (Base Erosion Payments).

<sup>57</sup> Code §59A(d)(5).

**g. 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>58</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>59</sup> as well as certain electing real property, farming, and utilities businesses, from the application of the 30% ceiling.<sup>60</sup>

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

Certain businesses are not covered by the ceiling. These include, *inter alia*, taxpayers with less than \$25 million in average annual

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<sup>58</sup> Code §163(j).

<sup>59</sup> Code §163(j)(1)(C).

<sup>60</sup> Code §163(j)(7)(A).

gross receipts for the period of three taxable years ending with the prior taxable year and electing real property trades or businesses.<sup>61</sup>

#### **h. 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>62</sup>
- An exception to immediate gain recognition provided under prior law was eliminated,<sup>63</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.

#### **C. 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.

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<sup>61</sup> Code §§163(j)(3) and 448(c).

<sup>62</sup> Code §482.

<sup>63</sup> Code §367(a)(3) prior to enactment of the T.C.J.A.

The goal is to determine whether a particular European country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies. It must be staffed with competent persons having authority to make decisions and must avoid being a conduit to the U.S. parent. For many U.S. planners advising corporate groups, this represents a major change of thinking, as the group's substance is frequently attributed to all group members – even those having no employees. In today's world, tax benefits must be seen as non-abusive and business plans must be generated by operational personnel rather than tax advisers. A structure that is recommended based on the arithmetic of tax – net income multiplied by a low corporation tax rate – will likely face unpleasant surprises on both sides of the Atlantic.

## **B.E.P.S. AND HOLDING COMPANIES<sup>64</sup>**

### **A. 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>65</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>66</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.

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<sup>64</sup> This portion of the article was written by Eric Fort, of Arendt & Medernach, Luxembourg. The author would like to acknowledge the contributions of Alexandra Clouté, Guilhèm Becvort, and Elodie Schmidt, also of Arendt & Medernach, in the preparation of this section.

<sup>65</sup> Communiqué of February 16, 2013.

<sup>66</sup> O.E.C.D. (2013), *Action Plan on Base Erosion and Profit Shifting*, O.E.C.D. Publishing.

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

### **B. B.E.P.S. Action Plan**

On July 19, 2013, the O.E.C.D. published the B.E.P.S. Action Plan,<sup>67</sup> addressing perceived flaws in international tax rules and transfer pricing rules, which were previously studied in a report released in February 2013.<sup>68</sup> The B.E.P.S. Action Plan proposed 15 measures to combat various forms of B.E.P.S. In addition to the February report, the Action Plan identifies elements of concern in relation to double nontaxation or low taxation and proposes concrete actions with deadlines for compliance.

The actions are organized around three main pillars:

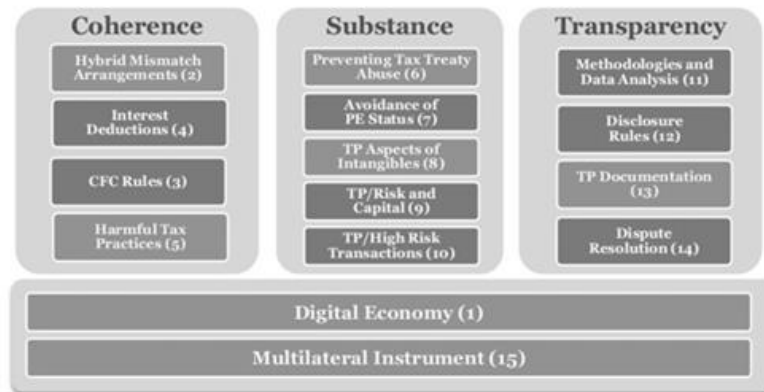
- Coherence of corporate tax at the international level
- Substance and realignment of taxation
- Transparency coupled with certainty and predictability

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

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

<sup>68</sup> O.E.C.D. (2013), *Addressing Base Erosion and Profit Shifting*, O.E.C.D. Publishing.



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

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

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

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

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

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

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

Action Item 3, Action Item 4, and Action Item 12), and guidance for the implementation of best practices (*e.g.*, Action Item 1, Action Item 11, and Action Item 15).<sup>69</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 being implemented by the G-20, European countries, and others.

### **C. Reflecting a Sea Change in Acceptable Tax Planning**

The B.E.P.S. Project demonstrates the passage from a system highlighted by individual competition among states for the greater good of one state to a system of international cooperation that reflects fiscal harmony, rather than abusive practices by certain operators. Cynics might say that the change is one in which smaller economies that thrived on arrangements to reduce tax in other countries will be required to reshape their economies to focus on more productive endeavors.

In calling for an internationally coordinated response, the B.E.P.S. Project requires support from each state at the domestic level. Each state retains its fiscal sovereignty and is free to apply the measures proposed by the O.E.C.D. on different terms, as long as it does not go against its international legal commitments. Thus, an adjustment period may be required in order to renegotiate tax treaties or to amend domestic law. At the same time, the O.E.C.D. created a mandate through Action Item 15 that called for an international conference to develop a multilateral instrument to amend the network of existing bilateral tax treaties in order to implement the B.E.P.S. Project's treaty measures all at once (the "M.L.I."). On November 24 and 25, 2016, negotiations regarding the M.L.I. among over 100 jurisdictions were concluded and a signing ceremony was held on June 7, 2017 in Paris. The M.L.I. is expected to be transposed into more than 1,500 tax treaties worldwide.

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<sup>69</sup> O.E.C.D. (2015), *Explanatory Statement*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D.

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

#### **D. 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.

#### **E. B.E.P.S Action 2: Hybrid Mismatch**

##### **i. Focus**

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

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

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

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

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

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

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

Further, it should be noted that the O.E.C.D. issued additions to its Final Recommendations. The additions address hybrid mismatches<sup>70</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.

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<sup>70</sup> O.E.C.D. (2017), *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

## **ii. 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 or holder treats the payment as a tax-exempt dividend.

Another example of hybrid mismatch can be found in arrangements with payments to reverse hybrid entities. Such entities are treated as tax transparent in one jurisdiction and as opaque in another. By way of illustration, a company that is resident in Country A owns all the issued and outstanding shares in a subsidiary resident in Country B. The subsidiary was formed under the laws of Country B. The subsidiary is tax transparent under Country B's laws but is regarded as a separate taxable entity under the laws of Country A. Company C, residing in Country C, borrows money from the subsidiary and makes an interest payment under the loan. The payment is deductible under Country C's tax law but is not included in income under the laws of either Country A or B. Each of those countries treats the income as being derived by a resident of the other jurisdiction.<sup>71</sup>

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

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<sup>71</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

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.

### **iii. 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, of November 2017, notably reflects the additional hybrid mismatches recommendations under Action Item 2.

F. **B.E.P.S. Action 3: Drafting Effective Controlled Foreign Company Rules**<sup>72</sup>

i. **Focus**

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

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<sup>72</sup> O.E.C.D. (2015), *Designing Effective Controlled Foreign Company Rules, Action 3 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

- Rules to prevent or eliminate double taxation occurring within the context of the C.F.C. rules

## **ii. Recommended Actions**

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

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

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

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

Possible approaches to identifying C.F.C. income that should be attributed to the controlling shareholders include (i) a categorical analysis of the income, (ii) determination of the part of the profit that could be considered to exceed a "normal return" generated by

C.F.C.'s located in low tax jurisdictions, and (iii) a case-by-case analysis based on the transactions and entities involved.

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

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

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

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

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

**G. B.E.P.S. Action 4: Interest Deductions and Other Financial Payments**

**i. 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>73</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 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.

**ii. 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

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<sup>73</sup> O.E.C.D. (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

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

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

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

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

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

## H. **B.E.P.S. Action 5: Harmful Tax Practice**

### i. **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>74</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.

### ii. **Illustrative Fact Patterns**

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

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

To address the situation, the M.N.E. interposes a company (“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

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<sup>74</sup> O.E.C.D. (1998), *Harmful Tax Competition: An Emerging Global Issue*, O.E.C.D. Publishing, Paris.

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.

### **iii. Recommended Action**

In October 2015, a final report on Action Item 5 was published.<sup>75</sup> In broad terms, Action Item 5 is aimed at tackling any corporate arrangements benefiting from disproportionate tax advantages in a given jurisdiction. It requires that corporate substance and activity should be in line with taxation and that tax transparency should be enhanced through the exchange of rulings related to low tax schemes.

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

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<sup>75</sup> O.E.C.D. (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

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>76</sup>

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<sup>76</sup> *Id.*, p. 46.

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

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

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

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

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

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

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

On February 1, 2017, the O.E.C.D. released the *Terms of Reference and Methodology for Peer Reviews*<sup>77</sup> addressing the exchange of information on tax rulings. The peer review and the monitoring process will be conducted by the Forum to ensure the effective implementation of the agreed-upon standards.

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

In January 2019, the O.E.C.D. released the report “Harmful Tax Practices – 2018 Progress Report on Preferential Regimes,”<sup>78</sup> which includes the results of a review of preferential tax regimes since the start of the B.E.P.S. Project. This review was undertaken by the Forum on Harmful Tax Practices (“F.H.T.P.”) in accordance with the B.E.P.S. Action 5 minimum standards. In total, 255 preferential tax regimes were reviewed to ensure compliance with the nexus approach. More than half of these have been amended or abolished. The others are either already compliant with the Action 5 standard or are in the process of being reviewed or reformed.

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<sup>77</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 B.E.P.S. Project, O.E.C.D., Paris.

<sup>78</sup> O.E.C.D. (2019), *Harmful Tax Practices – 2018 Progress Report on Preferential Regimes: Inclusive Framework on BEPS: Action 5*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

In addition, exchanges of information on more than 21,000 tax rulings have taken place since the start of the B.E.P.S. Project.

As part of ongoing work to revise the existing F.H.T.P. criteria, a new standard, which imposes substantial activities requirements on low or no-tax jurisdictions, was adopted in 2018.

## **I. B.E.P.S. Action 6: Prevent Treaty Abuse**

### **i. Focus**

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

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

The B.E.P.S. Action Plan has identified treaty abuse, and particularly treaty shopping, as one of the most important sources of base erosion and profit shifting. The Final Recommendations on Action Item 6<sup>79</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

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<sup>79</sup> O.E.C.D. (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

## ii. 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>80</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>81</sup> would not qualify under the L.O.B. rules, as they do not meet any of the proposed requirements.<sup>82</sup> Regarding their particular activity, discussions are taking place to determine whether these non-C.I.V. funds should qualify *per se* under the L.O.B. provisions or whether a genuine diversity-of-ownership test

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<sup>80</sup> *Id.*

<sup>81</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>82</sup> O.E.C.D. (2015), *Revised Discussion Draft, B.E.P.S. Action 6: Prevent Treaty Abuse*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing, Paris.

should apply under which each investor must meet an L.O.B. test separately.<sup>83</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>84</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>85</sup>

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<sup>83</sup> O.E.C.D. (2016), *Public Discussion Draft, Treaty Entitlement of Non-C.I.V. Funds*, O.E.C.D./G-20 B.E.P.S. Project, O.E.C.D. Publishing.

<sup>84</sup> O.E.C.D., *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*.

<sup>85</sup> *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue*, Case C-196/04, [2006] E.C.R. I-07995.

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>86</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 nontaxation or reduced taxation and to carry out that intention by (i) a combined L.O.B. rule with a P.P.T. rule, (ii) the P.P.T. rule, or (iii) the L.O.B. rule complemented by an anti-conduit arrangement rule.

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

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

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

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<sup>86</sup> O.E.C.D., Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, p. 19, ¶21-22.

On February 14, 2019, the O.E.C.D. released peer review reports assessing the implementation of the Action 6 minimum standards, which reveal that as of June 30, 2018, a majority of the 116 B.E.P.S. Inclusive Framework members were in the process of modifying their treaty networks. The M.L.I., which implements the treaty-related B.E.P.S. measures, appears to be the preferred tool. The next peer review exercise will be launched in the first half of 2019, and there will be a review of methodology in 2020.

**J. B.E.P.S. Action 15: Multilateral Instrument**

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

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

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

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

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

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

### **a. 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.

#### **1) Transparent Entities**

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

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

#### **2) 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.

### **3) 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.

#### **b. Treaty Abuse**

##### **1) 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.

## **2) P.P.T. and L.O.B.**

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

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

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

The P.P.T. may be supplemented by an L.O.B. clause. The M.L.I. does not provide for a standard *detailed* L.O.B. as outlined in the Final Report on Action Item 6, but merely states that a detailed L.O.B. clause may be agreed on bilaterally. As a result, only a *simplified* L.O.B. clause is included in the M.L.I., which provides that the benefits of a Covered Treaty are only accessible to a “qualified person” unless the person is engaged in the active conduct

of a business. A qualified person must fulfill certain requirements proving a sufficiently strong link with the claimed state of residence in order to receive benefits under the Covered Treaty.

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

### **3) 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.

### **4) 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.

#### **5) 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.

#### **6) 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).

#### **c. 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.

#### **1) 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.

## **2) 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.

## **3) 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.

#### **4) Implementation of Action 7 Through the M.L.I.**

In June 2019, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. published a progress report covering July 2018 through May 2019.<sup>87</sup> According to this report, of the 88 jurisdictions that are party to the M.L.I.

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

#### **d. 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

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<sup>87</sup> <http://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2018-may-2019.pdf>

of the tax treaty. Both Contracting States should endeavor to resolve the case by mutual agreement with a view to the avoidance of the tax measure that is supposedly inappropriate and for that reason is under dispute. Any agreement reached shall be implemented without a time limit.

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

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

The minimum standard is subject to a peer review process. As of May 2019, 45 jurisdictions have been reviewed and around 990 recommendations for improvement have been issued to these jurisdictions. The monitoring process (*i.e.*, stage 2) is underway.

#### **e. 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.

#### **f. 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 May 29, 2019, the M.L.I. has been signed by a total of 88 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 Depositary and provide a list of Covered Treaties and options.

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

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

- taxes withheld at the source on the first day of the next calendar year that begins on or after the date on which the M.L.I. entered into force between the Contracting States; and
- all other taxes for taxable periods following the expiration of a period of generally six calendar months after the date on which the M.L.I. entered into force between the Contracting States.
- As of May 2019, 25 out of the 88 jurisdictions that are party to the M.L.I. have deposited their instrument of ratification of the M.L.I.

### **iii. 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.

### **K. Concluding Remarks on the E.U.'s Action**

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

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

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

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

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

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

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. On March 12, 2019, the E.U. Council failed to reach an agreement on an E.U. digital services tax, which was based on a new compromise limiting the scope to digital advertising services. In parallel, the Council is conducting work on the E.U. position in international discussions on digital tax, in particular in view of O.E.C.D.'s report due by mid-2020.

On May 29, 2019, the O.E.C.D./G-20 Inclusive Framework on B.E.P.S. approved the *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*<sup>88</sup> (the “Programme”), which is intended to be a roadmap for resolving the tax challenges arising from the digitalization of the economy to lay out a process for reaching a new global agreement for taxing multinational enterprises. The Programme contains two main pillars: pillar one<sup>89</sup> for the allocation of taxation rights (revised nexus and profit allocation rules) and pillar two<sup>90</sup> concerning a minimum level of tax (global anti-base erosion proposal). The O.E.C.D. envisages that a final report will be delivered the end of 2020.<sup>91</sup>

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<sup>88</sup> O.E.C.D. (2019), *Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy*, O.E.C.D./G-20 Inclusive Framework on B.E.P.S., O.E.C.D., Paris.

<sup>89</sup> Programme, pp. 9 et seqq.

<sup>90</sup> Programme, p. et seqq.

<sup>91</sup> Programme, p. 40.

## EUROPEAN TAX LAW<sup>92</sup>

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.

### A. State Aid

#### i. 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>93</sup>
- The intervention provides an economic advantage to the recipient.<sup>94</sup>

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<sup>92</sup> This portion of the article was written by Matthias Scheifele of Hengeler Mueller in Munich. The author would like to acknowledge the contribution of Tobias Schwab, also of Hengeler Mueller, in the preparation of this section.

<sup>93</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>94</sup> State Aid and Direct Business Taxation, *supra* note 93, ¶9.

- The intervention affects or may affect competition and trade between the Member States.<sup>95</sup>
- The advantage is selective, *i.e.*, it is only granted to specific recipients.<sup>96</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>97</sup> In addition, the following may also be considered to be compatible with the internal market:<sup>98</sup>

- Aid to promote the economic development of certain areas.<sup>99</sup>
- Aid promoting the execution of projects of common interest or to remedy serious disturbances in the economy of a Member State.<sup>100</sup>
- Aid to facilitate the development of certain economic activities or areas without affecting trading conditions.<sup>101</sup>

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<sup>95</sup> *Id.*, ¶11.

<sup>96</sup> *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 ¶9.

<sup>97</sup> Consolidated Version of the Treaty on European Union art. 107, 2012 O.J. C 326/47, §2 [hereinafter “T.F.E.U.”].

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*, §3(a).

<sup>100</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>101</sup> *Id.*, §3(c).

- Measures promoting culture and heritage conservations without affecting trading conditions and competition.<sup>102</sup>
- Other categories of aid as specified by decision of the European Council upon proposal by the European Commission.<sup>103</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>104</sup>

Pursuant to the Procedural Regulation, the Commission decides whether a proposed measure constituting State Aid is compatible with the internal market.<sup>105</sup> After notice but prior to the Commission’s authorization, proposed State Aid measures must not be put into effect.<sup>106</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>107</sup> State Aid must be recovered from the beneficiary

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<sup>102</sup> *Id.*, §3(d).

<sup>103</sup> *Id.*, §3(e).

<sup>104</sup> Council Regulation 2015/1589/E.U. on the Application of Article 108 of the T.F.E.U. (codification), 2015 O.J. L 248/9.

<sup>105</sup> *Id.*, art. 9.

<sup>106</sup> *Id.*, art. 3.

<sup>107</sup> T.F.E.U., *supra* note 97, art. 108, §2.

unless the recovery of the aid would be contrary to a general principle of E.U. law.<sup>108</sup>

## **ii. 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>109</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>110</sup>

### **a. 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>111</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>112</sup>

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<sup>108</sup> Procedural Regulation, *supra* note 104, art. 16, §1.

<sup>109</sup> State Aid and Direct Business Taxation, *supra* note 93, ¶2.

<sup>110</sup> *Id.*, et seq.

<sup>111</sup> *Id.*, ¶9.

<sup>112</sup> State Aid in the T.F.E.U., *supra* note 93, ¶156 et seq.

**b. 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>113</sup> This applies even if the tax-related State Aid may have an indirect positive overall effect on budget revenue.<sup>114</sup> State support need not be provided only by legislation. It may be provided through the practices of tax authorities.<sup>115</sup>

**c. 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>116</sup>

**d. 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>117</sup> Pursuant to this principle, the determination of tax rates, depreciation rules, and rules regarding tax loss carry-forwards do not constitute State Aid

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<sup>113</sup> State Aid and Direct Business Taxation, *supra* note 93, ¶10.

<sup>114</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>115</sup> State Aid and Direct Business Taxation, *supra* note 93, ¶10.

<sup>116</sup> *Id.*, ¶11.

<sup>117</sup> *Id.*, ¶13.

due to their equal application to all economic participants in a Member State.<sup>118</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>119</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>120</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>121</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>122</sup> Since the Commission replaces one ambiguous term with another vague description, only the case law provides concrete guidance regarding what may qualify as acceptable justification.

With respect to the nature or the general scheme of an identified tax system, the Commission holds, that progressive tax rates are justified by the redistributive purposes of income taxes, and that the exemption from income tax enjoyed by nonprofit organizations such as foundations or associations is justified by the fact that such organizations basically do not generate any income, and only

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<sup>118</sup> *Id.*

<sup>119</sup> *Id.*, ¶14.

<sup>120</sup> *Id.*, ¶16.

<sup>121</sup> *Jestaed* in Heidenhain, European State Aid Law, 2010, §8 ¶19.

<sup>122</sup> State Aid and Direct Business Taxation, *supra* note 93, ¶16.

income is subject to tax within the income tax system.<sup>123</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>124</sup>

### **iii. 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>125</sup> or if the protection of the doctrine of legitimate expectation overrides the need for recovery.<sup>126</sup> These exemptions are rarely applicable. Further, the recovery of unlawful State Aid is subject to a limitation period of ten years.<sup>127</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>128</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.

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<sup>123</sup> *Id.*, ¶24-25.

<sup>124</sup> *Id.*, ¶23.

<sup>125</sup> *Sinnaeve* in Heidenhain, *European State Aid Law*, 2010, §32, ¶26.

<sup>126</sup> *Id.*, §32, ¶24.

<sup>127</sup> Procedural Regulation, *supra* note 104, art. 17, §1.

<sup>128</sup> *Id.*, art. 16, §2.

According to case law decided by the E.C.J., national procedural law must be interpreted in a way that does not negatively affect the enforcement of E.U. law (known as the “Supremacy of Community Law”).<sup>129</sup> Therefore, national rules providing that an administrative decision cannot be appealed after the expiration of a limitation period<sup>130</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>131</sup>

#### iv. 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>132</sup> Targets of these investigations include aid to (i) Apple granted by Ireland,<sup>133</sup> (ii) Starbucks granted by the Netherlands,<sup>134</sup> and (iii) Fiat granted by Luxembourg.<sup>135</sup>

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

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<sup>129</sup> *Land Rheinland-Pfalz v. Alcan Deutschland*, Case C-24/95, [1997] E.C.R. I-01591.

<sup>130</sup> *Id.*, ¶38.

<sup>131</sup> *Commission v. France*, Case C-232/05, [2006] E.C.R. I-10071.

<sup>132</sup> Commission Press Release, IP/14/663 (Jun. 11, 2014).

<sup>133</sup> Commission Decision No. 2017/1283/E.U. (*Apple*), 2016 O.J. L 187/1. See also *Ireland v. Commission*, Case T-778/16 (pending case); *Apple Sales International and Apple Operations Europe v. Commission*, Case T-892/16 (pending case).

<sup>134</sup> Commission Decision No. 2017/502/E.U. (*Starbucks*), 2015 O.J. L 83/88. 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>135</sup> Commission Decision No. 2016/2326/E.U. (*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).

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>136</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>137</sup> By allowing an unsubstantiated transfer pricing plan, Ireland may have granted a selective benefit to Apple by lowering its total tax burden.<sup>138</sup>

Another example is the in-depth investigations opened by the Commission in February 2015 regarding the Belgian excess profit ruling scheme.<sup>139</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

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<sup>136</sup> *State Aid to Fiat*, 2015 O.J. L 351/1; *State Aid to Starbucks*, 2015 O.J. L 83/38.

<sup>137</sup> *State Aid to Apple*, C(2016) 5605 Final.

<sup>138</sup> *Id.*

<sup>139</sup> Commission Decision No. 2016/1699 (*State Aid*), 2016 O.J. L 260/61.

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>140</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>141</sup> The Commission's decision required Belgium to stop applying the excess profit scheme and to recover the full unpaid tax from the at least 35 multinational companies that benefitted from the illegal scheme (around €700 million).<sup>142</sup> However, the European Court of Justice ("E.C.J.") annulled the Commission's decision.<sup>143</sup> The E.C.J. affirmed the competence of the European Commission to examine tax rulings under State Aid law. However, the E.C.J. found that, in principle, a tax ruling does not constitute unlawful aid if the underlying decision was in the discretion of the national tax authority and such discretionary decision was not a purely technical process. According to the E.C.J., this is different if the European Commission can demonstrate that rulings of that type have been granted in a systematic fashion. In February 2016, the General Court ("E.G.C.") confirmed the Commission's decision<sup>144</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>145</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

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<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> *Id.*

<sup>143</sup> *Kingdom Belgium and Magnetrol International v. Commission*, Joined Cases T-131/16 & T-263/16, [2019] ECLI:EU:T:2019:91.

<sup>144</sup> Commission Decision No. 2011/527/E.U. (*Sanierungsklausel*), 2011 O.J. L 235/26.

<sup>145</sup> *SinnLeffers v. Commission*, Case T-620/11, [2016] E.G.C. ECLI:EU:T:2016:59.

has been a significant change in the shareholding structure of the company concerned. The restructuring relief therefore favored ailing companies over financially-sound competitors that suffer losses in a given year. For those competitors, the tax benefit of a carryforward is not allowed when a significant change occurs in their shareholder structure. The clause therefore distorts competition in the single market. The German authorities' view was that the clause was merely a new technical feature of the German tax system, and for that reason, could escape qualification as State Aid. This argument convinced neither the Commission nor the E.G.C. However, in line with the opinion<sup>146</sup> of the Advocate General Wahl, the E.C.J. followed the German authorities' view arguing that the general right to carry forward losses is the relevant reference framework rather than the forfeiture of loss carry-forwards in case of a change of control. Since the restructuring relief clause restores this general principle, it may not be qualified as selective.<sup>147</sup>

In another decision by the E.C.J., a rule under the German real estate transfer tax law which provided benefits to intra-group transfers of real estate or shares in real estate owning entities<sup>148</sup> (subject to certain strict requirements), was found not to constitute unlawful State Aid. The intra-group relief is justified by the nature and overall structure of the underlying tax system as it helps to avoid double taxation and thus excessive taxation since real estate transfer tax was triggered by the initial acquisition of the real estate by the relevant group company.

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<sup>146</sup> Opinion of the Advocate General Wahl, *Dirk Andres (administrator of Heitkamp BauHolding GmbH), previously Heitkamp BauHolding GmbH v. Commission*, Case C-203/16 P, [2017] ECLI:EU:C:2017:1017.

<sup>147</sup> *Andres (faillite Heitkamp BauHolding) v. Commission*, Case C-203/16 P, [2018] ECLI:EU:C:2018:505; *Germany v. Commission*, Case C-208/16 P, [2018] ECLI:EU:C:2018:506; *Germany v. Commission*, Case C-209/16 P, [2018] ECLI:EU:C:2018:507, *Lowell Financial Services v. Commission*, Case C-219/16 P, [2018] ECLI:EU:C:2018:508.

<sup>148</sup> *A-Brauerei*, Case C-374/17, [2018] ECLI:EU:C:2018:1024.

Another relatively recent ruling of the E.C.J. relates to a Spanish provision under which goodwill could be deducted when a Spanish-resident corporation acquired a shareholding in a foreign company equal to at least 5%.<sup>149</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>150</sup> There is no need to identify certain specific features that characterize a group of undertakings that are beneficiaries to the tax advantage.<sup>151</sup>

The increasing relevance of the State Aid rules for individual Member State's tax legislation is further evidenced by Germany's decision to notify the Commission of a new statutory rule providing for an exemption of waiver gains from income tax and trade tax.<sup>152</sup> The Commission responded to the notice by way of an informal and unpublished comfort letter confirming that they do not see any conflict with the State Aid rules.

## **B. Transparency Measures**

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

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<sup>149</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>150</sup> *Id.*, ¶79.

<sup>151</sup> *Id.*, ¶78.

<sup>152</sup> Section 3a *Einkommensteuergesetz* – *EstG* [hereinafter the “Income Tax Act”] and Section 3a *Gewerbesteuerengesetz* – *GewStG* [hereinafter the “Trade Tax Act”].

**v. Current Measures**

Currently, Council Directive 2011/16/E.U. (the “Administrative Cooperation Directive”), as amended,<sup>153</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>154</sup>

**e. 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.

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<sup>153</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>154</sup> Administrative Cooperation Directive, *supra* note 153, art. 2, §2.

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>155</sup>

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

- Unilateral advance pricing arrangements and/or decisions;
- Bilateral or multilateral advance pricing arrangements and decisions;
- Arrangements or decisions determining the existence or absence of a permanent establishment;
- Arrangements or decisions determining the existence or absence of facts with a potential impact on the tax base of a permanent establishment;
- Arrangements or decisions determining the tax status of a hybrid entity in one Member State which relates to a resident of another jurisdiction; 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

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<sup>155</sup> *Id.*, art. 8, §3(a), as amended by Council Directive 2014/107/E.U., *supra* note 153.

Member States and, to the extent that it is required for monitoring the correct implementation of the directive, to the Commission.

**f. 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>156</sup>

**g. 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>157</sup>

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<sup>156</sup> *Id.*, art. 9, §1.

<sup>157</sup> *Id.*, art. 5.

#### **h. Country-by-Country Reporting**

The amendment of the Administrative Cooperation Directive by Council Directive 2016/881/E.U. of May 25, 2016<sup>158</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

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*Supra* note 153. 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.

- 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>159</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>160</sup>

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

On May 25, 2018, the Ecofin Council of Economic and Finance Ministers adopted the Council Directive 2018/822/E.U., which amended Council Directive 2011/16/E.U. and entered into force on June 25, 2018. This directive addresses mandatory automatic exchange of information in the field of taxation of reportable cross-border models as a tool to prevent aggressive cross-border tax arrangements. Under the new rules, the external designer (intermediary), who designs, markets, organizes, and makes available for use or controls the implementation of a model is required to report any tax arrangement that generates an abusive tax benefit identified in Annex IV of Council Directive No. 2018/822/E.U. (*Hallmarks*), *e.g.*, circular transactions or payments to affiliated companies. The users of the tax model must also be identified. The competent national authority that receives the tax model reporting must communicate the report by automatic exchange to any other Member State. The report must include the

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<sup>159</sup> *Id.*, art. 1, ¶2.

<sup>160</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"].

following information for every tax jurisdiction in which the group is active:

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

In general, the report must be provided within 30 days of the first act of implementation of the tax model or within 30 days after the tax model has been made available to the users. However, the Council Directive will not take effect until July 1, 2020.

#### **vi. Tax Transparency Package**

As part of its efforts to tackle corporation income tax avoidance and harmful tax competition in the E.U.,<sup>161</sup> and certainly as a reaction to the State Aid investigations resulting from the tax rulings to multinationals,<sup>162</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>163</sup>

#### **vii. 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

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<sup>161</sup> Commission Press Release, IP/15/4610 (Mar. 18, 2015).

<sup>162</sup> See Paragraph A.iv above.

<sup>163</sup> See Paragraph 1.A.i.h below.

tied into the tax transparency package.<sup>164</sup> Key actions include a plan to relaunch the Common Consolidated Corporate Tax Base (“C.C.C.T.B.”)<sup>165</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>166</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>167</sup> The Commission also promoted greater cooperation between Member States in the area of tax audits.<sup>168</sup>

#### **viii. 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

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<sup>164</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>165</sup> Commission Proposal for a Council Directive on a Common Corporate Tax Base, COM (2016) 685 Final (Oct. 2016).

<sup>166</sup> 5 Key Areas, *supra* note 164, p. 7.

<sup>167</sup> *Id.*, p. 12.

<sup>168</sup> *Id.*, p. 14.

years.<sup>169</sup> The proposal is undergoing the parliamentary process, facing some criticism.<sup>170</sup>

#### **ix. 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>171</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>172</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>173</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

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<sup>169</sup> Commission Proposal for a Directive Amending Council Directive 2013/34/E.U. on the Disclosure of Income Tax Information by Certain Undertakings and Branches, COM (2016) 198 Final.

<sup>170</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>171</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>172</sup> Application of I.A.S., *supra* note 171, art. 2 and art. 3, § 1.

<sup>173</sup> Commission Regulation 1126/2008/E.C. Adopting Certain International Accounting Standards, 2008 O.J. L 320/1.

new provisions follows a complex endorsement process.<sup>174</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>175</sup> and the Prospectus Directive.<sup>176</sup>

- Pursuant to the Transparency Directive, issuers are required to inform the public market periodically about their financial statements and their management report.<sup>177</sup>
- Pursuant to the Transparency Directive, shareholders of listed companies are subject to reporting obligations if their voting rights exceed or fall below defined thresholds following an acquisition or a disposal of shares.<sup>178</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>179</sup>

Companies in the legal form of limited liability companies or in the legal form of partnerships, whose partners have limited liability, fall

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<sup>174</sup> For further details regarding the endorsement process, see Application of I.A.S., *supra* note 171, art. 6, and Council Decision No. 1999/468/E.C., 1999 O.J. L 184/23, art. 5(a) and art. 8.

<sup>175</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>176</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>177</sup> Transparency Directive, *supra* note 175, Chapter II.

<sup>178</sup> *Id.*, Chapter III.

<sup>179</sup> Prospectus Directive, *supra* note 176, art. 5.

under the scope of the Accounting Directive.<sup>180</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>181</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>182</sup>

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<sup>180</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>181</sup> *Id.*, art. 53, §1.

<sup>182</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.

### C. Anti-Abuse and Tax Avoidance Measures

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

In two decisions,<sup>183</sup> the E.C.J. recently dealt with situations in which the abusive use of the Parent-Subsidiary Directive and the Interest and Royalties Directive was at issue.

The joined cases regarding the abusive use of the Interest and Royalties Directive<sup>184</sup> had essentially the same, or a similar, fact pattern. Private equity funds (“A”) based outside the E.U. held shares in an E.U.-based (Danish) group of companies through intermediary holding companies that were based in another E.U. Member State (Luxemburg or Sweden). The E.U.-based intermediary holding companies granted interest-bearing loans to the Danish companies. The Danish debtor companies requested an exemption from Danish withholding tax for interest payments made to the E.U. intermediary holding companies based on the place of residence of the intermediary holding companies in a Member State of the E.U. The exemption request was based on the Interest and Royalties Directive, whose benefits are available solely to E.U.-based companies. The Danish tax authorities denied the exemption on the grounds that the intermediate holding companies were not the beneficial owners of the interest income, but rather their non-E.U. owners, and that the insertion of the intermediate holding companies with little substance constituted an abusive practice designed to artificially create the conditions for obtaining a tax benefit under E.U. law.

This back-to-back lending arrangement was designed to achieve a reduction in withholding taxes under the Interest and Royalties Directive. The companies ultimately receiving the interest payments did not qualify for the elimination of withholding tax imposed by the E.U. Member State that was the place of residence

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<sup>183</sup> N Luxembourg 1 v. Skatteministeriet, Joined Cases C-115, C-118, C-119 & C-299/16, [2019] ECLI:EU:C:2019:134; *Skatteministeriet v. T Danmark und Y Denmark Aps*, Joined Cases C-116/16 & C-117/16, [2019] ECLI:EU:C:2019:135.

<sup>184</sup> *Id.*

of the ultimate borrower (Denmark). Hence, a two-legged arrangement was entered, in which the first leg of the back-to-back arrangement was the loan to the intermediary entities and the second leg was the loan to the Danish ultimate borrowers.

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

Moreover, applying general principles of E.U. law, the Interest and Royalties Directive cannot be relied upon as support for abusive and fraudulent ends. National courts and authorities are to refuse a taxpayer a benefit granted under E.U. law even if there are no domestic law or agreement-based provisions providing for such a refusal. Proof of an abusive practice requires a combination of (i) objective circumstances in which the purpose of those rules has not been achieved (despite their formal observance) and (ii) a subjective element consisting in the intention to obtain an advantage from the E.U. rules by artificially creating a fact pattern that suggests the conditions are met for obtaining the benefit. The presence of certain number of indications may demonstrate that an abuse of law exists. These include the existence of a conduit company that is without economic justification and the purely formal nature of the structure of the group of companies, the financial arrangements, and the loans.

As a final point, the E.C.J. looked at one of the structures in which A was a collective investment entity based in Luxembourg that benefitted from favorable tax treatment as a *Société d'Investissement en Capital à Risque* or S.I.C.A.R. A S.I.C.A.R. is a company with share capital and in principle is subject to Luxembourg corporate income tax and municipal business tax at ordinary rates. However, dividends and interest on risk capital derived by a S.I.C.A.R. is

specifically exempt from tax in its hands. Similar tax rules apply to Reserved Alternative Investment Funds known as R.A.I.F.'s. The E.C.J. concluded that a S.I.C.A.R. cannot benefit from the Interest and Royalties Directive with regard to interest income that is exempt from tax in its hands.

The E.C.J. affirmed this principle in several cases regarding the Parent-Subsidiary Directive.<sup>185</sup> These cases concerned holding companies of E.U. Member States receiving dividends from their Danish subsidiaries and distributing them through other intermediary companies to investment funds and their shareholders. In these cases the granting of benefits of the Parent-Subsidiary Directive to the holding companies was in issue. The E.C.J. ruled that the Parent-Subsidiary Directive cannot be applied in an improper or abusive fact pattern. A Member State is obligated to apply anti-abuse rules of its tax conventions and the O.E.C.D. Commentary to prevent abuse where national law contains no anti-abuse provision applicable to a particular transaction.

However, in a decision dealing with the German anti-treaty shopping legislation and directive rules regarding relief from dividend withholding taxes, the E.C.J.<sup>186</sup> ruled that a domestic anti-abuse provision<sup>187</sup> infringes upon the anti-abuse provision found in Article 2(1) of the E.U. Parent-Subsidiary Directive, as well as fundamental freedoms, where it contains, based on predetermined criteria, an irrebuttable presumption of abuse if certain facts exist without the tax authorities being required to provide even *prima facie* evidence of fraud or abuse. Furthermore, under the German law in question, it was not possible for the applicant to refute the allegation of abuse by evidence to the contrary. In the view of the E.C.J., in order to determine whether abuse is present, the structure must to be examined on a case-by-case basis, with an overall assessment based on factors such as the organizational, economic,

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<sup>185</sup> *Id.*

<sup>186</sup> Deister -Holding AG and Juhler Holding A/-S, Joined Cases C-504/16 & C-613/16, ECLI:EU:C:2017:1009.

<sup>187</sup> Section 50d(3) of the German Income Tax Act in the version of the Annual Tax Act 2007.

or other substantial features of the group of companies to which the parent company belongs and the structures and strategies of that group.

## **ii. Legislative Measures**

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>188</sup> One key element of this package is the Anti-Tax Avoidance Directive (“A.T.A.D. I”). It introduces five legally-binding anti-abuse measures that all Member States should apply against common forms of aggressive tax planning until December 31, 2018.<sup>189</sup> Its scope was expanded by A.T.A.D. 2 with regard to Hybrid Mismatches with Third Countries.

The Directive applies to all taxpayers that are subject to corporate tax in one or more Member States, including permanent establishments Member States of entities resident for tax purposes in a third country.<sup>190</sup>

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<sup>188</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. [http://ec.europa.eu/taxation\\_customs/business/company-tax/anti-tax-avoidance-package\\_en](http://ec.europa.eu/taxation_customs/business/company-tax/anti-tax-avoidance-package_en), c.f., Commission Communication to the European Parliament and the Council on the Anti-Tax Avoidance Package, COM (2016) 23 Final (Jan. 2016).

<sup>189</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1 [A.T.A.D. I], amended by Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1 [hereinafter “A.T.A.D. II”].

<sup>190</sup> Id., Article 1 §2.

#### **j. 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>191</sup> The limitation applies without distinction as to the origin of the debt (*e.g.*, it is irrelevant whether the interest is related to intra-group, third-party, E.U., or third-country debt, or whether the lender is effectively taxed on such interest).

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

#### **k. 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

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<sup>191</sup> This provision on the interest limitation rule is similar to the current German interest limitation rule.

- 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;
- 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>192</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>193</sup>

### **1. 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.

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<sup>192</sup> A.T.A.D. *supra* note 189, art. 5.

<sup>193</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.

**m. 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;
  - 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.

#### **n. 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 non-taxation without inclusion exists, the jurisdiction where the business is resident includes the income in its tax base.

In respect of its territorial scope, A.T.A.D. 1 was limited to hybrid mismatches that arise in interaction between two Member States. Provisions concerning hybrid mismatches involving third countries were not included. In order to fix this insufficient territorial scope, the E.U. Council adopted A.T.A.D. 2,<sup>194</sup> which aims at neutralizing also tax effects from hybrid mismatches involving third countries, consistent with the recommendations outlined in the O.E.C.D. B.E.P.S. Report on Action 2.<sup>195</sup>

In addition to the broadening of the territorial scope, the amended provisions<sup>196</sup> now also address further types of hybrid mismatches which were not yet covered by the anti-tax avoidance measures in

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<sup>194</sup> Council Directive 2017/952/E.U. on Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

<sup>195</sup> O.E.C.D. (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 2015 Final Report*, O.E.C.D./G-20 Base Erosion and Profit Shifting Project, O.E.C.D., Paris.

<sup>196</sup> *Id.*, art. 9, 9a, 9b.

A.T.A.D. 1. The rules on hybrid mismatches are divided into three provisions as follows:

- **Hybrid Mismatches:**<sup>197</sup> Article 9 already existed under A.T.A.D. 1, the amended version now acts as a catch-all element tying on the broadly defined terms “hybrid mismatch” and “hybrid transfer.” In comparison to the original scope the provision additionally covers the following structures:
  - **Hybrid Permanent Establishment Mismatches:** Two jurisdictions differ on whether a business activity is being carried out through a permanent establishment.
  - **Hybrid Transfers:** Two jurisdictions differ on whether the transferor or the transferee of a financial instrument has the ownership of the payments on the underlying asset.
  - **Imported Mismatches:** The effect of a hybrid mismatch between parties in third countries is shifted into the jurisdiction of a Member State through the use of a non-hybrid instrument thereby undermining the effectiveness of the rules that neutralize hybrid mismatches.
- **Reverse Hybrid Mismatches:**<sup>198</sup> Reverse hybrid mismatch structures occur where an entity is incorporated or established in a Member State that qualifies the entity as transparent and a direct or indirect interest in 50% or more of the voting rights, capital interest or rights to a share of profit is held in aggregate by one or more associated non-resident entities located in a third country that regards the entity as non-transparent. Pursuant to Article 9a(1) the hybrid entity shall be regarded as a resident of that Member State and taxed on its income to the extent that that income

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<sup>197</sup> *Id.*, art. 9.

<sup>198</sup> *Id.*, art. 9a. Article 9a also applies to all entities that are treated as transparent for tax purposes by a Member State.

is not otherwise taxed under the laws of the Member State or any other jurisdiction. This provision shall not apply to a collective investment vehicle, *i.e.*, an investment fund or vehicle that is widely held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.<sup>199</sup>

- **Tax Residency Mismatches:**<sup>200</sup> The taxpayer is resident for tax purposes in two (or more) jurisdictions. A deduction for payment, expenses or losses from the tax base of this taxpayer is possible in both jurisdictions. Article 9b directs the Member State of the taxpayer to deny the deduction to the extent that the other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member States where the taxpayer is not deemed to be a resident according to the D.T.C. between the two Member States concerned shall deny the deduction.

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

#### D. **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.

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<sup>199</sup> *Id.*, art. 9a §2.

<sup>200</sup> *Id.*, art. 9b.

## LUXEMBOURG<sup>201</sup>

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

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

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

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<sup>201</sup> This portion of the article was written by Mélanie Staes of Loyens & Loeff in Luxembourg. The author would like to acknowledge the contribution of Delphine Martel, also of Loyens & Loeff, in the preparation of this section.

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

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

#### **A. General/Participation Exemption**

A S.O.P.A.R.F.I. established in the city of Luxembourg is subject to Luxembourg income tax at a combined top rate of 24.94% as of January 1, 2019. This rate includes the 17% national corporation income tax (“C.I.T.”), plus the 6.75% Luxembourg City municipal business tax (“M.B.T.”), and a 7% unemployment fund surcharge.

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

**i. Dividends**

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

- (a) The S.O.P.A.R.F.I. holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax-transparent entity), or the participation has an acquisition cost of at least €1.2 million.
- (b) The subsidiary is (i) an entity falling within the scope of Article 2 of the E.U. Parent-Subsidiary Directive (2011/96/E.U.), as amended from time to time, (the “P.S.D.”) or a permanent establishment thereof, provided the hybrid loan provision and the general anti-abuse rule known as “the G.A.A.R.” do not apply (please see below), (ii) a fully taxable Luxembourg capital company having a legal form that is not listed in the annex to the P.S.D., or (iii) a non-Luxembourg capital company subject in its country of residence to a profit tax comparable to Luxembourg’s C.I.T. in terms of rate and taxable basis (“the Comparable Tax Test”). See Section B below for further details.
- (c) At the time of distribution, the S.O.P.A.R.F.I. must have held, or must commit itself to continue to hold, the participation for an uninterrupted period of at least 12 months, and during this period, its interest in the subsidiary may not drop below the threshold mentioned above (10% or an acquisition cost of €1.2 million).

Regarding the second condition described in item (b)(i) above, the Luxembourg participation exemption was amended in line with the revised P.S.D.<sup>202</sup> and includes a provision countering hybrid loan arrangements and implementing the G.A.A.R. The hybrid loan

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<sup>202</sup> The P.S.D. was amended in 2014 and 2015 by Council Directive 2014/86/E.U. and Council Directive 2015/121, respectively. By law of December 18, 2015, and effective January 1, 2016, such amendments were implemented in the I.T.A.

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

The Luxembourg domestic participation exemption could be viewed as still being available notwithstanding the G.A.A.R. if the subsidiary meets the Comparable Tax Test referred to under item (b)(iii) above, and further detailed in Paragraph B 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).

## **ii. Capital Gains**

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

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

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

#### **B. Subject to Tax**

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

Based on parliamentary history, the Comparable Tax Test requires that the nonresident subsidiary (i) be subject to a tax rate of at least half the Luxembourg C.I.T. rate (*i.e.*, at least 8.5% as from 2019) and (ii) be subject to tax on a basis that is determined in a manner comparable to the determination of the taxable basis in Luxembourg. However, the Comparable Tax Test is based on parliamentary history and is not set out in the law in detail. It is, amongst other issues, not fully clear whether the Comparable Tax Test should be applied on the basis of an effective rate or basis. Furthermore, no list of qualifying countries exists for this purpose. Thus, where comparability is subject to doubt, an advance tax agreement (“A.T.A.”) can be requested from the Luxembourg tax authorities (“L.T.A.”).

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

### C. **Tax-Free Reorganizations**

The Luxembourg I.T.A. provides for certain reorganizations that are viewed as tax-free in the hands of shareholders of certain capital companies (*i.e.*, application of a roll-over). Such favorable tax treatment applies to the following situations:<sup>203</sup>

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

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

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<sup>203</sup> Such tax-free reorganizations used to include conversions of a loan whereby securities representing share capital of the debtor were issued to the creditor. Effective January 1, 2019, Article 22-*bis* of the I.T.A. was amended to no longer include such conversions.

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.

**D. 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 Paragraph B above).

**E. 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 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.

**F. Withholding Tax in a Foreign Subsidiary's Country**

Dividends paid by a foreign subsidiary to a Luxembourg holding company and gains on alienation of shares may be subject to

withholding tax or capital gains tax. Such taxes may be eliminated or reduced pursuant to the P.S.D. or a tax treaty concluded by Luxembourg and the foreign subsidiary's country of residence.

As of the date of this article, Luxembourg has 83 income tax treaties in force with the following jurisdictions:

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

In 2017, Luxembourg and Cyprus signed a treaty which was ratified by Luxembourg in 2018 and entered into force in 2019. Cyprus was the only E.U. Member State with which Luxembourg did not have a tax treaty. Additionally, Luxembourg is in the process of negotiating 15 new income tax treaties, five of which have already been signed. Amendments to the existing treaties entered into with

the U.S. and South Africa are being negotiated and new treaties are being discussed with the U.K. and Slovakia. Finally, a treaty with France has been renegotiated with respect to its capital gains provision on shares in “real estate rich companies.”

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

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

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

The extent to which treaties will be amended as a result of the Multilateral Instrument depends on whether or not the other treaty partners signed the Multilateral Instrument. Based on the choices of its treaty partners, Luxembourg currently expects 62 of its income

tax treaties to be affected by the Multilateral Instrument (these treaties will hereinafter be referred to as “Affected Treaties”), which include the following treaty partners: Austria, Canada, France, Germany, Italy, the Netherlands, Spain, and the U.K.

The entry into force of the Multilateral Instrument with respect to Luxembourg will occur on August 1, 2019. However, that does not mean that the Affected Treaties will be revised by the Multilateral Instrument as per that date. Rather, the Multilateral Instrument has a relatively complex mechanism to determine as of which date it will actually affect specific tax treaties, whereby a difference exists between the effect on withholding taxes and the effect on other taxes. For Affected Treaties with treaty partners which have already notified, or will notify the O.E.C.D. prior to October 1, 2019, of their ratification of the Multilateral Instrument, the Multilateral Instrument will enter into effect (i) for withholding taxes, on January 1, 2020, and (ii) for all other taxes for financial years starting on or after February 1, 2020 (*i.e.*, for calendar year taxpayers on January 1, 2021). In respect to Affected Treaties with treaty partners that will notify the O.E.C.D. after October 1, 2019, of their ratification of the Multilateral Instrument, the Multilateral Instrument will enter into effect (i) for withholding taxes January 1, 2021, at the earliest, and (ii) for all other taxes, for calendar year taxpayers, it could be as early as January 1, 2021, or it could be a later year.

#### **G. Deduction of Costs**

##### **i. Value Adjustments**

A S.O.P.A.R.F.I. may make deductible value adjustments on a participation. The deductions can be used to offset other income (such as income from financing activities or commercial activities) and may result in tax losses. Losses that were incurred before 2017 may be carried forward indefinitely while the carry forward of losses incurred as of January 1, 2017, is limited to 17 years after the losses occurred (*i.e.*, until December 31, 2034, for losses incurred during the 2017 fiscal year). 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 Paragraph A.ii 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.

## **ii. Financial Costs**

Financing expenses connected with an exempt participation are not tax deductible to the extent that they do not exceed exempt income arising from the participation in a given year. The exceeding part is further only deductible and can only be used to offset other types of income and capital gains (resulting from a subsequent disposition of shares, subject to the recapture rule described above) to the extent it does not fall within the scope of the interest deduction limitation rules described in Paragraph H.ii.

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.

## **iii. Liquidation Losses**

A loss realized upon liquidation of a participation is deductible.

## **H. Withholding Tax on Outbound Dividends and Capital Gains**

### **i. Distributions on Shares**

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

- (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; or
- (d) A company resident in a treaty country and meets the Comparable Tax Test (see Paragraph B).

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>204</sup>

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

In a manner that is similar to testing the application of the participation exemption discussed in Paragraph A 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 the G.A.A.R., if the shareholder meets the Comparable Tax Test as referred to in item (d) above and further detailed in Paragraph B above, which should be the case in the context of an income tax treaty as well as for many shareholders that are entities resident in an E.U. Member State. In this respect, reference must however be made to the potential future impact of the Multilateral Instrument (Paragraph F) and recent case law of the C.J.E.U. (defined below; Paragraph O.i).

## **ii. 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

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

profit, is subject to 15% withholding tax, unless a lower tax treaty rate applies.

Under certain conditions, hybrid debt instruments may be issued by a S.O.P.A.R.F.I. These hybrid debt instruments (*e.g.*, convertible preferred equity certificates, commonly referred to as “C.P.E.C.’s”) are normally treated as debt for Luxembourg legal, accounting, and tax purposes, but may be treated as equity for tax purposes in the country of residence of the holder of the instrument such as the U.S.<sup>205</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 Paragraph A above, the use of hybrid instruments may be limited where two E.U. Member States are concerned. In addition, effective January 1, 2019, Luxembourg, has implemented the Anti-Tax Avoidance Directive (2016/1164) (“A.T.A.D.”) which, under certain conditions, bars the deduction of interest paid on hybrid instruments issued by a Luxembourg company, as well as the deduction of interest paid on instruments held by a hybrid entity.

A.T.A.D. forms the E.U.-wide implementation of Action 2 of the O.E.C.D.’s work on base erosion and profit shifting (“B.E.P.S.”), which called for rules to neutralize the effects of hybrid mismatch arrangements through deduction limitations and a general anti-abuse rule.

In this context, A.T.A.D. and the Anti-Tax Avoidance Directive 2 (2017/952) (“A.T.A.D. 2”), together referred to as the “A.T.A.D.’s,” have been adopted by the E.U. Council. The main goal of the

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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 a C.P.E.C. to be treated as fully taxable dividends that do not bring along indirect foreign tax credits and that do not qualify for the foreign source dividends received deduction under Code §245A.

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 to the extent they concern third countries (January 1, 2020) and the reverse hybrid mismatch rules (January 1, 2022). In Luxembourg the law implementing A.T.A.D. provisions into national law was published on December 21, 2018.

With regard to the interest deduction limitation rules, these cap the deductibility of "exceeding borrowing costs" at the highest of 30% of the E.B.I.T.D.A. or €3 million. This refers to the excess, if any, of a Luxembourg taxpayer's deductible interest and economically equivalent expenses over such taxpayer's taxable interest income and economically equivalent income. A grandfathering provision states that loans that were concluded prior to June 17, 2016, and that were not subsequently modified are not subject to the interest deduction limitation rules. Luxembourg companies that are part of a fiscal unity apply the interest deduction limitation rules at the level of the integrating company (unless a request is made for application at individual entity level).

Among others the following three categories of Luxembourg taxpayers are excluded altogether from the application of the interest deduction limitation rules:

- A taxpayer that constitutes a financial undertaking which is, *inter alia*, the case if the taxpayer is an A.I.F.
- A taxpayer that qualifies as a Standalone Entity, which means a taxpayer that is not part of a consolidated group for financial accounting purposes and has no Associated Enterprise (as defined hereafter) and has no permanent establishment in another jurisdiction. An Associated Enterprise means (i) an entity (capital company, partnership, *etc.*), in which the taxpayer holds directly or indirectly 25% or more of the voting rights or capital ownership or is entitled to receive 25% or more of the profits of such undertaking or (ii) an individual or collective undertaking (capital company, partnership, *etc.*) which holds directly or indirectly 25% or more of the voting rights or capital ownership of the taxpayer or is entitled to receive 25% or more of the profits of the taxpayer.
- A taxpayer that qualifies for the “Group Ratio Exclusion,” which is the case if the following conditions are cumulatively met:
  - (i) the taxpayer is a member of a consolidated group for financial accounting purposes;
  - (ii) the ratio of equity over total assets (the “Equity Ratio”) of the consolidated group does not exceed the Equity Ratio of the taxpayer by more than 2 percentage points (*e.g.*, if the Equity Ratio of the consolidated group is 10%, this condition is met as long as the taxpayer’s Equity Ratio is at least 8%);
  - (iii) all assets and liabilities are valued using the same method as in the consolidated financial statements established in accordance with I.F.R.S. or the national financial reporting system of an E.U. Member State; and
  - (iv) the taxpayer has filed a request to benefit from the Group Ratio Exclusion.

As far as the C.F.C. legislation is concerned, Luxembourg opted to provide that where, in short, a C.F.C. has been put in place for the purpose of obtaining a tax advantage, Luxembourg corporate taxpayers will be subject to C.I.T. on the undistributed net income of a C.F.C., *pro rata* to their ownership or control of the foreign branch or the indirectly held subsidiary, but only to the extent such income is related to significant functions carried out by the Luxembourg corporate taxpayer. To the extent that a Luxembourg company can establish, on the basis of adequate documentation of its activities or functions, or both, that it does not perform significant functions related to the C.F.C.'s activities, the C.F.C. rules should not have an adverse tax impact.

#### **I. Capital Gains in Hands of Shareholders**

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

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

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

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

before the alienation. Note, however, that Luxembourg, in general, will not be entitled to tax this gain under applicable tax treaties.

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

A repurchase of shares in a S.O.P.A.R.F.I. should be considered as a capital gain and not subject to Luxembourg dividend tax. However, following a case dated 2017,<sup>206</sup> the repurchase could be viewed in certain circumstances as a “simulated” dividend that is subject to dividend tax (if no exemption applies). Typically, the risk of this type of challenge exists when the repurchase price is not supported by valid economic principles or when the repurchase should be viewed as a fictional, simulated transaction, and in fact the intention was to distribute profits out of the company to the shareholder.

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

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

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<sup>206</sup> Administrative Court, March 3, 2017, no. 39193C.

## **K. Other Tax Issues**

### **i. Debt-to-Equity Ratio**

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

In addition, Luxembourg tax authorities have published a Circular in transfer pricing matters which is discussed in Paragraph O.ii 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 without actually specifying what an "appropriate amount of equity" is (*i.e.*, no set formula has been provided). Thus, the amount of equity to be contributed to a group financing company is a factual question and should be determined on a case-by-case basis.

### **ii. 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.

### **iii. 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 Paragraph A 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 worth tax applies, set at €4,815 (including a 7% surcharge), based on the closing balance sheet of the preceding year, when the resident corporate taxpayer's financial assets for the prior year exceeded 90% of its total balance sheet and the balance sheet total exceed €350,000, which is the case for most holding and financing companies. In all other cases, the minimum tax is contingent on the balance sheet total of the resident corporate taxpayer, varying from €535 to €32,100, the latter maximum applying in case of a balance sheet total exceeding €30 million.

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

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

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

#### **iv. Advance Tax Agreements and Advance Pricing Agreements**

The procedure to obtain an A.T.A. is codified into Luxembourg law. In an A.T.A., the Luxembourg tax authorities confirm the interpretation of the tax law as applied to the specific facts of the case presented by the taxpayer. Following submission, an A.T.A. request will be reviewed by a committee that will advise the relevant

tax inspector. Submission of a request is subject to a fee of up to €10,000 payable to the Luxembourg tax authorities.

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

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

Subject to the foregoing requirements, case law<sup>207</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.

As for intra-group transactions, the arm's length character of the remuneration to be earned by a Luxembourg company may be confirmed by the tax authorities in an advance pricing agreement

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<sup>207</sup> Administrative Court, July 12, 2016, no. 37448C.

(“A.P.A”). However, the issuance of an A.P.A. is subject to certain conditions, set out in an administrative circular issued by the Luxembourg tax authorities on December 27, 2016 (the “Circular”). Such conditions include, *inter alia*, the following:

- The relevant employees or board members of the Luxembourg entity are qualified to carry out the functions and tasks assigned to the Luxembourg entity.
- The countries affected by the financing transactions have been listed.
- Full information has been provided regarding the parties involved in the controlled transaction.
- A detailed transfer pricing analysis has been submitted. See in this respect Paragraph O.ii below.

**v. State Aid Investigations by the European Commission**

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 by way of 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 advance the application of tax law in a particular case is legitimate. On the other hand, an A.T.A. or A.P.A. that grants State Aid is not allowed under the E.U. treaties. In that regard, it is generally illegal for E.U. Member States to grant aid in the form of a tax advantage on a selective basis to undertakings. If unlawful aid was granted, the 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 (or is investigating) A.T.A.’s issued to GDF Suez, Amazon, McDonald’s, Fiat Finance and Trade (“F.F.T.”), and Huhtamaki to determine whether A.T.A.’s amounted to illegal State Aid.

On October 21, 2015, the European Commission's negative decision with regard to the F.F.T. case was published (Decision C(2015) 7152 final), stating that Luxembourg granted selective tax advantages to F.F.T. The 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 4, 2017, the European Commission took a negative decision in the Amazon case (Decision (E.U.) 2018/859). The decision ordered 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).

On June 20, 2018, the European Commission took a negative decision in the Engie case (Decision (E.U.) 2019/421). The European Commission found that Luxembourg granted state aid to Engie. Luxembourg has since challenged this decision to the European Union General Court (cases T-525/18 and T-516/18, respectively).

On September 19, 2018, the European Commission took a positive decision in the McDonald's case stating that Luxembourg did not grant McDonald's a selective advantage (Decision C(2018) 6076 final).

On May 3, 2019, the European Commission published its opening decision (Decision C(2019) 1615 final dated March 7, 2019) in the Huhtamaki case, which concerns A.T.A.'s issued by the Luxembourg tax authorities to the Finnish packaging group in 2009, 2012, and 2013. These rulings concern a Luxembourg intra-group financing company funded with interest-free loans ("I.F.L.") granted by an Irish sister company. The A.T.A.'s allowed the Luxembourg company to impute a deduction for deemed interest expenses on the I.F.L. for M.B.T. and C.I.T. purposes. In the European Commission's view, such downward adjustment

constitutes a selective advantage which deviates from Luxembourg's reference system (*i.e.*, its corporate income tax).

L. **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 Paragraph K.iii 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.

M. **R.A.I.F.**

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

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

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

N. **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>208</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*,

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<sup>208</sup> Article 1(1) of the law of March 22, 2004, on securitization.

or in the form of a fund managed by a management company. Securitizations with Luxembourg special purpose vehicles outside the scope of the S.V. Law are also possible.

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

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

Securitization vehicles are, in principle, fully subject to Luxembourg C.I.T. at the standard combined rate of 24.94% (for Luxembourg city in 2019). However, the securitization vehicle is able to deduct from its taxable base all "commitments" owed to investors and creditors (subject to the interest deduction limitation rules referred to in Paragraph H.ii applying). 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 Paragraph A. 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.

#### **O. Recent and Current Developments**

##### **i. The Concepts of “Beneficial Owner” and “Abuse” Under C.J.E.U. Case Law**

The C.J.E.U. recently issued several judgments<sup>209</sup> addressing the concepts of “beneficial owner” and “abuse” under the Interest and Royalty payments Directive (2003/49/E.C.) (the “I.R.D.”) and the P.S.D. The targeted structures all had in common the use of intermediate holding companies that could claim the benefit from withholding tax exemption on interest/dividend payments within the group on the basis of the I.R.D. and the P.S.D. The C.J.E.U., however, denied the benefit from the I.R.D./P.S.D. considering that the recipient companies of the interest/dividend payments were not the ultimate beneficial owner. In that respect, the C.J.E.U. identified the beneficial owner as the entity which actually benefits from that

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<sup>209</sup> The four joined cases were all rendered on February 26, 2019, case N Luxembourg 1 (C-115/16), X Denmark (C-118/16), C Denmark 1 (C-118/16), and Z Denmark case (C-299/16), in addition to two additional joined cases (case T Denmark (C-116/16) and Y Denmark Aps (C-117/16).

interest economically, and accordingly has the power to freely determine the use to which it is put.

In addition, the judgments provide useful indicators on how to apply the abuse concept, which requires first identification of an “artificial arrangement.” An arrangement is identified as artificial if the principal objective or one of its principal objectives is to obtain a tax advantage running counter to the aim or purpose of the applicable tax law.<sup>210</sup> The C.J.E.U. further illustrated the concept of abuse by providing different situations that may constitute an abuse. All of them concern situations in which the recipient of the interest payments, claiming the I.R.D.’s benefit, merely acts as a conduit company. The C.J.E.U. also took into consideration the way in which the transactions are financed, the valuation of the intermediary companies’ equity, and the conduit companies’ inability to have economic use of the income received.

Although the indicators are presented in an E.U. directive context, tax authorities may take the position that they are relevant in a tax treaty context, as the P.P.T. introduced under the Multilateral Instrument uses very similar concepts (Paragraph F above).

## **ii. 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, there are arguments to support that Luxembourg companies should be allowed to deduct a deemed interest expense on interest-free debt for C.I.T. and M.B.T.

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<sup>210</sup> This is a lower threshold than the “wholly artificial” requirement derived from the *Cadbury Schweppes* case law (case C-196/04, September 12, 2006).

purposes, though such position is being challenged by the European Commission in the Huhtamaki case (see Paragraph K.v).

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

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

The guiding principles of the Circular are that intra-group financing companies must have the financial capacity to assume risks and the ability to control and manage such risks. With respect to the financial capacity, the previous circular generally considered a minimum amount of equity at risk equal to the lower of either 1% of the intra-group financing amount or €2 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 Paragraph K.iv above.

### **iii. 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 pass that information to the U.S. I.R.S.

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

On December 8, 2015, the E.U. Council adopted Directive 2015/2376/E.U. (the "E.O.I. Directive") amending Directive 2011/16/E.U. regarding the mandatory automatic exchange of information in the field of taxation. The E.O.I. Directive was implemented in Luxembourg by law on July 23, 2016, and has introduced, as of January 1, 2017, the mandatory automatic exchange of information on advance cross-border rulings and advance pricing arrangements and is aimed at enhancing fiscal transparency between E.U. Member States and deterring aggressive tax planning and abusive tax practices. The automatic exchange should include a defined set of basic information that will be sent to all Member States and the E.U. Commission (though the latter's access is limited). After the exchange of information takes place, an E.U. Member State may request additional information if it believes the information is relevant to the application of its own tax rules. The information is covered by Form 777E, which serves to summarize the content, scope, and application of the A.T.A./A.P.A.

The automatic exchange covers A.T.A.'s/A.P.A.'s (i) issued, amended, or renewed after December 31, 2016, and (ii) issued less than five years prior to January 1, 2017. Only rulings involving cross-border transactions are covered by the E.O.I. Directive, and rulings concerning only natural persons are excluded.

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

Finally, as a result of the implementation into the laws of the Member States of the E.U. Directive (E.U./2018/822) introducing mandatory disclosure rules (the “Mandatory Disclosure Directive”), advisers, other intermediaries and taxpayers may be legally required to disclose information to E.U. Member States’ tax authorities on certain advice given and services rendered regarding cross-border tax planning arrangements that qualify as reportable cross-border arrangements. The domestic law (which is not yet available in Luxembourg) relating to the Mandatory Disclosure Directive will enter into force on July 1, 2020. Nevertheless, cross-border arrangements that are reportable under the new rules and of which the first step of implementation takes place from June 25, 2018, to July 1, 2020, should be reportable on August 31, 2020.

#### **iv. Country-by-Country Reporting**

On December 13, 2016, the Luxembourg Parliament adopted a law on country-by-country reporting (“CbC 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.

**v. U.B.O. Register**

On January 13, 2019, Luxembourg published a new law with regard to the implementation of E.U. Directive 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (the “A.M.L.D.”), introducing a publicly-accessible register of ultimate beneficial owners (the “U.B.O. Register”). Effective as of March 1, 2019, the entities falling within the scope of the law (*i.e.*, Luxembourg civil and commercial companies, European interest groupings, and Luxembourg branches of foreign entities) have six months to comply with their obligations (until September 1, 2019).

An U.B.O. is any natural person who ultimately owns or controls the company through (i) direct or indirect ownership of more than 25% of the shares or voting rights or ownership interest in that company or (ii) through control via other means.

The information to be disclosed for each U.B.O. includes the full name, place and date of birth, address, national identification number, nationality, and country of residence. Apart from the private or professional address and the identification number, such information will be publicly available. As an exception thereto, a duly motivated request can be filed for the information not to be publicly available. If such request is approved, which will occur only in exceptional circumstances, access to the information will be limited to national authorities (*e.g.*, the Luxembourg tax authorities) or financial institutions.

For Luxembourg companies, non-compliance may result in a criminal fine ranging from €1,250 to €1,250,000. A U.B.O. that

does not comply with their obligation to cooperate with the Luxembourg company may also receive a criminal fine ranging from €1,250 to €1,250,000.

**vi. I.P. Regime**

On March 22, 2018, Luxembourg adopted a new I.P. regime set out in article 50ter I.T.A. (the “New I.P. Regime”) effective January 1, 2018. The New I.P. Regime applies to any Luxembourg tax resident carrying out a business activity in Luxembourg and owning qualifying I.P.

Eligible net income from qualifying I.P. assets may benefit from an exemption up to 80% from income taxes and a full exemption from net wealth tax. The eligible assets must have been developed or improved after December 31, 2007, and are limited to patents, utility models, supplementary protection certificates granted for a patent on medicine and plant protection, plant variety certificates, extensions of a complementary protection certificate for pediatric use, orphan drug designations, and software protected by copyrights.

The portion of the I.P. income benefiting from the advantageous tax treatment is calculated based on a ratio taking into account the R&D costs. The ratio corresponds to the eligible R&D costs divided by the overall R&D expenses. Luxembourg allows the eligible R&D costs to be uplifted by 30% insofar the resulting ratio does not exceed the total amount of expenditure. Expenses must be incurred within the framework of an R&D activity but need not be undertaken by the taxpayer. Outsourced activity is eligible for favorable treatment.

The New I.P. Regime is in line with the recommendations made by the O.E.C.D. and adopts a nexus approach to ensure that only the R&D activities having a nexus with the Luxembourg taxpayer itself benefit from the New I.P. Regime.

Unlike the previous regime, I.P. assets of a marketing nature (*e.g.*, trademarks) are excluded from the scope of the proposed regime.

The former I.P. regime was abolished in 2016 but 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<sup>211</sup>

### A. In General

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

The Federal corporate income tax rate for ordinarily taxed companies is 8.5%, but because taxes are deductible, the effective Federal income tax rate is 7.8%. The cantonal and communal corporate income tax rates depend on the company's location. The combined effective ordinary income tax rates (which include Federal, cantonal, and communal taxes) vary among the cantons. The combined rates of tax are as follows: 12.3% in Lucerne; 13.0% in Appenzell Ausserrhoden; 12.7% in Obwalden; 12.7% in Nidwalden; 14.6% in Zug; 21.2% in Zürich; and 24.2% in Geneva. However, for possible future lower income tax rates see section C.v. below.

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

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<sup>211</sup> This portion of the article was written by Stephan Neidhardt of Walder Wyss Ltd. in Zürich.

## **B. Taxation of Holding Companies**

### **i. Corporation Income Tax**

After Corporate Tax Reform III was defeated in a referendum in February 2017, Swiss tax reform and A.H.V. (pension) financing (“S.T.A.F.”) was passed on May 19, 2019.

The reform has consequences in regard to the taxation of holding companies. The complete income tax exemption on the cantonal and communal level will be terminated. However, a dividend from a qualifying participation<sup>212</sup> will be subject to the participation relief, as described below for the federal level, and also on the cantonal and communal level. This reform will end the complete tax exemption of income other than dividend income on the cantonal and communal level.

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 threshold of CHF 1 million is not available for a capital gains relief. The participation relief is not an outright tax exemption, but rather a tax abatement mechanism. The corporate income tax liability will be reduced by the ratio of net dividend income (taking into account administrative and financing costs) to total net profit. As financing costs (*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).

### **ii. Capital Tax**

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 ( $\text{capital} \times 0.001$ ) of

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<sup>212</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.

the company's total net equity (at book value). Most of the other cantons have already reduced their capital tax. Due to the positive public vote on May 19, 2019, many cantons will change or reduce their capital tax rates.

The cantons may allow corporate 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 corporate income tax is due.

### **iii. Stamp Duty**

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

However, relief is available for shares issued pursuant to a corporate restructuring, share-for-share acquisition, or inbound migration. For example, in a share-for-share acquisition, the issuer of new shares may benefit from the stamp duty exemption when (i) the acquiring company issues shares in consideration for the acquisition of shares of the target company and holds at least 50% of the shares in the target company after completion of the transaction, and (ii) the tendering shareholders of the target company receive less than 50% of their total compensation for accepting the share-for-share exchange in the form of a consideration other than shares of the acquiring company (*i.e.*, cash or a credit or note). In further illustration, the transfer of a participation of at least 10% to another company would also qualify as a tax neutral restructuring and, thus, benefit from the stamp duty exemption.

### **iv. 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.

**v. 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).

**vi. 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.

#### **vii. 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.

#### **viii. 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*	Estonia*	Liechtenstein*	Slovakia
Algeria	Faroe Is.	Lithuania**	Slovenia*
Anguilla	Finland	Luxembourg**	South Africa**
Antigua & Barbuda	France*	Macedonia	South Korea
Argentina**	Gambia	Malawi	Spain*

Armenia	Georgia	Malaysia	Sri Lanka
Australia*	Germany	Malta*	St. Kitts & Nevis
Austria**	Ghana	Mexico*	St. Lucia
Azerbaijan	Greece	Moldova	St. Vincent & the Grenadines
Bangladesh	Grenada	Mongolia	Sweden
Barbados	Hong Kong*	Montenegro	Taiwan*
Belarus	Hungary*	Montserrat	Tajikistan
Belgium*	Iceland	Morocco*	Thailand
Belize	India*	Netherlands*	Trinidad & Tobago
B.V.I.	Indonesia	New Zealand	Tunisia
Bulgaria*	Iran	Norway	Turkey**
Canada	Ireland*	Oman*	Turkmenistan
Chile*	Israel	Pakistan*	Ukraine
China*	Italy*	Peru*	U.A.E.*
Colombia*	Ivory Coast	Philippines	U.K.*
Croatia	Jamaica	Poland	U.S.A.*
Cyprus*	Japan*	Portugal*	Uruguay
Czech Republic*	Kazakhstan	Qatar*	Uzbekistan
Denmark	Kosovo*	Romania	Venezuela
Dominica	Kuwait	Russia*	Vietnam
Ecuador	Kyrgyzstan	Serbia	Zambia
Egypt	Latvia*	Singapore	

\* Treaty that includes a treaty abuse clause, in force.

\*\* Treaty that includes a treaty abuse clause, not yet in force.

New treaties with Brazil, Bahrain, Saudi Arabia, Zimbabwe, and Zambia have been signed but are not yet ratified. The proposed treaties with Brazil and Zambia include a treaty abuse clause.

**ix. 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.

**x. 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.

**xi. 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.

**xii. 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.

**xiii. Holding Company Activities**

Since the complete income tax exemption on the cantonal and communal level will be terminated, a Swiss holding company may be even more attractive because its functions are not strictly limited to holding activities. Thus, 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. However, since the cantonal and communal tax exemption will be terminated, it will no longer be necessary to ask for a respective tax ruling.

#### **xiv. Multilateral Instrument**

Switzerland has signed the Multilateral Instrument (“M.L.I.”) to implement Tax Treaty Related Measures to prevent Base Erosion and Profit Shifting. The Federal government announced that it will implement the minimum standards either within the framework of the M.L.I. 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 M.L.I.:

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 income tax treaties. If agreements on the technical implementation of the M.L.I. can be obtained with further partner states, the corresponding income tax treaties will equally be amended by the M.L.I. 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 M.L.I.

The Swiss parliament approved ratification of the M.L.I. on March 22, 2019. If no objecting popular vote is called until July 12, 2019 (which is very unlikely), then the Swiss government will place its M.L.I. ratification bill with the O.E.C.D.

Section C.viii above shows all Swiss treaties that contain a treaty abuse clause; some of which are in force already (\*), while others are not.

### **C. Additional Tax-Related Issues**

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

In Switzerland, companies are, in most cases, incorporated either as an *Aktiengesellschaft* or as a GmbH. Since the Swiss *Aktiengesellschaft* qualifies as a *per se* corporation for 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).

#### **ii. 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.

### **iii. 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.

### **iv. 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.
- 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.

v. **Future Taxation of Swiss Holding Companies**

Due to the favorable result reached in the referendum held on May 19, 2019, the following details to the future taxation of Swiss Holding companies are noteworthy:

- On a date not yet known, but possibly as of January 1, 2020, the tax-free treatment of interest and other income will be 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 will not lead to higher taxes. Eventually, taxes might even be lower due to the new notional interest deduction (“N.I.D.”), as described below.
- When a foreign company is domesticated into Switzerland or a change occurs 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 will be allowed with regard to the basis of the assets reported on the company’s tax balance sheet. This will result in an increase in the allowance for depreciation for Federal and cantonal tax purposes in Switzerland.
- A mandatory Patent Box regime will be introduced at the cantonal and communal level (but not at the Federal level), providing for privileged taxation of income from patents and similar intellectual property rights. A broad tax exemption will apply to 90% of qualifying I.P. income, with each canton having the option to reduce (but not increase) exempt qualifying income. The O.E.C.D.’s nexus approach

for I.P. regimes will be applied, *i.e.*, the R&D expenses need to be incurred through operations carried on by the Patent Box company itself.

- A super-deduction of up to 150% for Swiss (but not foreign) R&D expenses can be introduced at the cantonal and communal tax level. Each canton is free to choose whether to enact the incentive.
- The N.I.D. can be introduced on the cantonal and communal level but only in “high” corporate tax cantons, which include at the moment only the cantons of Zurich, Berne, and Aargau. This provision favors companies that are highly financed with equity, as a notional interest expense deduction will be generated by equity. Detailed regulations will be published soon.
- The combination of tax reductions of patent box treatment, R&D super deductions, and N.I.D. may not exceed 70% of the overall taxable income in a certain tax period.
- In addition to the above, the cantons are free to reduce both the corporate income and capital tax rates.

Since S.T.A.F. now will come into effect, many Swiss cantons are expected to reduce their ordinary corporate income tax rates as follows (all rates include Federal income tax):

- Zug will reduce its rate from 14.6% to 11.9%
- Schwyz will reduce its rate from 15.0% to 14.1%
- Schaffhausen will reduce its rate from 15.8% to 12.4%
- Vaud will reduce its rate from 21.0% to 13.8%
- Geneva will reduce its rate from 24.2% to 14.0%
- Zürich will reduce its rate from 21.2% to 18.2%

The above reduced rates will apply to all income of Swiss holding companies other than dividend income from qualifying participations (*i.e.*, a shareholding of 10% or more or that has a fair market value of at least CHF 1 million per investment), which will be subject to the participation relief on the Federal, cantonal, and communal levels (see Paragraph B.i. above). Consequently, income that was previously excluded from tax on the cantonal and communal level before the tax reform will be taxed. 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 may consider relocating to another canton. All factors must be considered in evaluating the need for relocation, including the cantonal introduction of the N.I.D. In any event, since the sum of (i) the reduced tax rates in many cantons plus (ii) the Federal income tax will likely be in the range of 12% or a little more, it is anticipated that Switzerland will remain very attractive to all companies based in cantons with attractive tax rates, not only holding companies.

## NETHERLANDS<sup>213</sup>

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.

### A. 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 19%. In the coming years the Dutch corporation income tax rates will be further reduced as follows:

- In 2020, the rate will be lowered to 16.5% for profits up to €200,000, and 22.55% thereafter.
- In 2021, the rate will be lowered to 15% for profits up to €200,000, and 20.5% thereafter.

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<sup>213</sup> This portion of the article was written by Ewout van Asbeck of Van Doorne in Amsterdam.

## **B. Participation Exemption**

### **i. In General**

Under the participation exemption set forth in Article 13 of the Corporation Income Tax Act (“C.I.T.A.”), dividends (including dividends in kind and “hidden” profit distributions) and capital gains derived from qualifying shareholdings are exempt from Dutch corporation income tax, while capital losses are deductible only under special circumstances (see Paragraph C.vi below). No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax exempt capital 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 Paragraph B.ix below. Similarly, if a Dutch taxpayer (i) holds less than 5% of the shares in a company, (ii) granted a hybrid loan to a company, or (iii)

holds a profit-sharing right in a company and a company related to the Dutch taxpayer holds a qualifying participation in that company, such smaller shareholding, hybrid loan, or profit-sharing right will qualify for the participation exemption based on the so-called pull along rule. Note that the term “related” is statutorily defined and refers to share ownership of at least one-third of the shares of the company. This is discussed in Paragraph C.ii 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”).

## **ii. 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%.

### **iii. 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.

### **iv. 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.

#### **v. 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.

**vi. 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.

**vii. 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.

**viii. 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.

**ix. Hybrid Loans and Profit Rights**

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

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

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporation income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporation income tax purposes and, in principle, will be subject to a 15% dividend withholding tax.<sup>214</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 Paragraph B.i 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.

#### **x. 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.

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<sup>214</sup> For further explanation regarding dividend withholding tax, see Paragraph E.

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).

### C. **Other Aspects**

#### i. **Costs and Expenses**

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

#### ii. **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.

### **iii. Earnings Stripping**

As of January 1, 2019, the Anti-Tax Avoidance Directive (“A.T.A.D. 1”)<sup>215</sup> was implemented in Dutch law through the introduction of Article 15b of the C.I.T.A. As a consequence,

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<sup>215</sup> See also Paragraph C.i of the chapter European Tax Law.

interest deductions will be limited to the highest of the following amounts:

- 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 allowed by A.T.A.D. 1).

The Netherlands will not implement a "group ratio escape rule."

Furthermore, Article 15b of the C.I.T.A. does not provide for a grandfathering rule for existing loans nor an exemption for financial businesses and stand-alone entities.

An exception is included for existing Public-Private Partnerships established in connection with public infrastructure projects.

The implementation of A.T.A.D. 1 resulted in a redundancy and subsequent repeal of Articles 13L and 15ad of the C.I.T.A. These articles sought to restrict interest deduction in cases of excessive debt financing for Dutch holding companies.

#### **iv. Controlled Foreign Corporations**

As a consequence of A.T.A.D. 1, Article 13ab of the C.I.T.A. was introduced providing for the immediate taxation of passive income (less related expenses) generated by a foreign direct or indirect subsidiary established in a jurisdiction that

- levies a profit tax at a rate of less than 9%, or
- is included in the E.U. list of non-cooperative jurisdictions.

The new controlled foreign corporation ("C.F.C.") rule is applicable to foregoing proscribed foreign entities in which the Dutch holding company holds directly or indirectly an interest

- of more than 50% of the shares,
- that represents more than 50% of the voting rights, or

- that entitles the holder to more than 50% of the profits.

Passive income is defined as interest, royalties, dividends, and capital gains derived from shares, benefits derived from financial lease activities, benefits derived from insurance activities, banking activities or other financial activities, and benefits derived from certain re invoicing activities.

Immediate taxation on the basis of Article 13ab of the C.I.T.A. will not be imposed if:

- the income of the foreign entity consists for 70% or more of other income than above defined passive income, or
- the foreign entity is incorporated or established on the basis of valid business reasons that reflect the economic reality.

Article 13ab of the C.I.T.A. became effective as of January 1, 2019.

#### **v. 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 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 19% for profits up to €200,000 and 25% over the excess.

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 requirements to qualify for the Dutch Innovation Box regime include the following:

- To be eligible for the reduced rate, all technical innovations must be developed as part of an "approved project," which is an R&D project that qualifies for the Dutch R&D subsidy (also known as "W.B.S.O.").
- For larger companies, *i.e.*, companies with a global group-wide turnover of at least €50 million annually or income generated by technical innovations of at least €7.5 million per year, technical innovations must (i) be protected by a patent or plant breeders' rights,<sup>216</sup> or (ii) qualify as software.

Finally, grandfathering rules apply up to July 1, 2021, for innovations that were produced before June 30, 2016, and that were already benefiting from the Innovation Box at that time.

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<sup>216</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.

#### **vi. 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 one exception. Liquidation losses may be deductible under certain circumstances.

#### **vii. Tax Treaty Network**

The Netherlands has a robust tax treaty network with more than 90 countries. The jurisdictions with which the Netherlands has a tax treaty currently in force as of May 1, 2019, are listed in the table below.

Albania	Ethiopia	Malawi	South Korea
Argentina	Finland	Malaysia	Spain
Armenia	France	Malta	Sri Lanka
Aruba	Georgia	Mexico	St. Martin
Australia	Germany	Moldova	Suriname
Austria	Ghana	Montenegro	Sweden
Azerbaijan	Greece	Morocco	Switzerland
B.E.S. Is.	Hong Kong	New Zealand	Taiwan
Bahrain	Hungary	Nigeria	Tajikistan
Bangladesh	Iceland	Norway	Thailand
Barbados	India	Oman	Tunisia
Belarus	Indonesia	Pakistan	Turkey
Belgium	Ireland	Panama	Uganda
Bermuda	Israel	Philippines	Ukraine
Bosnia & Herzegovina	Italy	Poland	U.A.E.
Brazil	Japan	Portugal	U.K.
Bulgaria	Jordan	Qatar	U.S.A.
Canada	Kazakhstan	Romania	Uzbekistan
China	Kosovo	Russia	Venezuela
Croatia	Kuwait	Saudi Arabia	Vietnam

Curaçao	Kyrgyzstan	Serbia	Zambia
Czech Republic	Latvia	Singapore	Zimbabwe
Denmark	Lithuania	Slovakia	
Egypt	Luxembourg	Slovenia	
Estonia	Macedonia	South Africa	

#### **viii. Multilateral Instrument**

As part of the B.E.P.S. Project, the Multilateral Instrument (“M.L.I.”) was introduced. The M.L.I. aims to prevent international tax avoidance and improve coordination between tax authorities. For further background please see Paragraph J of the chapter on European Tax Law. The Netherlands became a signatory to the M.L.I. in June 2017 and the M.L.I. was ratified by Dutch Parliament in March 2019. The instrument of ratification was deposited with the O.E.C.D. shortly after. A reservation to Article 12 of the M.L.I. was made by the Netherlands in regard to the artificial avoidance of permanent establishment status. Depending on when the instruments of ratification will be deposited by other countries, for most treaties the M.L.I. will take effect by January 1, 2020.

#### **D. 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 the following substance requirements are met:

- 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 are made 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>217</sup>

It is also necessary, in certain situations, for foreign intermediate holding companies 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 Paragraphs E and F below, regarding the aforementioned situations).

On April 23, 2019, the Dutch Ministry of Finance announced a revamp of the Dutch tax ruling policy for transactions with an international character by publication of a draft decree. The decree focuses on the content of the tax rulings, the process of issuance, and transparency.

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<sup>217</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.

With respect to content, rulings will not be issued for transactions or structures without economic nexus with the Netherlands, transactions where the saving of Dutch or foreign tax is the sole or primary aim, or if the transaction involves an entity located in a jurisdiction that is included the Netherlands' list of low-taxed or non-cooperative countries.

The draft decree further provides a list of topics for which tax rulings can be issued, such as the applicability of the participation exemption, the presence or absence of a permanent establishment, and the applicability of the principal purpose test (“P.P.T.”) under tax treaties.

If the decree is implemented as proposed, summaries of all tax rulings issued will be published but the identity of the tax payer involved will not be disclosed.

#### **E. 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 Dutch cooperative used as a holding vehicle are also subject to Dutch dividend withholding tax. The rate may be reduced under an applicable tax treaty. Under certain conditions, the dividend withholding tax payable by the distributing Dutch holding company may be reduced by 3% in order to compensate for foreign withholding taxes levied over incoming dividends that cannot be claimed as a credit by the holding company by virtue of the participation exemption.

No dividend withholding tax is levied on dividends paid by a Dutch-resident entity to nonresident corporate shareholders, if

- the corporate shareholder is a tax resident of a country within the E.U. or E.E.A., or a country with which the Netherlands has concluded a tax treaty containing a provision covering dividends;

- the Dutch participation exemption, which in principle requires a minimum shareholding of 5%, would have been applicable to the shareholding in the Dutch entity distributing the dividends had the recipient of the dividends been a resident of the Netherlands;
- the corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch zero-taxed investment institution; and
- the corporate shareholder is the beneficial owner of the dividends.

The dividend withholding exemption at source does not apply however 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 it was not put into place for valid business reasons that reflect economic reality. Valid business reasons may be present if, *inter alia*, the nonresident company (i) conducts a material business enterprise and the shareholding is part of the business enterprise’s assets, (ii) is a top-level holding company that carries out material management, policy, and financial functions for the group it heads, or (iii) functions as an intermediate holding company performing a linking function within the group structure in relation to the relevant Dutch target. An intermediate holding company can only perform a linking function if its direct or indirect corporate shareholder and its direct or indirect subsidiary or subsidiaries each conduct a material business enterprise.

In the case of an intermediate holding company, the company must also meet the 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 requirements, alongside the Dutch minimum substance requirements discussed in Paragraph D 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.

After the publication of two decisions by the E.U. Court of Justice regarding the inappropriateness of the German substance requirements in December 2017 (*Deister Holding/Juhler Holding*), the Dutch Ministry of Finance has indicated that the above additional substance requirements may be too strict and should be used as safe haven requirements only. Whether a structure is completely artificial should be determined on the basis of all relevant facts and circumstances.

If based on the above-mentioned anti-abuse provisions the dividend withholding tax exemption will not be applicable, then in principle protection under the provisions of an applicable tax treaty may still be available. It should be noted however that as of January 1, 2020, the P.P.T. of the M.L.I. may be applicable to a number of the tax treaties concluded by the Netherlands. This may imply that if it can be argued that the principal purpose of setting up the intermediary holding company was to obtain a tax treaty benefit, protection under the tax treaty will not be available.

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 rate of withholding tax will be equal to the highest rate of corporation income tax applicable at that point in time (20.5% in 2021). It is unclear when a company will be deemed to be “affiliated,” but it is likely that low-tax jurisdictions will be the jurisdictions that will be included in the Netherlands' list of low-taxed and non-cooperative countries. The expected date of implementation of the withholding tax on interest and royalties is January 1, 2021.

**F. Extra-Territorial Taxation and Anti-Abuse Rules**

In addition to dividend withholding tax levied on dividends distributed, a nonresident corporate shareholder of a Dutch holding entity may be subject to Dutch corporation income tax on the dividends or capital gains derived from its shareholding, if the following conditions are met:

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

Dutch corporation income tax will be levied at a rate of 19% over the first €200,000 and 25% over the excess (2019 rates). Any dividend withholding tax levied can be offset against the corporation income tax due.

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

**G. 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%.

#### H. **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 and the position of the Dutch government has not changed. 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 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
- C.F.C. rules
- The general anti-abuse rule
- 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. A.T.A.D. 1 is in force in the Netherlands as of January 1, 2019. These 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.

## **I. 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. Currently, the European Commission has opened an in-depth investigation to examine whether tax rulings granted by the Netherlands to Nike constitute State Aid in breach of E.U. State Aid rules.

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<sup>218</sup>**

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

### **A. Recent Developments**

#### **i. 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

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<sup>218</sup> This portion of the article was written by James Somerville of A & L Goodbody in Dublin.

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., requires tax advisors and companies to disclose any tax planning arrangements that meet certain hallmarks indicative of aggressive tax planning. Ireland has been supportive of such measures and 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.

**ii. 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 (Controlled Foreign Corporation 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 deposited its instrument of ratification with the O.E.C.D. on January 29, 2019, meaning the Multilateral Instrument came into force in Ireland on May 1, 2019.

### iii. 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.

### iv. 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.

**v. 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.

**vi. 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 had to be implemented by all E.U. Member States by January 1, 2019. Among the measures in A.T.A.D. is an interest limitation rule 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 opted to defer implementation to January 1, 2024, as in its view it already has domestic interest limitation rules. However, indications are the measures could be introduced as early as January 1, 2020.

**vii. 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.

**B. Corporate Tax Rate**

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

The applicable rate of Irish tax on passive income is 25%. Dividends, however, may be taxed at the 12.5% rate, depending on the circumstances, as discussed in Paragraph D 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>219</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.

### **C. 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

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<sup>219</sup> Ireland has signed double taxation treaties with 74 countries, 73 of which are in effect.

- 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.

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.

#### **D. 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 the following:

- A person, not being a company, who is neither resident nor ordinarily resident in Ireland and who is, by virtue of the law of an E.U. Member State or of a treaty country, resident for tax purposes in that country.
- A company that is resident in an E.U. Member State (other than Ireland) or in a treaty country, and which is not under the direct or indirect control of a person, or persons, resident in Ireland.
- A company that (i) is neither a resident of Ireland nor a resident of any other E.U. Member State or a treaty country, and (ii) is under the ultimate indirect control of a person that is resident in an E.U. Member State (other than Ireland) or in a treaty country.<sup>220</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

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<sup>220</sup> Where there is a chain of ownership, the exemption does not apply if an Irish-resident company is in the chain.

which a main purpose is the avoidance of income tax, corporation tax, or capital gains tax.

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

E. **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.

F. **Financing the Irish Holding Company – Interest Payment Deductions**

Until the A.T.A.D. interest limitations rules come into effect,<sup>221</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 borrowed to finance the acquisition of shares. Interest is allowed as a deduction if it is used in acquiring any part of the ordinary share capital of

- a trading company,
- a company whose income consists mainly of real estate rental income,
- a direct holding company of a company referred to above,
- a company whose business consists wholly or mainly of holding stocks, shares, or securities of a company that is a

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<sup>221</sup> See Paragraph A.vi.

trading company indirectly through an intermediate holding company or companies, or

- a company whose business consists wholly or mainly of the holding of stocks, shares, or securities directly in a company whose income consists mainly of real estate rental income.

A deduction is also allowed for interest on funds 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.

**G. 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.

**H. Treaty Network**

Ireland has signed double taxation agreements with 74 jurisdictions, listed below, 73 of which are currently in effect (*i.e.*, excluding Ghana).

Albania	Ethiopia	Macedonia	Singapore
Armenia	Finland	Malaysia	Slovakia Republic
Australia	France	Malta	Slovenia
Austria	Georgia	Mexico	South Africa
Bahrain	Germany	Moldova	South Korea
Belarus	Greece	Montenegro	Sweden

Belgium	Hungary	Morocco	Spain
Bosnia & Herzegovina	Ghana	Netherlands	Switzerland
Botswana	Iceland	New Zealand	Thailand
Bulgaria	India	Norway	Turkey
Canada	Hong Kong	Pakistan	U.A.E.
Chile	Israel	Panama	U.K.
China	Italy	Poland	U.S.A.
Croatia	Japan	Portugal	Ukraine
Cyprus	Kazakhstan	Qatar	Uzbekistan
Czech Republic	Kuwait	Romania	Vietnam
Denmark	Latvia	Russia	Zambia
Egypt	Lithuania	Saudi Arabia	
Estonia	Luxembourg	Serbia	

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>222</sup>

#### I. **Capital Duty**

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

#### J. **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

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<sup>222</sup> See Paragraph C, above, regarding tax credits for foreign dividends.

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.

**K. 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).

**L. C.F.C., Thin Capitalization, and Transfer Pricing Rules**

Pursuant to FA 2018, Ireland introduced controlled foreign corporation ("C.F.C.") rules. The rules apply for accounting periods beginning on or after January 1, 2019. C.F.C. rules are an anti-abuse measure targeted at the diversion of profits to offshore entities in low or no tax jurisdictions. The basic premise of C.F.C. rules is to attribute certain undistributed income of the offshore entity to its controlling parent and taxing same. Broadly, an entity will be a C.F.C. where it is (i) subject to more than 50% control by a parent company and its associated enterprises and (ii) tax on its profits account for less than half the tax that would have been paid had the income been taxed in the parent company's country of tax residence.

The C.F.C. regime applies to Irish tax on income of foreign resident companies where certain activities are performed in Ireland by a company that controls the C.F.C.

A.T.A.D. allows Member States to determine whether the income of a C.F.C. should be attributed to its parent using one of two options. Ireland has opted for option B. Option B attributes

undistributed income arising from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. It focuses on bringing the income that is artificially diverted from Ireland to a low tax jurisdiction back into the Irish tax net.

There are a number of exclusions from the scope of the C.F.C. charge. For example, the C.F.C. charge does not apply where securing a tax advantage was not the essential purpose of the arrangement giving rise to the C.F.C.'s income or where the C.F.C. has profits of less than €75,000 or low value activities.

Apart from the recharacterization rules under which interest may be treated as a dividend, and certain anti-avoidance provisions restricting interest deductibility in certain intra-group debt scenarios, Ireland does not have thin capitalization rules.

Limited transfer pricing legislation was introduced in 2010. Broadly, the legislation is only applicable to trading transactions between associated persons (effectively, companies under common control). It utilizes the O.E.C.D. Guidelines on the basis of Article 9.1 of the model treaty. It does not apply to small- and medium-sized enterprises. It applies to accounting periods commencing in January 2011 with respect to arrangements agreed on or after July 1, 2010. An independent review of Ireland's corporation tax code commissioned by the Irish Government has recommended that Ireland should update and extend the scope of its transfer pricing legislation in line with commitments under the O.E.C.D. B.E.P.S. project. Indications are that legislation will be introduced in the Finance Bill 2019 to update Ireland's transfer pricing rates with effect from January 1, 2020.

#### **M. 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.

#### **N. Conclusion**

In the broader context of the E.U. Member States and other treaty countries, Ireland is a comparatively tax efficient location for a holding company. Generally, the negative factors disappear when

Ireland is used as the jurisdiction for an intermediate holding company. The greatest tax benefit can be obtained when head office activity is carried out by the Irish company in addition to its role as a holding company.

## SPAIN<sup>223</sup>

A Spanish holding company, or “*entidad de tenencia de valores extranjeros*” (familiarily known by its Spanish acronym “E.T.V.E.”), is an ordinary Spanish company subject to 25% tax on its income, 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 93 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	Ecuador	Lithuania	Serbia
Algeria	Egypt	Luxembourg	Slovakia
Andorra	El Salvador	Macedonia	Slovenia
Argentina	Estonia	Malaysia	South Africa
Armenia	Finland	Malta	South Korea
Australia	France	Mexico	Sweden

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<sup>223</sup> This portion of the article was written by Guillermo Canalejo Lasarte of Uría Menéndez in Madrid.

Austria	Georgia	Moldova	Switzerland
Barbados	Germany	Morocco	Tajikistan
Belarus	Greece	Netherlands	Thailand
Belgium	Hong Kong	New Zealand	Trinidad & Tobago
Bolivia	Hungary	Nigeria	Tunisia
Bosnia & Herzegovina	Iceland	Norway	Turkey
Brazil	India	Oman	Turkmenistan
Bulgaria	Indonesia	Pakistan	Ukraine
Canada	Iran	Panama	U.A.E.
Chile	Ireland	Philippines	U.K.
China	Israel	Poland	U.S.A.
Colombia	Italy	Portugal	Uruguay
Costa Rica	Jamaica	Qatar	Uzbekistan
Croatia	Japan	Romania	Venezuela
Cuba	Kazakhstan	Russia	Vietnam
Cyprus	Kuwait	Saudi Arabia	
Czech Republic	Kyrgyzstan	Senegal	
Dominican Republic	Latvia	Singapore	

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

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

**A. 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.

**B. 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.

**i. 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>224</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.

## **ii. 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

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<sup>224</sup> Investments made by an E.T.V.E. prior to January 1, 2015, will qualify for this regime for amounts exceeding €6 million.

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>225</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 qualify for the E.T.V.E. tax exemption regime:<sup>226</sup>

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

Those countries or territories that enter into an exchange of information treaty or a tax treaty with an exchange of information

<sup>225</sup> This is an *iuris et de iure* presumption (*i.e.*, the Spanish tax authorities will not be entitled to provide rebutting evidence).

<sup>226</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.

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).

### **iii. 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>227</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.

### **iv. Qualified Holding Company**

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

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

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Article 5 of the C.I.T. Law.

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.

**v. 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.

**vi. 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.

#### **vii. 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.

#### **viii. 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 Paragraph H of this chapter 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.

### C. **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.

### D. **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>228</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.

#### **E. 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

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<sup>228</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.

income tax treaty with the U.S.,<sup>229</sup> allow Spain to tax capital gains at the general 19% tax rate, provided that the foreign shareholder holds a substantial stake in the Spanish entity (usually more than 25% of the capital).

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

#### **F. 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 Paragraph

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<sup>229</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.

E. A liquidation will also trigger capital duty unless specific or special provisions apply (see Paragraph H.v below).

#### **G. 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.

#### **H. Corporation Income Tax**

##### **i. 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.

## **ii. Interest Barrier Rule**

Royal Decree-Law 12/2012 has replaced the thin capitalization rules with a general restriction on the deduction of financing expenses. The scope of 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.

## **iii. 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.

#### **iv. 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>230</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 adjustments, such as tax exemptions or tax credits).<sup>231</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.

#### **v. 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

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<sup>230</sup> Royal Decree Law 2/2016 of September 30, introducing tax measures intended to reduce the public deficit.

<sup>231</sup> The conformity of this amendment and minimum payment with constitutional principles is questionable.

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.

#### **vi. Transfer Pricing**

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

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

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

For the taxable year beginning on January 1, 2016, country-by-country reporting is required for operations of multinational groups based in Spain. These reporting requirements will apply also to a Spanish company that is a member of a foreign-based group when

(i) its nonresident parent company is not required to make a country-by-country filing in its country of tax residence and (ii) the foreign-based group has a consolidated annual turnover exceeding €750 million.

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

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

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

#### **vii. 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.

#### **viii. 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.

#### **ix. 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 2019.



## UNITED KINGDOM<sup>232</sup>

### A. Introduction

This summary of U.K. law is correct as of May 30, 2019.

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.

#### i. 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”).

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This section of the article was written by Eloise Walker, of Pinsent Masons LLP, London. The author would like to acknowledge the contribution of Penny Simmons, also of Pinsent Masons LLP, London, in its preparation.

- **£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 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, became 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.

Changes to this relief intended to further encourage investment in U.K. companies by Non-Doms were introduced in Finance (No. 2) Act 2017 and took 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.

## **ii. Corporations**

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

- The U.K. has competitive corporate income tax rates. The main rate of U.K. corporate income tax is currently 19% (reduced from 20% in April 2016). The main rate of U.K. corporate income tax is due to be further reduced to 17% in April 2020.
- An exemption from corporate income tax is available for most dividends received from U.K.- and foreign-resident companies, and is backed up by a foreign tax credit system where the exemption does not apply.
- No withholding tax is levied on dividends paid by U.K. companies to nonresident shareholders, except for

distributions made by certain types of investment funds, such as real estate investment trusts (“R.E.I.T.’s”).

- The U.K. offers an exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups. However, it should be noted that during 2016, the U.K. government consulted on changes to the Substantial Shareholding Exemption. Legislation effecting changes was 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 (except for certain companies with substantial interests in U.K. real estate, as discussed further below).
- There are no capital taxes on formation or paid-in capital of companies.
- The U.K. has an optional “Patent Box” regime, 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 October 31, 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>233</sup> (see below),
- the *Cadbury Schweppes plc v. H.M.R.C.*<sup>234</sup> (see below), and
- the *Thin Cap Group Litigation*.<sup>235</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>236</sup> As a result of this case, U.K. holding companies are able to claim losses incurred by subsidiaries in other E.U. Member States, under certain circumstances.

On March 29, 2017, in compliance with Article 50 of the Treaty of the European Union, the U.K. formally notified the E.U. Council of its intention to withdraw from the E.U. Written notification under Article 50 triggered formal negotiations between the U.K. and the E.U. to determine the terms of the U.K.’s withdrawal.

The original date set for the U.K. to formally leave the E.U. was March 29, 2019. However, following agreement with the E.U., this

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<sup>233</sup> *Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue*, Case C-446/04 [2006] E.C.R. I-11753.

<sup>234</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>235</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>236</sup> *Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes)*, Case C-446/03, [2005] E.C.R. I-10837.

date has been changed to October 31, 2019. 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.

## **B. 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.

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

A company tax resident in the U.K. is liable to U.K. corporate income tax on its worldwide income and gains. Generally, capital gains realized by a U.K. company are included in profits for the purposes of calculating corporate income tax and are taxed at the same rate as income (currently 19%). However, there are exceptions to this rule, such as for gains realized on disposals of U.K. residential real estate assets (see below).

For U.K. corporate income tax purposes, trading profits are calculated by deducting certain reliefs and allowances together with expenses incurred wholly and exclusively for the purpose of the trade. Trading profits are taxed on an accruals basis and, generally, in accordance with the financial accounting treatment for determining profits and losses. The U.K. permits the use of U.K. generally accepted accounting principles (“G.A.A.P.”), or the International Accounting Standards in the case of companies whose shares are listed on an exchange in the E.U. Generally, capital gains are taxed on realization.

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

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

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

Under new provisions introduced by Finance Act 2019, effective April 2020, non-U.K. companies carrying on a U.K. real estate business or receiving income from U.K. real estate will be liable for U.K. corporate tax on U.K.-related real estate income. This income will include profits arising from loan relationships or derivative contracts for which the company is a party for the purposes of its U.K. real estate business, electric-line wayleaves, and post-cessation receipts from U.K. property businesses.

U.K. corporate tax will be applied as though the entity were a U.K. tax resident, and therefore, other U.K. tax rules will apply to the non-U.K. company when computing the U.K. corporate tax payable. Such provisions include (i) restrictions on interest deductibility specific to the corporate tax regime, (ii) the use of corporate losses, and (iii) the corporate tax instalment payment regime.

Effective April 2019, a nonresident company is liable to U.K. tax on gains realized on disposals of U.K. real estate. This is discussed in greater detail below.

### **iii. Annual Tax on Enveloped Dwellings (“A.T.E.D.”)**

Certain non-U.K. companies (and other U.K. and non-U.K. “non-natural persons”) that hold certain high-value (*i.e.*, over £500,000) U.K. residential real estate assets are subject to an annual charge. The A.T.E.D. amount increases as the value of the real estate asset increases. The lowest rate is currently £3,650 (for real estate valued at more than £500,000 but less than £1,000,000), whilst the top rate is currently £232,350 (for real estate valued at more than £20 million).

Originally, the A.T.E.D. applied only to residential real estate assets valued at more than £2 million, but subsequent Finance Acts have extended the scope of the tax so that the A.T.E.D. applies to residential real estate assets valued at more than £500,000. There

are certain reliefs from the A.T.E.D. for genuine real estate development companies and rental companies.

iv. **Disposals of U.K. Real Estate Subject to A.T.E.D. Prior to April 6, 2019**

Prior to April 6, 2019, when an asset fell within the scope of the A.T.E.D. charge, the disposal of that asset was subject to 28% C.G.T. (“A.T.E.D.-related C.G.T.”). With respect to these disposals, U.K. companies were liable to A.T.E.D.-related C.G.T., rather than U.K. corporate income tax.

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

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

The nonresident C.G.T. charge for gains realized on disposals of U.K. residential real estate assets also applied to individuals, trustees, and personal representatives. The rate of the charge was 18% or 28% for individuals (depending on the person’s overall taxable income and applicable income tax rate) and 28% for trustees and personal representatives.

v. **Position from April 6, 2019**

In November 2017, the U.K. government announced its intention to change the rules regarding the taxation of gains realized on the disposal of U.K. real estate by nonresidents. Following a lengthy public consultation, changes were introduced in the U.K.’s Finance Act 2019 and have effect from April 6, 2019.

The new rules operate to ensure that gains realized on disposals of U.K. real estate (including both residential and non-residential) are

subject to U.K. C.G.T. or U.K. corporate tax on chargeable gains. The new rules apply to direct and indirect disposals. For that reason, they can apply where a nonresident company disposes of an interest in an entity holding U.K. real estate.

The higher rates of C.G.T. for disposals of interests in U.K. residential real estate continue to apply for disposals by individuals, trustees, and personal representatives.

The new rules also apply to indirect disposals of U.K. real estate assets by nonresidents, although the “indirect charge” will only apply if the nonresident investor has at least a 25% interest in the entity owning the property (or had that level of interest at any time in the prior five years). Ownership of related parties will be aggregated for this purpose.

#### **C. 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 Paragraph R 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.

#### D. **Foreign Tax Credit for U.K. Companies**

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

Where an income tax treaty is not in place to provide relief, a credit is generally granted against U.K. tax for foreign withholding tax

levied on non-U.K. dividends. A U.K. tax credit will not be available if the relevant income tax treaty expressly denies foreign tax credit relief under the particular circumstances of the U.K. corporate resident.

Generally, companies pay dividends out of taxed profits. If a nonresident pays foreign tax on profits out of which a dividend is paid, the foreign tax payment is referred to as an underlying tax. In the U.K., an indirect foreign tax credit may be allowed for underlying tax where the recipient is a U.K. tax resident company. Typically, this underlying tax credit will be available only where the U.K. recipient company has a substantial interest in the foreign payer.

Broadly, to meet the substantial interest standard, the recipient must directly or indirectly control, or be a subsidiary of a company that indirectly or directly controls, 10% or more of the voting power of the payer company. However, in limited circumstances, the underlying tax credit may be available where the 10% control condition is not strictly met.

For the purpose of the underlying tax credit, underlying tax will generally include underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two companies are associated if the shareholder receiving the dividend, directly or indirectly, controls 10% or more of the voting power in the paying company. A U.K. tax credit given for foreign tax will be reduced or denied if a foreign tax authority has repaid any amount of the foreign tax paid to (i) the recipient of the U.K. tax credit, (ii) any person connected with the recipient, or (iii) a third party as a result of a scheme (which is broadly defined). An example of the type of tax caught by this limitation is the tax paid by Maltese corporations and refunded to its shareholders.

#### **i. Source of Income**

Although the U.K. does not have a “basket” system for allocating foreign tax credits, the “source” doctrine has imposed significant restrictions on the pooling of foreign tax credits. The shares in a foreign company constitute a distinct source, and the foreign tax may only be credited against income from that particular source. In

certain cases, a particular class of shares in a company may be a distinct source.

## **ii. Credit Pooling**

Previously, the U.K. had a relatively complex regime of “onshore pooling” of foreign tax credits, allowing excess foreign tax credits from one source to be applied against the U.K. tax due on other foreign-source dividends. However, this regime has been discontinued in conjunction with the substantial Shareholding Exemption. In the majority of cases, there will now be no U.K. tax liability levied on the corporate recipient of an overseas dividend and, therefore, there is no need for a credit pooling system to relieve any associated U.K. tax liability.

## **iii. Anti-Avoidance**

A broad anti-avoidance rule, specifically aimed at foreign tax credits, exists to combat arrangements designed to secure excessive foreign tax credits, such as “dividend buying” schemes, where extra income is deliberately purchased to enhance the foreign tax credit of the purchaser. The rule applies where four conditions are satisfied:

- Foreign tax is allowable as a credit against U.K. tax under any arrangements.
- There is a scheme or arrangement, the main purpose, or one of the main purposes, of which is to cause an amount of foreign tax to be taken into account.
- The scheme or arrangement satisfies certain statutory conditions (outlined below).
- The aggregate of claims for credit that have been made or that may be made by the taxpayer and any connected persons is more than minimal.

Broadly, schemes or arrangements are those that meet any of the following criteria:

- The scheme or arrangement enables attribution of foreign tax, when the foreign tax is properly attributable to another source of income or gains.
- The scheme or arrangement concerns the effect of paying foreign tax, so that on entering the scheme it would be reasonable to expect that the total amount of foreign tax would be increased by less than the amount allowable as a tax credit.
- The scheme or arrangement involves deemed foreign tax, where an amount is treated as if it were foreign tax paid and either no real foreign tax would reasonably be expected to be paid or it would be reasonable to expect that the increase in foreign tax credit allowed exceeds the increase in actual tax paid.
- The scheme or arrangement concerns claims or elections for tax credits the effect of which is to increase or give rise to a claim for a relief by way of a tax credit.
- The scheme or arrangement reduces a person's reported tax liability.
- The scheme or arrangement involves tax-deductible payments.

H.M.R.C. will issue a counteraction notice where it has reasonable grounds to determine that the above criteria have been met. Taxpayers will then have 90 days to determine whether to (i) accept H.M.R.C.'s application of the legislation and amend their self-assessment tax return as required, or (ii) disregard the counteraction notice. Disputes regarding the application of the rules will be resolved through the normal self-assessment examination and appeals procedure. Where the counteraction notice is successfully invoked, the tax credit claim will be limited so as to cancel the effect of the scheme or arrangement.

Different rules apply where the underlying tax of a nonresident company is involved. In such circumstances, the counteraction will apply where, had the nonresident company that paid the foreign tax

been a U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company.

#### **iv. 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.

#### **E. Dividends Paid by U.K. Companies to U.S. Shareholders**

There is no U.K. withholding tax on dividends paid by U.K. companies to U.S. shareholders as the U.K. does not impose withholding tax on dividends to nonresident shareholders as a matter of domestic law.

However, U.K. withholding tax at 20% applies to property income distributions (“P.I.D.’s”) paid in relation to certain qualifying activities by R.E.I.T.’s to shareholders who are not within the scope of U.K. corporate tax (which can include companies not resident in the U.K.). This may be reduced by an applicable U.K. income tax treaty. Since a company will not be able to qualify as a R.E.I.T. if it has a corporate shareholder with a 10% or greater participation, treaty relief will be at the rate applicable to portfolio dividends. This rate currently is 15% for qualified U.S. residents under the U.K.-U.S. Income Tax Treaty. The position is essentially the same with respect to the 20% withholding that applies to P.I.D.’s made by property-authorized investment funds.

#### **F. 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. corporate 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 arrangements between connected parties “lack economic substance” in order to exploit tax mismatches. One example of this would be if profits are taken out of a U.K. subsidiary by way of a large tax-deductible payment to an associated entity in a tax haven that bears no relation to the provision of any property, service, or financing that was actually made to the U.K. subsidiary or permanent establishment.
- A non-U.K. trading company carries on activity in the U.K. in connection with supplies of goods, services, or other property. The activity is designed to ensure that the non-U.K. company does not create a permanent establishment in the U.K. and either (i) the main purpose of the arrangement is to avoid U.K. tax, or (ii) a tax mismatch is secured such that the total profit derived from U.K. activities is significantly reduced. This is referred to as the “avoidance of a U.K. taxable presence.”

D.P.T. does not apply to S.M.E.’s.

Where companies or permanent establishments lack economic substance, there are two tests that must be considered: (i) the insufficient economic substance condition, and (ii) the effective tax mismatch condition. If either test is met, a D.P.T. charge will be payable.

The insufficient economic substance condition will apply where (i) the tax benefit of the transaction is greater than any other financial benefit, and (ii) it is reasonable to assume that the transactions were designed to secure the tax reduction. Alternatively, it will apply where (i) a person is a party to one or more of the transactions, (ii) the contribution of economic value by that person is less than the tax benefit, and (iii) it is reasonable to assume that the person's involvement was designed to secure the tax reduction. Broadly, this condition will not be met if there are real people engaged in activities that have a real financial benefit.

There will be an effective tax mismatch if the transaction gives rise to a tax reduction for one party and the tax payable by the other party is less than 80% of the tax reduction obtained by the first party.

There is an exemption for tax reductions arising solely from payments to registered pension schemes, charities, and persons with sovereign immunity, or to certain offshore funds or authorized investment funds.

Broadly, where a transaction has been designed to ensure the avoidance of a U.K. taxable presence, a D.P.T. charge may arise where either (i) both the insufficient economic substance condition and the effective tax mismatch condition are satisfied, or (ii) the tax avoidance condition is satisfied.

The tax avoidance condition will apply if arrangements are in place in connection with supplies of goods or services in the U.K. and the main purpose, or one of the main purposes, of the structure is the avoidance or reduction of a U.K. corporate income tax charge.

There will not be an avoidance of a U.K. taxable presence if the U.K. activity is undertaken by someone acting as an agent of independent status or for the purposes of alternative finance arrangements.

There are also specific exceptions from a D.P.T. charge if, in a 12-month accounting period, U.K.-related sales are below £10,000,000, or U.K.-related expenses are below £1,000,000.

Calculating the D.P.T. charge is complex and various rules must be considered. Broadly, it will be necessary to consider profits that would have arisen if the company made a full transfer pricing adjustment. It will also be necessary to determine the amount of profit that would have arisen from an alternative transaction that would have reasonably taken place if a tax reduction had not been relevant to the parties.

No taxable diverted profits should arise if, in the relevant transactions, the company made transfer pricing adjustments that put it in the same tax position as if arm's length pricing had been used.

D.P.T. has its own specific rules for assessment and payment. D.P.T. is not self-assessed; rather, companies have to notify H.M.R.C. if they are potentially within the scope of D.P.T. and do not satisfy any of the exemptions.

Following notification, if H.M.R.C. considers a company potentially liable for D.P.T., it will issue a preliminary notice to the company calculating the D.P.T. and outlining the grounds on which they consider D.P.T. to be payable. H.M.R.C. must issue a preliminary notice within two years of the end of the accounting period in which the D.P.T. charge arose. A company then has 30 days to contact H.M.R.C. to correct obvious errors in the notice, following which H.M.R.C. must either issue a charging notice stating the amount of D.P.T. payable, or notify the company that no D.P.T. is payable. The company then has 30 days from receipt of the charging notice to pay any D.P.T. due. There is no right to appeal the preliminary notice or charging notice prior to payment and there are no grounds for delaying payment.

Following payment, H.M.R.C. has 12 months to review the charge to D.P.T. During this time, the charge may be reduced or increased. The company can only appeal a D.P.T. charge after the 12-month review period has ended.

There is no formal clearance procedure for D.P.T., although it may be possible to obtain a written opinion from H.M.R.C. on the likelihood a D.P.T. notice will be issued.

**G. C.G.T. Exemption on the Disposal of Substantial Shareholdings**

Any gains realized on a U.K. company's disposal of shares in an operating company may be exempt from U.K. tax if the gains qualify under the Substantial Shareholding Exemption (the "S.S.E."). The S.S.E. is available only if several conditions are satisfied by the company making the disposal (the "Seller") and the company that issued the shares being sold (the "Target Company"). The application of the S.S.E. is automatic and a company need not make an election in order to claim the benefit.

The conditions of the S.S.E. were substantially amended following changes introduced in Finance (No. 2) Act 2017 which are applicable from April 1, 2017.

Where the S.S.E. would apply to a gain, but in fact a loss arises from the relevant transaction, that loss is disallowed for U.K. corporate tax purposes.

Broadly, the key conditions for the S.S.E. to apply relate to (i) the shares in the Target Company held by the Seller, and (ii) the trading status of the Target Company and the Target's group.

The S.S.E. legislation had previously contained conditions relating to the trading status of the Seller and its group, but these conditions ceased to apply as of April 1, 2017.

**i. The Seller's Shareholding in the Target Company (the "Shareholding Condition")**

To satisfy the Shareholding Condition, the Seller must meet the following requirements:

- The Seller holds 10% of the Target Company's ordinary share capital.
- The Seller is beneficially entitled to not less than 10% of the profits available for distribution to equity holders. Broadly, this includes all other ordinary shareholders in the Target Company and certain loan note holders.

- On a winding-up of the Target Company, the Seller would be beneficially entitled to not less than 10% of the assets available for distribution to equity holders.

The Seller must hold or have held the interests described above throughout a 12-month period beginning not more than six years before the date of the disposal of the relevant shares in the Target Company. For disposals taking place prior to April 1, 2017, the 12-month holding period must have occurred not more than two years prior to the eventual disposal.

From April 1, 2017 onwards, qualifying institutional investors (“Q.I.I.’s”) are not required to hold the 10% interest in the Target Company as described above. Where at least 25% of the ordinary share capital of the Seller is owned by Q.I.I.’s, the requirement relating to the Seller’s shareholding is satisfied under the following conditions:

- The Seller holds ordinary shares, or interests in ordinary shares, in the Target Company, and the cost of the acquisition of such shares or interests was at least £20,000,000 (the “Value Test”).
- The Seller’s beneficial interest in the Target Company is proportionate to the relevant shares or interests referred to for the purposes of the Value Test (or, where there is a difference in proportion, such proportion can reasonably be regarded as insignificant).

The “cost” of shares for the purposes of the Value Test means the value of the consideration given by the Seller (or on the Seller’s behalf) wholly and exclusively for the acquisition of the relevant shares or interests, together with any incidental costs of acquisition.

**ii. Conditions Relating to the Trading Status of the Target Company (the “Trading Condition”)**

The Trading Condition requires that from the start of the latest 12-month period that is used for the purposes of determining whether the Shareholding Condition applies, the Target Company must be a “qualifying company.”

Prior to April 1, 2017, the Target Company also had to be a qualifying company immediately after the disposal of its shares. This position caused some practical difficulty in that the Seller was required to rely on a third-party buyer's operation of the Target Company following the disposal. From, April 1, 2017, this condition is relevant only where both following facts exist:

- The relevant buyer and the Seller are connected.
- The relevant shareholding in the Target Company has been held by the Seller for less than 12 months, but the Shareholding Condition has been met by virtue of a transfer of trade to the Target Company from within the Seller's group.

A Target Company is a qualifying company if it is a trading company or the holding company of a trading group. A trading company is a company carrying on trading activities and activities other than trading activities are not carried on "to a substantial extent." A trading group has a similar definition, where one or more members carry on a trading activity and, when taken together, the activities of the group members do not include "to a substantial extent" activities other than trading activities. Broadly, for these purposes, H.M.R.C. considers the term "substantial" to mean more than 20%, although H.M.R.C. has cautioned that it will consider the facts and circumstances of each case when determining whether a company carries on non-trading activities to a substantial extent.

For the purpose of the S.S.E., a company will form part of a group if it is a 51% subsidiary of another company (*i.e.*, the parent). A company will be a 51% subsidiary of another company if the parent owns, directly or indirectly, more than 50% of the ordinary share capital of the subsidiary. When determining whether a group is undertaking trading activities, the group is treated as a single business.

The Target Company does not need be a U.K.-resident company for the S.S.E. to apply.

Gains derived from disposals of shareholdings that do not meet the requirements of the S.S.E. will be liable to U.K. corporate income

tax. Consequently, capital losses should be allowable but may only be offset against capital gains of the company.

#### **H. Capital Gains on the Disposal of Shares by a Nonresident**

Generally, no U.K. tax is payable on the disposal of shares in a U.K. company by a nonresident shareholder. A limited exception exists in the case of shares in oil companies whose value is based on exploration or exploitation rights in the U.K. sector of the North Sea. C.G.T. may also be payable on gains realized from the disposal of shares forming part of the assets of a U.K. branch of a nonresident company.

However, as outlined above, from April 6, 2019, U.K. tax is payable on gains realized by a nonresident on the sale of an interest including shares in an entity holding U.K. real estate.

#### **I. 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 introduced a new provision to ensure that the transfer of U.K. securities into a depository receipt facility, or clearance system following the exercise of an option, will give rise to a 1.5% stamp duty or S.D.R.T. charge on the greater of the fair market value or option strike price, as of the date of the transfer.

This change was introduced to combat the avoidance of U.K. stamp duty and S.D.R.T. arising on the transfer of shares using Deep-in-the-Money Options (“D.I.T.M.O.’s”). An option is a D.I.T.M.O. when the strike price is significantly below fair market value.

Finance Act 2019 further updated the rules relating to the stamp duty and S.D.R.T. payable on documents transferring or agreements to transfer listed securities to connected companies. Effective October 29, 2018, the rate for such transfers will be the higher of the consideration for the transfer, or the market value of the listed securities.

#### J. **Tax Treaty Network**

As noted above, the U.K. has one of the most extensive tax treaty networks in the world – treaties are in effect with over 130 jurisdictions, listed below:

Albania	Fiji	Liechtenstein	Sierra Leone
Algeria	Finland	Lithuania	Singapore
Antigua & Barbuda	France	Luxembourg	Slovakia
Argentina	Gambia	Macedonia	Slovenia
Armenia	Georgia	Malawi	Solomon Is.
Australia	Germany	Malaysia	South Africa
Austria	Ghana	Malta	South Korea
Azerbaijan	Greece	Mauritius	Spain

Bahrain	Grenada	Mexico	Sri Lanka
Bangladesh	Guernsey	Moldova	St. Kitts &
Barbados	Guyana	Mongolia	Nevis
Belarus	Hong Kong	Montenegro	Sudan
Belgium	Hungary	Montserrat	Swaziland
Belize	Iceland	Morocco	Sweden
Bolivia	India	Myanmar	Switzerland
Bosnia & Herzegovina	Indonesia	Namibia	Taiwan
Botswana	Ireland	Netherlands	Tajikistan
B.V.I.	Isle of Man	New Zealand	Thailand
Brunei	Israel	Nigeria	Trinidad & Tobago
Bulgaria	Italy	Norway	Tunisia
Canada	Ivory Coast	Oman	Turkey
Cayman Is.	Jamaica	Pakistan	Turkmenistan
Chile	Japan	Panama	Tuvalu
China	Jersey	Papua New Guinea	Uganda
Croatia	Jordan	Philippines	Ukraine
Cyprus	Kazakhstan	Poland	U.A.E.
Czech Republic	Kenya	Portugal	U.S.A.
Denmark	Kiribati	Qatar	Uruguay
Egypt	Kosovo	Romania	Uzbekistan
Estonia	Kuwait	Russia	Venezuela
Ethiopia	Latvia	Saudi Arabia	Vietnam
Falkland Is.	Lesotho	Senegal	Zambia
Faroe Is.	Libya	Serbia	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 achieve the following goals:

- To reduce the risk of double taxation where the same income is taxable in two states
- To provide certainty of treatment for cross-border trade and investment
- To prevent excessive foreign taxation and other forms of discrimination against U.K. business interests abroad
- To protect the U.K.'s taxing rights against attempts to evade or avoid U.K. tax

The latter point has become a driver for U.K. tax treaty policy, consistent with E.U. and O.E.C.D. policies.

The extensive U.K. treaty network is also significant in reducing or eliminating non-U.K. taxes on payments made to recipients that are U.K. tax resident. One specific aim of U.K. treaty policy is the elimination of withholding tax on interest and royalties. About one-quarter of the U.K. treaties achieve this goal. The remaining treaties typically reduce withholding tax rates. U.K. tax treaties 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.

**K. Debt Financing of U.K. Companies**

**i. 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).

## **ii. 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.

### **a. 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.

#### **b. 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 amount of interest that is carried forward interest may be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period. Additionally, if a group has spare interest capacity for an accounting period, it can carry this forward and use it as additional interest capacity in subsequent periods, although it will expire after five years.

The new restrictions apply to interest on existing loans as well as new loans, although limited grandfathering is available in certain circumstances. This is discussed in greater detail below.

As stated above, the worldwide debt cap was repealed and replaced by new legislation that has a similar effect.

### **c. 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. 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.

### **d. 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.

### **1) Meaning of Public Infrastructure Assets**

For this purpose, public infrastructure assets include (i) tangible U.K. infrastructure assets that meet a “public benefit test” and (ii) buildings that are part of a U.K. property business and are let on a short-term basis to unrelated parties.

The public infrastructure asset must also have or be likely to have an expected economic life of at least ten years, and must be shown in a balance sheet of a member of the group that is fully taxed in the U.K.

An asset meets the public benefit test if it is procured by a relevant public body (such as a government department, local authority, or health service body) or will be used in the course of an activity that is or could be regulated by an “infrastructure authority.” This second limb should be wide enough to include projects relating to airports, ports, harbors, waste processing, energy, utilities, electric communications, telecoms, roads, and railways.

Companies will qualify for the exemption if they provide a public infrastructure asset or carry on activities that are ancillary to, or facilitate the provision of, a public infrastructure asset.

The exemption also applies to activities relating to the decommissioning of a public infrastructure asset.

Any building may be a “qualifying infrastructure asset” if it is part of a U.K. property business and intended to be let on a short-term basis to persons who are not related parties. Here, “short-term basis” means having an effective duration of less than 50 years and not being considered a structured finance arrangement. Buildings that are sublet are included in the definition.

## **2) 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.

## **3) 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 (i) loan relationships were entered into on or before May 12, 2016, and (ii) at least 80% of the total value of the company's future qualifying infrastructure receipts for a period of at least ten years was highly predictable by reference to certain public contracts.

The grandfathering exemption applies to interest on loans between related parties if the conditions are satisfied.

A transitional provision also applied in the first year to enable groups to restructure to fall within the P.I.E.

### **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. corporate tax return. U.K. companies also need to file an interest restriction return.

The return contains basic information about the composition of the worldwide group, the key figures from the group interest level computation, and the allocations of any disallowances.

A short-form interest restriction return can be completed by companies claiming that the £2 million *de minimis* threshold applies to them. If a company elects to complete the short-form interest restriction return, it will not be able to use its interest allowance in a later period, although it will have 60 months to revoke its election and submit a full return.

Groups must appoint a reporting company to make the return. This is a company that is not dormant and is a U.K. group company, or a group member subject to U.K. corporate income tax for at least part of the relevant period to which the return relates.

### **iii. Withholding Tax on Interest**

Generally, a U.K. company has a duty to withhold tax on U.K.-source payments of yearly interest. Currently, the rate of withholding is 20%. Broadly, “interest” will constitute “yearly interest” if it relates to debt that is intended to extend beyond one year.

There are a number of exemptions to this general rule. For example, there is currently no withholding tax on payments of interest to U.K. banks and U.K. corporate taxpayers.

Quoted Eurobonds also benefit from an exemption from U.K. withholding tax. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized exchange.

As explained above, bilateral tax treaties may also reduce the amount of withholding tax payable on interest payments to non-U.K. lenders. Administrative burdens arise when a reduction is claimed under a treaty.

To encourage the use of private placements as an alternative form of financing, effective January 1, 2016, an exemption exists for certain qualifying private placements. A private placement is a type of unlisted debt instrument that is sold by way of a private offering to a small number of investors.

The exemption only applies to a security under the loan relationship rules. Therefore, it must be a money debt, as previously discussed. The term of the security must not be more than 50 years, and the aggregate value of the securities contained in the private placement must be at least £10 million.

The exemption will be available only if the debtor holds a certificate from the creditor, confirming that (i) the creditor is resident in an approved territory and is beneficially entitled to the interest in the private placement for genuine commercial reasons and (ii) the private placement is not being held as part of a tax avoidance scheme. Broadly, a country will be an approved territory if it has been designated as such by other U.K. tax regulations or it has a double tax agreement with the U.K. and the tax agreement has a non-discrimination article.

Debtors are also required to have entered into the private placement for genuine commercial reasons and not as part of a tax advantage scheme.

From April 6, 2017, certain open-ended investment companies (“O.E.I.C.’s”), authorized unit trusts (“A.U.T.’s”) and investment trust companies (“I.T.C.’s”) no longer have to withhold U.K. tax on interest distributions that are treated as payments of yearly interest.

#### **L. 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.

#### **M. Offshore Intangibles**

Finance Act 2019 introduced a new tax on U.K. sales linked to intangible property held in low tax jurisdictions. The new rules, which take effect from April 6, 2019, apply a 20% tax charge on offshore receipts from intangible property. The targets of the tax are multinational groups that hold I.P. such as patents in tax havens and exploit that I.P. to generate revenue from sales to U.K. customers.

The new tax only applies to non-U.K. entities that are resident in jurisdictions which do not have a double tax treaty with the U.K. which contains a non-discrimination clause. On this basis, for the most part, the new tax is expected to be restricted to tax havens and should not affect U.S. tax resident entities generating revenue in the U.K. from intangible property held in the U.S. or other suitable double tax treaty countries.

#### **N. C.F.C.'s**

##### **i. 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.

## **ii. Overview of the Current Regime**

Broadly, the C.F.C. regime imposes a tax charge on U.K. corporate shareholders of foreign-resident, U.K.-controlled companies that are perceived to have or derive “U.K.-source income.”

The rules widely define the meaning of U.K.-source income for the purposes of the C.F.C. regime. There are five categories of income that are regarded as U.K.-source and they are mutually exclusive:

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

A company can be controlled from the U.K. by reason of, (i) shareholder control (“legal control”), (ii) ownership or entitlement to assets (“economic control”), or (iii) the treatment of the company as an undertaking by the U.K. parent for accounting purposes, even if consolidated accounts are not formally required (“accounting control”).

There are five exemptions that operate to reduce or exempt the profits falling within the C.F.C. charge. These are assessed at the entity level:

- The exempt period exemption (effectively a grace period)
- The excluded territories exemption
- The low profits exemption
- The low margin exemption
- The tax exemption, which looks at the rate of tax paid or payable by the C.F.C.)

Virtually every provision in the C.F.C. regime contains an anti-avoidance rule based on the presence of an intent to obtain the tax benefit as a principal reason for casting a transaction through a C.F.C. As indicated above, these will apply in addition to G.A.A.R.

Under the rules, a U.K. company will not be liable to a C.F.C. charge unless it holds a qualifying interest in the C.F.C., which, broadly, is ownership of at least 25% of share capital.

Prior to January 1, 2019, an important exemption applied to finance companies that satisfied certain conditions. The finance company exemption could be full or partial, set at 75%. Where the finance company partial exemption applied, the finance C.F.C. suffered an effective U.K. tax rate of 5% when the U.K. corporate income tax rate was 19% for the 2018-2019 tax year.

However, in October 2017, the European Commission opened a formal investigation into whether provisions of the U.K.'s C.F.C. regime, including this exemption, contravened E.U. law and specifically E.U. State Aid rules. In April 2019, the European Commission ruled that the exemption amounted to unlawful state aid and that the U.K. must recover the benefit of the aid from any groups which had claimed the exemption.

At the time of writing, it is unclear whether the U.K. will appeal the decision.

In any event, the Finance Act 2019 removed the exemption for finance companies from the U.K.'s C.F.C. rules, with effect from January 1, 2019. The amendments were introduced to ensure that

the rules would comply with the E.U.'s Anti-Tax Avoidance Directive ("A.T.A.D"). As a broad principle, the profits of the C.F.C. are calculated on the assumption that the U.K. accounting and tax rules apply.

### **iii. C.F.C. Rules Apply to Profits, Not Gains**

The C.F.C. regime seeks only to apportion profits liable to be taxed as income 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.

### **O. 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 Paragraph C 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 foreign branch of most U.K.-resident companies.

The term "branch" is a domestic equivalent of a permanent establishment and the calculation of profits falling within the exemption is determined in accordance with the income tax treaty between the U.K. and the jurisdiction where the permanent establishment is established. If no such treaty exists, the model O.E.C.D. treaty is used. Special and complex rules apply to

determine which losses and other reliefs, such as capital allowances, can be claimed if the exemption is not applied.

The regime applies to branches in all countries and territories – even those that do not have a treaty with the U.K. – but an irrevocable opting-in election must be made on an individual company basis.

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

Like the C.F.C. rules, the regime contains a number of anti-avoidance rules, and G.A.A.R. provisions will also apply.

P. **V.A.T.**

The U.K. charges V.A.T. on the supplies of most goods and services with notable exclusions, such as the supply of financial services. Currently, V.A.T. is charged at 20% (“standard rated”), although some supplies are charged at 0% (“zero rated”) and others at 5% (“reduced rated”). Ultimately, the burden of V.A.T. is intended to be borne by the final consumer. As a general principle of V.A.T. law, a fully “taxable person” should be able to recover all the input V.A.T. incurred in the course of its economic activities. The term “taxable person” is a concept used by the V.A.T. legislation to describe a person who is engaged in economic activities. Conversely, V.A.T. is not recoverable by the “end user,” which is the person who acquires supplies on which V.A.T. has been charged but who is unable to show that the supplies were used by it in connection with its economic activities.

The UK’s V.A.T. system is based on E.U. law and once the U.K. leaves the E.U., U.K. V.A.T. laws will no longer be required 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.

A company with activity limited to the holding of shares in a subsidiary in order to receive a dividend does not carry on an economic activity for V.A.T. purposes. Therefore, any V.A.T. incurred on the costs of acquiring and holding shares by a parent company for the sole purpose of holding the shares generally is not recoverable. For V.A.T. to be potentially recoverable, the shares must be held for some other “economic” purpose. Consequently, U.K. holding companies seeking to recover V.A.T. should take steps to ensure that they carry on an “economic activity” for V.A.T. purposes. Very broadly, this will involve carrying on a business. If this can be achieved, the V.A.T. costs on share acquisitions or disposals and takeovers may be recoverable.

The V.A.T. treatment of supplies made by holding companies came under scrutiny by the C.J.E.U. in *A.B. v. SKF*<sup>237</sup> and by the U.K.’s Court of Appeal in *B.A.A. Limited v. The Commissioners for Her Majesty’s Revenue & Customs* (the “B.A.A. case”). In *A.B. v. SKF*, the sale of shares by SKF was found to be more than a mere passive disposal of securities. Instead, SKF demonstrated that it was actively involved in the management of its subsidiaries. This constituted an economic activity. In the *B.A.A.* case, the Court of Appeal held that V.A.T. incurred on advisors’ fees by the relevant group company, in connection with the takeover of the B.A.A. plc group in 2006, was not recoverable under the particular facts involved. Although the acquiring entity carried on an “economic activity” for V.A.T. purposes, the court found that the fees incurred by it related principally to the acquisition rather than the post-acquisition business of the acquired group.

Both these cases confirm that companies contemplating a share acquisition or disposal should be able to recover V.A.T. incurred on fees if they can show an intention to make taxable supplies. The

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<sup>237</sup> *Skatteverket v. AB SKF*, Case C-29/08, [2009] E.C.R. I-10413.

discussion contained in the *B.A.A.* decision suggests that, possibly, this may be achieved by the acquiring entity showing an intention to supply taxable services to the target upon completion of the takeover. For example, it could supply management services in return for a fee. The intention to make taxable supplies may also be established where the acquirer is grouped for V.A.T. purposes with the target after completion of the takeover and clear evidence exists in the lead-up to the transaction that an intention to report on a group basis exists. In July 2015, in the joint cases of *Larentia and Minerva*,<sup>238</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

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<sup>238</sup> *Larentia & Minerva v. Finanzamt Nordenahm*, Joined Cases C-108-109/14, [2015] E.C.R. I\_\_\_\_ (delivered on July 16, 2015).

supply, including by novation, and it has made use of, been invoiced, and paid for the supply.

- The holding company must undertake economic activity for V.A.T. purposes. This condition will be satisfied where the holding company makes or intends to make supplies of management services for consideration to its subsidiaries. The management services must be genuine and provided for a consideration that is more than nominal. Full recovery may not be possible if management services are not supplied to all subsidiaries.
- The economic activity must involve the making of taxable supplies. The holding company should create and retain contemporaneous evidence of its intention to make taxable supplies. Full recovery may not be possible if in addition to providing management services, the holding company makes exempt supplies in providing loans to the subsidiaries. However, 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.

**Q. G.A.A.R. and Further H.M.R.C. Powers**

**i. G.A.A.R.**

The G.A.A.R. was introduced in the U.K. in July 2013, with the broad intention of counteracting “tax advantages” arising from abusive tax arrangements. This includes obtaining or increasing relief from tax. For the purposes of the G.A.A.R. provisions, a tax arrangement includes agreements, understandings, and transactions to obtain tax relief, whether or not legally enforceable. The G.A.A.R. applies to most U.K. taxes, other than V.A.T.

All 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 a transaction that is likely to be abusive and includes cases where the tax position does not reflect the economic reality, such as when an interest expense deduction is greater, for tax purposes, than the amount actually paid. Arrangements that are in accordance with established and acknowledged H.M.R.C. practice will generally not violate G.A.A.R. principles.

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

Where the G.A.A.R. applies, H.M.R.C. will be entitled to counteract the tax advantage. To illustrate, it may deny a deduction for interest expense.

There is no clearance procedure enabling taxpayers to obtain confirmation from H.M.R.C. that the G.A.A.R. will not apply to a particular transaction. However, depending on the transaction type and circumstances, other clearances in comparable circumstances will be available over time.

H.M.R.C. has published Advisory Panel guidance on its interpretation of the G.A.A.R., including examples of where G.A.A.R. will apply. The guidance confirms arrangements reflecting straightforward choices, such as funding an acquisition through debt or equity, will not fall foul of the G.A.A.R. unless contrived. Similarly, and as mentioned above, arrangements that are in accordance with long-established practice will not be subject to the G.A.A.R. unless contrived.

## **ii. Disclosure of Tax Avoidance Schemes**

The Disclosure of Tax Avoidance Schemes (“D.O.T.A.S.”) rules were introduced in Finance Act 2004 and broadly require the promoters of certain tax avoidance schemes to disclose details to H.M.R.C. Essentially, the D.O.T.A.S. regime is intended to facilitate H.M.R.C.’s identification of potential tax avoidance schemes at an early stage, with a view to taking action to close down abusive schemes where appropriate.

Following a disclosure under D.O.T.A.S., H.M.R.C. may issue a scheme reference number (“S.R.N.”). Subsequently, taxpayers who choose to use the scheme are required to put the S.R.N. on self-assessment tax returns.

Broadly, the rules apply where (i) there are “arrangements” that are expected to provide a tax advantage, (ii) receiving a tax advantage is expected to be one of the main benefits, and (iii) the scheme falls within one of several descriptions (known as “hallmarks”). Currently, the hallmarks are aimed at new and innovative schemes, marketed schemes, and specific targeted schemes.

## **iii. Accelerated Payment Notices**

Finance Act 2014 introduced new powers for H.M.R.C. to combat tax avoidance by way of Accelerated Payment Notices (“A.P.N.’s”).

Since July 2014, H.M.R.C. has been able to demand the payment of disputed tax associated with a tax avoidance scheme upfront, before a tribunal or court has decided whether a scheme is effective. The demand is made in the form of an A.P.N., which can be issued where schemes demonstrate certain “avoidance hallmarks,” such as the scheme being subject to disclosure under the D.O.T.A.S rules, or the issuance of a counteraction notice under the G.A.A.R. A.P.N.’s can be issued in relation to schemes that were entered into before the A.P.N. legislation came into force.

In brief, once an A.P.N. is issued, a taxpayer has 90 days to pay the tax, unless they successfully make representations to H.M.R.C. that the notice should not have been issued. However, representations can be made only on the grounds that the statutory conditions for the notice to be issued were not fulfilled. Examples are (i) the scheme was not a D.O.T.A.S. scheme, and for that reason, should not have been notified under the D.O.T.A.S. regime and (ii) the amount claimed in the A.P.N. is incorrect. There is no right of appeal against an A.P.N. Advance payments will be repaid to the taxpayer with interest in the event that the scheme is ultimately proven to be legitimate.

The introduction of the A.P.N. regime has proved controversial, and the validity of a number of A.P.N.’s has been challenged by judicial review. To date, no judicial review challenge has been successful, and A.P.N.’s remain a powerful tool in H.M.R.C.’s crusade against tax avoidance.

#### **iv. Follower Notices**

Alongside A.P.N.’s, Finance Act 2014 introduced the power for H.M.R.C. to issue Follower Notices (“F.N.’s”), which are aimed at marketed tax avoidance schemes where H.M.R.C. has already succeeded in the courts against one scheme user.

H.M.R.C. can issue an F.N. to a taxpayer when a final judicial ruling has been reached in relation to a tax avoidance scheme and H.M.R.C. considers that the principles in the ruling can be applied to deny the tax advantage being claimed by another taxpayer. A final judicial ruling is one that cannot be further appealed.

An F.N. may require the taxpayer to amend its return, if the return is still under examination, or enter into an agreement with H.M.R.C. to settle the dispute, where the taxpayer is appealing a tax assessment. The taxpayer is also required to give H.M.R.C. notice that it has taken the necessary corrective action and notifying H.M.R.C. of the amount of additional tax that has become payable as a result. The taxpayer has 90 days in which to comply.

**R. Corporate Criminal Offenses of Failing to Prevent the Facilitation of Tax Evasion**

**i. Background to the Offenses**

On September 30, 2017, the Criminal Finances Act 2017 introduced two corporate criminal offenses (“C.C.O.’s”) of failing to prevent the facilitation of tax evasion, whereby a business will be held criminally liable if it fails to prevent its employees or any person associated with it from facilitating tax evasion.

**ii. 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 other associated person must have criminally facilitated the tax evasion in its capacity as an employee or associated person providing services to the business. A company cannot be criminally liable for failing to prevent the facilitation of tax evasion if the facilitator was acting in a personal capacity.

### **iii. Reasonable Prevention Procedures**

A company will have a defense against criminal liability if it can prove that it had put in place reasonable procedures to prevent the facilitation of tax evasion from taking place, or that it was not reasonable under the circumstances to expect there to be procedures in place. H.M.R.C. has published guidance on the offenses in which it explains that there are six guiding principles that underpin the defense of having reasonable prevention procedures:

- Risk assessment
- Proportionality of risk-based prevention procedures
- Top level commitment
- Due diligence
- Communication, including training
- Monitoring and review

A company must undertake a risk assessment to identify the risks of facilitation of tax evasion within the organization and the potential gaps in the existing control environment. The risk assessment should be documented so that it can provide an audit trail to support policy decisions regarding the implementation of new procedures to reduce the risk of exposure to the C.C.O.’s.

It is expected that following a risk assessment, most companies will introduce changes to ensure that they have robust procedures in place to prevent their employees, service providers, agents, suppliers, and customers from engaging in or facilitating tax evasion.

Securing top level commitment from a company's board and/or senior executives will be important in mitigating the risks of exposure to the C.C.O.'s and implementation of a policy in responses to the offenses is vital. Companies will need to adopt training programs on tax evasion and the C.C.O.'s and the programs should be available to all staff to accord with best practices.

#### **iv. Territoriality**

There are two separate offenses that apply where U.K. or non-U.K. tax is evaded. In relation to U.K. tax, the offense will apply to any company or partnership, wherever it is formed or operates. Where non-U.K. tax is evaded, a business will have committed an offense if the facilitation involves (i) a U.K. company or partnership, (ii) any company or partnership with a place of business in the U.K., including a branch, or (iii) if any part of the facilitation takes place in the U.K. In addition, the foreign tax evasion and facilitation must amount to an offense in the local jurisdiction and involve conduct that a U.K. court would consider to be dishonest.

#### **v. Distinguishing between Tax Avoidance and Tax Evasion**

As noted above, the C.C.O.'s will only apply when there has been fraudulent tax evasion. Fraudulent tax evasion is a crime and involves dishonest behavior. A person behaves dishonestly if he or she is aware of, or turns a "blind eye" to, his or her liability to pay tax but decides not to pay or declare the tax. Dishonest behavior may involve a person simply deciding not to declare income. It may involve someone deliberately trying to hide or misrepresent the source of money. In most countries, such dishonest tax evasion is considered illegal and therefore a crime.

Fraudulent tax evasion does not arise where a person makes a mistake or is careless. It also does not arise where a person actively

seeks to avoid tax. A person's attempts to avoid tax may involve using complicated and artificial structures to exploit gaps in the rules of the tax system. Tax avoidance will usually involve arrangements to move assets from one place to another to secure a better tax treatment. Tax authorities may not agree that what has been done is legally effective and may challenge the taxpayer.

Even if the tax authority successfully challenges a tax avoidance arrangement and the taxpayer is required to pay additional tax, the taxpayer will not have acted dishonestly if a reasonable belief is held that the tax was not due when the arrangement was entered, even though a taxpayer understands that the belief may be proven wrong. Tax avoidance becomes evasion only where the taxpayer dishonestly withheld or misrepresented information to try to make the planning appear effective when it is not in fact effective.

In relation to the C.C.O.'s, the facilitator must also have a criminal intent and thus be an "accomplice." At its simplest, this will occur where the facilitator knows that he is helping another person to carry out fraud. Unwitting facilitation of tax evasion is not enough, nor would knowing facilitation of tax avoidance be enough.

## **S. F.A.T.C.A. – U.K. Implications**

### **i. Background to Domestic Implementation**

The U.S. government introduced the Foreign Account Tax Compliance Act as part of the Hiring Incentives to Restore Employment Act of 2010. F.A.T.C.A.'s primary function is to require financial institutions ("F.I.'s") outside the U.S. to report information on U.S. account holders to the I.R.S. The associated penalty for noncompliance is the "big stick" of a 30% U.S. withholding tax on certain income and principal payments to recalcitrant F.I.'s by all persons, even those unrelated to the U.S. account in issue.

In the U.K., concerns were raised by the financial sector about the legal difficulties in complying with F.A.T.C.A. reporting. Particularly, F.I.'s foresaw issues with respect to U.K. data protection laws and a subsequent negative impact on the

competitiveness of U.K. financial institutions (“U.K.F.I.’s”) as a result of withholding on U.S.-source payments.

In response, the U.K. government, along with the governments of France, Germany, Italy, and Spain, entered into discussions with the U.S. to address the implementation of F.A.T.C.A. These discussions resulted in the publication of a joint statement on February 8, 2012, which set out an agreement to explore an intergovernmental approach, and the Model Intergovernmental Agreement to Improve Tax Compliance to Implement F.A.T.C.A. on July 26, 2012. This model has become the norm for U.S. agreements with other jurisdictions worldwide.

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

**ii. 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>239</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.

**iii. Implications of the I.G.A.**

The U.K.-U.S. I.G.A. has resulted in the following actions:

- F.A.T.C.A. withholding will be avoided on payments made to and by U.K.F.I.’s, although the position on pass-thru payments remains outstanding.

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<sup>239</sup> SI 2013/1962.

- 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.

For F.I.'s in the U.K., compliance with the U.S. Internal Revenue Code is intended to be superseded by equivalent obligations under the U.K. I.G.A. and its implementing legislation. The U.K. is responsible for enforcement of these obligations, in the first instance. Failure to comply with the U.K. rules will result in having to comply with the primary F.A.T.C.A. legislation in order to avoid withholding.

F.A.T.C.A. is particularly complex and its exact application can be uncertain. Most F.I.'s demand information regarding the U.S. or non-U.S. status of all customers or customers having accounts in excess of a certain amount. Where a U.K. holding company may be obliged to comply with F.A.T.C.A. as implemented in the U.K., information on the U.S. status of substantial holders must be provided to the U.K.F.I.

## **T. The Common Reporting Standard**

### **i. Background**

The Common Reporting Standard ("C.R.S.") was developed by the O.E.C.D. and provides a mechanism for countries to automatically exchange tax information. Specifically, the C.R.S. allows countries to obtain information from resident F.I.'s and automatically exchange that information with other countries.

The C.R.S. has been incorporated into U.K. law by the International Tax Compliance Regulations 2015. Reporting under the C.R.S. was introduced in 2016, with different countries adopting the regime at different times.

The U.K. was one of 56 jurisdictions that were “early adopters” of the C.R.S. and undertook to adopt reporting requirements from January 1, 2016. U.K.F.I.’s were required to commence reporting of specified information to H.M.R.C. by May 31, 2017. H.M.R.C. then committed to exchange the relevant information with participating jurisdictions by September 30, 2017. The remaining countries will implement the C.R.S. in the coming years.

The aim of the C.R.S. is to crack down on the use of offshore jurisdictions to facilitate tax evasion. At this stage, a notable exclusion to the list of participating countries is the U.S. However, the reason for the U.S. exclusion is that F.A.T.C.A. already exists as a mechanism for identifying assets held offshore by U.S. citizens and U.S.-resident individuals.

Under the C.R.S., an entity that is an F.I. must carry out due diligence on its “account holders” – generally, persons who have debt or equity interests in that F.I. A wide variety of entities can constitute F.I.’s that are subject to reporting obligations, including banks, companies, and trusts. Entities that are not F.I.’s may be required to undertake certain due diligence procedures in support of self-certification obligations to F.I.’s.

F.I.’s report the collected information to the tax authority in their home jurisdiction. If any of those reported account holders are tax resident in another jurisdiction that has signed up to the C.R.S., the information covering the account holder will be forwarded to the relevant jurisdiction not later than nine months after the end of the calendar year on which the report is made.

The C.R.S. was modeled on and closely follows F.A.T.C.A., although the two regimes differ in certain respects. 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.

**ii. 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<sup>240</sup>

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>241</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.

### A. Corporation Income Tax

#### i. 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

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<sup>240</sup> This portion of the article was written by Werner Heyvaert of AKD Benelux Lawyers in Brussels.

<sup>241</sup> Royal Decree of May 23, 2007.

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.

## **ii. Participation Exemption for Dividends Received**

Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 100% exemption from C.I.T. (up from 95% through December 31, 2017).

### **a. 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.

**b. 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>242</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

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<sup>242</sup> *Belgische Staat v. KBC Bank NV*, Joined Cases C-439/07 & C-499/07, [2009] E.C.R. I-04409.

equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect); or

- in another country, provided that Article 56 of the Treaty of Rome applies (free movement of capital – Article 63 of the Treaty on the Functioning of the European Union, or “T.F.E.U.”) to the (share) capital represented by the shares that produce the dividends.

In addition, Belgium disallows the 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.

Starting assessment year 2019, the participation exemption for dividends-received amounts to 100% of qualifying dividends received, making it almost useless to apply losses, costs, or expenses (such as the cost of financing the acquisition) to eliminate taxation of 5% of such dividends.

#### **c. 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.

#### **d. 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>243</sup> over the shares does not suffice.

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<sup>243</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

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.

**e. 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	Kosovo	Montenegro
Ajman	Kuwait	Oman
Andorra	Kyrgyzstan	Paraguay
Bosnia & Herzegovina	Liechtenstein	Qatar
Dubai	Macau	Ras al Khaimah

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latter is the *usufruct* right. The right exists for a limited period of time and is separate from the capital interest.

East Timor	Macedonia	Serbia <sup>244</sup>
Gibraltar	Maldives	Sharjah
Guernsey	Marshall Is.	Turkmenistan
Isle of Man	Micronesia	Umm al Qaiwain
Jersey	Monaco	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.

### **iii. Exceptions to Participation Exemption**

#### **a. 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

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<sup>244</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.

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.

**b. Regulated Real Estate Company**

The participation exemption for dividends received is not available for dividends derived from a Belgian regulated real estate company, *i.e.*, the functional equivalent of a real estate investment trust (“R.E.I.T.”). 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.

**c. 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.

#### **d. 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.

#### **e. 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.

**f. 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.

**g. 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.

**h. Purchased Dividend**

The term “purchased dividend” is used to describe the following fact pattern. At the time a target company (“Target”) is being acquired by an acquiring company (“Acquirer”), it has substantial earnings and profits on its balance sheet, and the Acquirer pays “dollar for dollar” for such earnings and profits. Shortly after completion of the acquisition, the Acquirer has the Target 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>245</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.

#### **i. 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 Paragraph A.ii.e above),<sup>246</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.

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<sup>245</sup> Advice No. 151/2 of March 1995.

<sup>246</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.

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.

#### **iv. 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. 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 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. Otherwise, they will be taxed at the standard rate (25%).<sup>247</sup>

The fact that, as of assessment year 2019 (accounting years ending on or after December 31, 2018), the capital gain exemption is fully

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<sup>247</sup> Law of December 25, 2017, implemented in Articles 192 ¶¶1(1), 216 (2), and (3) I.T.C.

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 of more than 10% or €2.5 million and that only a part of that participation amounting to less than 10% is sold or otherwise disposed of. 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 in principle to exchange tainted shares for untainted shares. After the exchange, a corporation could request the exemption for capital gains on shares as described above. To stop this practice, the Belgian legislature has implemented an anti-abuse provision limiting the exemption to the capital gains that accrue after the exchange of shares. This provision applies only to shares that do not meet the valuation standard for exemption. Why the holding and/or participation requirements are not also subject to this provision is unclear and may lead to its improper use.

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.

**a. 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 their actual value at the time of acquisition. The position of the Belgian tax authorities was that the difference between the artificially low acquisition value and the high actual value as of the date of acquisition should be booked as an undervaluation of assets and taxed as regular income of the holding company. The income would be deemed to have accrued in the year of acquisition. It would be taxed retroactively at the full 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>248</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 including interest and other costs or expenses related to the acquisition of the participation, 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>249</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

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<sup>248</sup> Court of Cassation, May 16, 2014, F.10.0092.F.

<sup>249</sup> Article 192, ¶1(1) I.T.C.

those shares at a rate of 25.5% (to reduce to 25% in 2020) or 20.4% (if applicable).

**b. Options**

If a Belgian company purchases stock below fair market value pursuant to the exercise of a call option or a warrant, any subsequent 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.

**c. 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, the 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.

**d. Capital Losses**

Capital losses on shares, whether realized or unrealized, are not tax deductible. However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of paid-up share capital.

**e. Expenses on Sales**

Pursuant to the Law of June 22, 2005, only the net amount of capital gain is exempt, *i.e.*, the gross capital gain minus costs and expenses incurred in connection to the realization of the gain, such as brokerage fees and stamp duties. In a circular letter of April 6, 2006, the Belgian tax authorities commented on the limitation of the exempt amount of the capital gain 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 gain that is eligible for exemption from corporation income tax. Included are:

- 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 benefit from the transactions. The first benefit is that the gross amount of the sales proceeds is taken into account determine the exempt capital gain. The second benefit is that all costs and expenses incurred with the sale of the shares were deductible against ordinary income.

**f. Liquidation and Redemption Proceeds**

The participation exemption applies to payments received in connection to a liquidation or redemption of shares.

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.

**B. Withholding Tax on Distributions**

**i. 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.

**ii. 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>250</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.

iii. **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), without an actual payment to the Belgian tax authorities for the notional tax retained. If the shares are sold prior to meeting the holding period requirement, the amount of withholding tax becomes due, increased by interest for late payment. Otherwise, the undistributed portion of the dividend can be distributed freely once the one-year holding requirement is met.

Unlike the participation exemption, the exemption from dividend withholding tax is subject to the conditions mentioned in the P.S.D. with respect to the legal form, E.U. tax residence, and the parent company's compliance with a subject-to-tax requirement. As a result of the amendment of the P.S.D., several types of entities that were not eligible for the withholding tax exemption now qualify, most notably the "European company" or *societas europaea*

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<sup>250</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.

(“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 Paragraph A.ii 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.

**iv. 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>251</sup> From January 1, 2018, onwards, any reduction of share capital, including qualifying share premium, will be deemed to be paid proportionally from (i) fiscal share capital and share premium and (ii) profits carried forward or retained earnings. Only insofar as the capital reimbursement is deemed to be paid from fiscal share capital and share premium will no dividend 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, as discussed above.

**v. 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>252</sup> regarding the conditions and formalities for nonresident investment funds to obtain a refund of Belgian withholding tax imposed on 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.

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<sup>251</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>252</sup> Ci.R.H. 233/623.711, AAFisc No. 11/2013, dated March 4, 2013, and the addendum dated June 13, 2013.

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 is initially paid.<sup>253</sup> The circular letter does not mention whether interest will be paid on the amount of tax refunded, 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.

### **C. Tax Treatment of Borrowing and Interest Payment**

#### **i. 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.

#### **ii. 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. Initially, the interest limitation rule was slated to enter into effect as

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<sup>253</sup> See the ruling of the Court of First Instance dated April 3, 2017.

of January 1, 2020, but under pressure from the E.U. Commission, the effective date was moved forward to January 1, 2019.

The new limitation only applies to interest on loans concluded or substantially amended after June 17, 2016. The thin capitalization ratio of 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 must 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.

As of May 15, 2019, a Royal Decree containing detailed guidance for the practical application of the interest limitation rules was under preparation. No details were known as of that date.

### **iii. 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”) incurring interest expense computed at an arm’s length rate.
- €350 million of the amount borrowed was used by BelCo to reimburse share capital to its shareholders, including

Parent, and €100 million was used to pay an intermediary dividend to its shareholders, also 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., as it was not a cost or expense incurred 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 a cost or expense that was incurred to produce or maintain taxable income for BelCo. Consequently, the Court of Appeals examined the facts and ruled that the interest expense was not deductible under the facts presented. BelCo 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. From a cash-flow perspective, neither Parent nor BelCo lost much cash, but BelCo owed interest on the full loan amount of €450 million. Although the Court of Appeals decision 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.

#### **iv. Notional Interest Deduction**

Pursuant to the law of June 23, 2005, Belgian corporations are entitled to a notional interest deduction (“N.I.D.”) and effective January 1, 2006. 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 2020 (financial book years ending on or after December 31, 2019), the N.I.D. rate is equal to 0.726% (1.226% 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>254</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 alia*, the commercial book value of participations that qualify for the participation exemption.<sup>255</sup>

Following the Belgian Corporate Income Tax Reform Law of December 25, 2017, the N.I.D. regime has been substantially amended.<sup>256</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 the qualifying equity is booked, and the balance will be taken into account in equal installments over each of the four subsequent years. Given the low N.I.D. rate – which

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<sup>254</sup> Law of December 13, 2012, on Tax and Financial Provisions (*Belgian State Gazette*, December 20, 2012, 4<sup>th</sup> Edition). Transitional provisions are available regarding the right to utilize any existing “inventory” of carried over N.I.D. going forward.

<sup>255</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>256</sup> Article 49 of the Law of December 25, 2017, on Corporate Income Tax Reform, *Belgian State Gazette*, December 29, 2017.

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.

(v) **Patent Income Deduction and Innovation Income Deduction**

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>257</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>258</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>257</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>258</sup> For further details, see: Heyvaert, Werner, "Belgium's New Innovation Income Deduction Regime," *European Taxation* 58, no. 5 (April 5, 2018): 206-09.

#### **vi. Withholding Tax on Outbound Interest Payments**

Interest paid by any Belgian company is, in principle, subject to an interest withholding tax of 30%. Often, this domestic rate can be reduced by bilateral tax treaties, the E.U. Interest and Royalty Directive, and several domestic exemptions that have been implemented in Belgium.

#### **D. Capital Duty**

Pursuant to the Law of June 23, 2005, the rate of capital tax is set at 0%<sup>259</sup> for all contributions to share capital occurring on or after January 1, 2006.

#### **E. V.A.T.**

On the basis of E.C.J. case law, a distinction is made between “active” and “passive” holding companies.<sup>260</sup> A passive holding company has no economic activity that gives entitlement to claim a credit for input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. In comparison, an active holding company is involved in its subsidiaries’ management in return for remuneration. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input V.A.T. against output V.A.T.

Based on a response in 2010 from the Belgian Minister of Finance on a Parliamentary Question,<sup>261</sup> even V.A.T. incurred in connection with a sale of shares may be creditable and refundable, under appropriate circumstances. This insight is derived from the E.C.J.’s ruling 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, such as an

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<sup>259</sup> Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

<sup>260</sup> A.o., *EDM v. Fazenda Pública*, Case C-77/01, [2004] E.C.R. I-04295.

<sup>261</sup> Parl. Question, No. 299 of January 12, 2010, (Brotcorne), Q&A, Chamber 2009-2010, No. 52-102, 107.

input transaction on which input V.A.T. is chargeable, and a “subsequent” transaction, such as an output transaction that is subject to output V.A.T. If a relationship exists, the input V.A.T. can be credited. 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. On May 3, 2018, the Advocate General of the E.C.J. clarified that V.A.T. incurred in connection with a failed sale of shares is fully deductible in the above mentioned circumstances.<sup>262</sup>

#### F. **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,

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<sup>262</sup> Opinion of Advocate General Kokott, *Ryanair Ltd. v. The Revenue Commissioners*, Case C-249/17 (pending case).

*i.e.*, persons investing at least €25,000.<sup>263</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 tax base 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 excess of (i) the capital invested by the private investors over (ii) the sum of the distributions made by the Private P.R.I.C.A.F. to the private investors as a result of the company’s complete liquidation, plus the dividends paid to the

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<sup>263</sup> Note that the Royal Decree of May 8, 2018, decreased the minimum investment threshold from €100,000 to €25,000.

private investors. The tax reduction is capped at €25,000 without indexation.

Dividends distributed by a Private P.R.I.C.A.F. are in principle subject to a 30% withholding tax. Several exceptions exist:

- Distributions paid 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.

#### G. **B.E.P.S. and F.A.T.C.A.**

##### i. **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., (ii) Action Item 2 regarding hybrid mismatches, (iii) Action Item 3 regarding C.F.C. rules, (iv) Action Item 4 regarding the interest limitation rule, and (v) 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.

Most measures were implemented in Belgium by December 31, 2018.

**ii. 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>264</sup> Dividends derived from a subsidiary are 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>265</sup>

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.

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<sup>264</sup> Articles 185, 198, and 203 I.T.C.

<sup>265</sup> *Id.*, Article 2 ¶1.

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.

**a. Taxable Hybrids**

**1) 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 be realized due to a hybrid mismatch arrangement and not taxed in the jurisdiction where the permanent establishment is located.

**2) 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.

**3) 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.

**4) Hybrid Entity Mismatch**

A hybrid mismatch exists where deductible income is paid by a foreign hybrid entity or its establishment in another country without

a taxable inclusion for the Belgian company. This is the case when a foreign hybrid entity is considered transparent for Belgian purposes and as a taxable entity in the foreign jurisdiction.

**b. Nondeductible Hybrids**

The deduction of expenses in Belgium in the context of hybrid mismatches will be disallowed.

**1) 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.

**2) 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.

### 3) 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.

### 4) Tax Residency Mismatch Rule

Payments are not deductible if they are made by a Belgian domestic company that is also a tax resident in one or more other jurisdictions and they are deductible from income in one of the other jurisdictions against income that is not taxable in that other jurisdiction. A deduction is allowed, however, if the other jurisdiction is an E.U. Member State with which Belgium has concluded a tax treaty that determines the company is treated as a Belgian-resident taxpayer.

Most of the above rules will be applicable as of assessment year 2020 (book years ending December 31, 2019, or later).

### **iii. B.E.P.S. Action 3: C.F.C. Rules**

Until January 1, 2019, Belgium did not have C.F.C. legislation in place *per se*, but it had, and still has, extensive anti-abuse rules with an effect similar to C.F.C. rules. For example, Article 344 §2 of the I.T.C. tackles transfers of assets to entities that are resident in tax havens. Article 54 of the I.T.C. denies the deduction of interest payments to low-taxed entities and Article 307 of the I.T.C. imposes a reporting obligation on taxpayers making payments to offshore entities.

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>266</sup> These new rules became effective as of January 1, 2019, (tax assessment year 2020 and later).

A C.F.C. is defined as a low-taxed foreign company or permanent establishment in which a Belgian corporate taxpayer holds, directly or indirectly, more than 50% of the capital or voting rights, or is entitled to receive more than 50% of the profits of that entity. A C.F.C. is deemed to be low taxed if (i) it is not subject to any income

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<sup>266</sup> Article 185/2 ¶1 I.T.C.

tax or (ii) 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>267</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 comparison, income that is generated through assets and/or risks connected to the performance of S.P.F.’s by a Belgian taxpayer is included in the Belgian taxpayer’s tax base.

If a C.F.C. distributes income that has already been subject to tax at the level of the Belgian corporate shareholder, these profits are fully deductible based on Belgian C.F.C. rules.

#### **iv. 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. This rule entered into effect on January 1, 2019, (tax assessment year 2020 and later). 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>268</sup> As expected, loans entered into prior to June 17, 2016, are grandfathered. Consequently, interest on such loans will

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<sup>267</sup> *Id.*, ¶2.

<sup>268</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.

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. Additionally, financial institutions are carved out of the interest limitation rule altogether.<sup>269</sup>

As of May 15, 2019, a Royal Decree containing detailed guidance for the practical application of the interest limitation rules was under preparation. No details were known as of that date.

**v. 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

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<sup>269</sup> For further information on the interest limitation rule, see: Heyvaert, Werner and Moonen, Eveert, “Belgium – ATAD Implementation in Belgium: An Analysis of the New Interest Limitation Rule,” to be published in *European Taxation* 59, no. 7/2019 (July 2019).

File and a Local File, if certain criteria are met. In addition, if the ultimate parent of a multinational group is a Belgian company, and if it has gross consolidated revenue of at least €750 million, it will also have to file a country-by-country report with the Belgian tax authorities within 12 months after the closing of the consolidated financial statements of the group.

**vi. 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.

**H. Income Tax Treaties**

As of January 1, 2019, Belgium has in effect 95 income tax treaties with the jurisdictions listed below.<sup>270</sup>

Albania	Finland	Macedonia (FYR)	Singapore
Algeria	France	Malaysia	Slovakia
Argentina	Gabon	Malta	Slovenia
Armenia	Georgia	Mauritius	South Africa
Australia	Germany	Mexico	South Korea

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<sup>270</sup> Belgium has negotiated or is negotiating new treaties with several other countries. These treaties are in various stages of the legislative process and were not in force at the time of writing: Barbados, Botswana, Cameroon (under negotiation); Colombia (initialed); Cuba and Ethiopia (under negotiation); Isle of Man (signed); Kenya (under negotiation); Macau (ratified); Moldova (new treaty), Oman, Qatar and Russia (new treaty) (all ratified); Saudi Arabia (initialed); Tajikistan (new treaty) and Uganda (both not in force yet).

Austria	Ghana	Moldova	Spain
Azerbaijan	Greece	Mongolia	Sri Lanka
Bahrain	Hong Kong	Montenegro	Sweden
Bangladesh	Hungary	Morocco	Switzerland
Belarus	Iceland	Netherlands	Taiwan
Bosnia & Herzegovina	India	New Zealand	Thailand
Brazil	Indonesia	Nigeria	Tunisia
Bulgaria	Ireland	Norway	Turkey
Canada	Israel	Pakistan	Turkmenistan
Chile	Italy	Philippines	Ukraine
China	Ivory Coast	Poland	U.A.E.
Congo (Dem. Rep.)	Japan	Portugal	U.K.
Croatia	Kazakhstan	Romania	U.S.A.
Cyprus	Kosovo	Russia	Uruguay
Czech Republic	Kuwait	Rwanda	Uzbekistan
Denmark	Kyrgyzstan	San Marino	Venezuela
Ecuador	Latvia	Senegal	Vietnam
Egypt	Lithuania	Serbia	
Estonia	Luxembourg	Seychelles	

In addition, Belgium has agreed on a substantial number of Tax Information and Exchange Agreements (“T.I.E.A.’s”), most of which were already in effect at the time of writing. Nearly all of these T.I.E.A.’s are concluded with countries which do not have a fully-fledged bilateral tax treaty in force with Belgium, *i.e.*, most often tax havens.

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 been ratified by the various competent legislative bodies in Belgium, and is expected to enter into effect shortly. 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<sup>271</sup>

### A. In General

Sweden has emerged as an attractive country for establishing financing and holding companies for both E.U. and non-E.U. corporations. However, 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 90 in effect) and additional tax information exchange agreements, which, to some extent, will positively affect tax treatment of dividends and capital gains;
- a low corporation income tax rate (*i.e.*, 21,4%) 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%

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This portion of the article was initially written by Peter Utterström of Peter Utterström Advokat AB in Stockholm. The author would like to acknowledge the contribution of Erik Nilsson of Svalner Skatt & Transaktion KB for his review and update of this article.

withholding tax for holdings amounting to 10% or more of the votes (with no holding period requirement).

The main legal entity used for holding and financing purposes is the Swedish limited liability company (“*Aktiebolag*” or “A.B.”). The A.B. has both legal competence and the formal capacity to act as a party before authorities and courts, and it is a legal entity for Swedish tax purposes. An A.B. is also a qualifying entity under the Swedish participation exemption.

## **B. Participation Exemption**

### **i. General**

The net income of a Swedish company is normally subject to corporation income tax at a rate of 21,4%. However, if both the holding company and the subsidiary are qualifying entities under the participation exemption, income from capital gains and dividends are tax exempt. Under Chapter 24 of the Swedish Income Tax Act (“I.T.A.”), the holding entity must be in one of the following forms in order to qualify:

- A Swedish A.B. or a Swedish economic association that is not an investment company
- A Swedish foundation or a Swedish non-profit association that is not subject to tax exemption according to Chapter 7 I.T.A.
- A Swedish savings bank
- A Swedish mutual insurance company
- A “foreign company” resident within the E.E.A. that is the equivalent of any of the foregoing entities

The term “foreign company” is defined in the I.T.A. as a foreign legal entity that is subject to tax in its country of residence, if such taxation is similar to the taxation of a Swedish A.B. In general, a tax charge of at least 10% should be acceptable. Also, a foreign legal entity resident in a country with which Sweden has signed a

double tax treaty is always deemed a “foreign company” if the entity is entitled to the benefits of the treaty and the treaty is not limited to certain types of income.

The share held must be a share in an A.B., an economic association, or a similar foreign entity (see Paragraph B.iv 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.

## **ii. Dividends**

In general, dividends received from business-related shares are tax exempt. If the shares are listed, they must be held for a period of at least one year from the time when the shares became business-related for the holding entity. Also, dividends on shares held indirectly through a Swedish partnership are tax exempt to the extent they would have been exempt if held directly by the partner.

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.

### **iii. 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.

### **iv. Qualifying Foreign Entities**

Shares in foreign legal entities may also qualify as business-related shares if the legal entity corresponds to a Swedish limited liability company. The relevant provisions in the I.T.A. do not state what conditions should be met in order for a foreign legal entity to correspond to a Swedish A.B. In a 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.

## **C. Withholding Tax**

### **i. Outbound Dividends**

Under the Swedish Withholding Tax Act (“W.T.A.”), a 30% withholding tax is levied upon the distribution of dividends by a Swedish A.B. However, due to the implementation of the E.U.

Parent-Subsidiary Directive (“P.S.D.”) and Sweden’s extensive network of double tax treaties, withholding tax will not be imposed or will be imposed at a reduced rate in most cases. Under the double tax treaty concluded between the U.S. and Sweden, for instance, Sweden may not impose withholding tax on dividends if the U.S. holding in the Swedish company amounts to at least 80% of the votes and has been in place for at least one year. If the size of the holding is below 80% but amounts to 10% or more of the votes, the withholding tax rate is instead reduced to 5% of the gross amount distributed.

Dividends distributed to a legal entity resident within the E.U. are exempt from withholding tax if the recipient holds at least 10% of the share capital in the distributing company and fulfills the conditions set forth in Article 2 of the P.S.D.

Additionally, if the shares in the distributing company are deemed business-related shares under the participation exemption regime and the dividend (or capital gains at disposal of the shares) would have been tax exempt if the entity holding the shares had been a Swedish company, the dividend is exempt from withholding tax.

Exemption also applies to dividends distributed to a foreign contractual fund. In addition, certain funds are exempted from withholding tax when the funds are within (i) the E.E.A. or (ii) a country with which Sweden has in effect a comprehensive income tax treaty or a tax information exchange agreement.

## **ii. 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 Paragraph C.iii below for the treaty chart).

## **iii. 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:<sup>272</sup>

Albania	Czech Republic	Kazakhstan	Saudi Arabia
Argentina	Denmark	Kenya	Serbia
Armenia	Egypt	Kosovo	Singapore
Australia	Estonia	Latvia	Slovakia
Austria	Faeroe Is.	Lithuania	Slovenia
Azerbaijan	Finland	Luxembourg	South Africa
Bangladesh	France	Macedonia	South Korea
Barbados	Gambia	Malaysia	Spain
Belarus	Georgia	Malta	Sri Lanka
Belgium	Germany	Mauritius	Switzerland
Bermuda	Greece	Mexico	Taiwan
Bolivia	Guernsey	Montenegro	Tanzania
Bosnia & Herzegovina	Hungary	Namibia	Thailand
Botswana	Iceland	Netherlands	Trinidad & Tobago
Brazil	India	New Zealand	Tunisia
B.V.I.	Indonesia	Nigeria	Turkey
Bulgaria	Ireland	Norway	Ukraine
Canada	Isle of Man	Pakistan	U.K.
Cayman Is.	Israel	Philippines	U.S.A.
Chile	Italy	Poland	Venezuela
China	Jamaica	Portugal	Vietnam
Croatia	Japan	Romania	Zambia
Cyprus	Jersey	Russia	Zimbabwe

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The treaty concluded between Sweden and the former Kingdom of Yugoslavia remains applicable to the present-day republics of Bosnia & Herzegovina, Croatia, Kosovo, Montenegro, Slovenia, and Serbia.

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

**D. Financing**

**i. Loan Financing**

As a rule, interest payments are deductible. However, Sweden has general interest deduction limitation rules based on the Anti-Tax Avoidance Directive (“A.T.A.D.”) and B.E.P.S. Action Item 4. Under the general limitation rule, deduction is limited to net interest expense corresponding to 30% of the company’s E.B.I.T.D.A. The general limitation applies to all debt.

In addition, a deduction is not allowed to a Swedish borrower for interest on intra-group debt unless the creditor within the group (i) is taxed on the interest income at a rate of at least 10% or (ii) is domiciled within the E.E.A. or within a country with which Sweden has a tax treaty in effect. Regardless, a deduction may be refused if the debt structure has been put in place mainly for the group to achieve a substantial tax benefit.

Interest may not be deducted on hybrid mismatch lending transactions. The rules apply to interest payable to a foreign company with which the Swedish company has a community of interest, and where the foreign company is not taxed on the interest income due to a difference in legal classification of the payment.

Sweden does not impose withholding tax on interest payments.

From a transfer pricing perspective, the interest rates charged must be at arm’s length. Interest rates charged between related parties may be – and most often are – challenged by the Swedish Tax Agency (“S.T.A.”).

**ii. 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.

#### **E. Liquidation**

##### **i. Distributions**

Under the I.T.A., the liquidation of a company is deemed a taxable disposal of the shares issued by the liquidated company. Thus, 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 Paragraph C above, withholding tax will in most cases be eliminated or imposed at a reduced rate.

## ii. Losses

Final losses on the liquidation of foreign subsidiaries give rise to a special group deduction (“*koncernavdrag*”). The deduction is a result of Sweden becoming an E.U. Member State. However, it applies in very restricted circumstances. For a deduction to be claimed, all of the following conditions must be met:

- The foreign subsidiary must be located within the E.E.A.
- The foreign subsidiary must be liquidated.
- Until the liquidation is completed, the foreign subsidiary must have been wholly-owned either during the entire fiscal year of both the parent and the subsidiary, or since it started conducting business of any kind.
- The deduction of the group contribution must be made in connection with the tax assessment of the fiscal year during which the liquidation is completed.
- The deduction of the group contribution must be openly disclosed in the tax assessment of the parent company.
- None of the companies within the parent company’s community of interests may conduct business in the domicile state of the subsidiary after the completion of the liquidation.

A loss is considered final only if the subsidiary, or another entity in the domicile state of the subsidiary, has not utilized the loss and will not be able to utilize it in the future. If the loss is not utilized because the law of the domicile state does not provide for such a possibility or because such a possibility is limited in time, the loss will not be considered final.

There are also limitations to the amount that may be deducted. The deduction may not exceed the loss of the foreign subsidiary at the end of the last complete fiscal year before the end of the liquidation or before the liquidation. The deduction may not exceed the positive result of the parent company before the deduction. When

calculating the result of the parent company, any group contribution received from the subsidiary after it became wholly-owned is disregarded if such a contribution has caused or increased the loss in the subsidiary.

#### **F. Net Operating Losses**

The taxable result of a business is calculated as the difference between gross taxable income and allowed deductions. Net operating losses (“N.O.L.’s”) can be utilized by means of a carryforward. Excess N.O.L.’s are forwarded to the next fiscal year and used as a deduction when calculating the taxable result of the business. N.O.L.’s from previous years may be carried forward indefinitely.

If a company acquires a controlling interest in a company with N.O.L.’s from previous years, certain restrictions apply regarding the use of those N.O.L.’s. First, the N.O.L. deduction is capped at 200% of the acquisition price. Second, the Swedish practice of moving losses within a group through group contributions, *i.e.*, value transfers that are deductible for the payer and income for the recipient, are not allowed until the sixth year following the year in which the loss company was acquired. These restrictions do not apply to group internal restructurings.

The above applies only to N.O.L.’s incurred during past fiscal years. N.O.L.’s incurred during the current fiscal year – the year of acquisition – are not subject to any restriction.

#### **G. 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 Paragraph **Error! Reference source not found..**

#### **H. 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 (11.77% at current Swedish tax rates). To be subject to C.F.C. taxation, the controlling entity must own or control shares representing at least 25% of the capital or votes of the foreign corporation alone or together with persons with which a communal interest exists.

There are two exceptions to the C.F.C. rules:

- The first exception is that, regardless of the level of taxation, a foreign legal entity will not be considered to be a C.F.C. if it is resident for tax purposes in a country mentioned on the so-called “white list” of countries. If Sweden has concluded a double tax treaty with a white listed country, the exception from the C.F.C. rules applies only to income that falls within the scope of the treaty.
- The second exception is that the C.F.C. rules does not apply to a corporation that is resident for tax purposes within the E.E.A. and is deemed to be a “real establishment” from which a commercially motivated business is conducted.

#### I. **B.E.P.S.**

Sweden has slowly taken an increased interest in combatting B.E.P.S. and in the development of the B.E.P.S. Project at the level of the O.E.C.D.

Until recently, the B.E.P.S. Project has primarily had only an indirect effect in Sweden. This has begun to change as the Swedish government implemented major changes in 2019 to the I.T.A. concerning corporate income tax (see Paragraph D.i above).

Beyond the B.E.P.S.-related legislation, it is clear that the S.T.A. is learning from the analysis and comments made by different parties, and 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<sup>273</sup>

### A. 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

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<sup>273</sup> This portion of the article was written by Nikolaj Bjørnholm of Bjørnholm Law in Copenhagen.

- 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 Paragraph F 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 (earnings-stripping rules), in particular, international tax planning strategies involving U.S.-Danish check-the-box structures, and in general, hybrid entities and loans
- To prevent the use of Denmark as an intermediary to reduce withholding tax in other countries, Denmark applies its internal exemption from withholding tax and instead applies a higher treaty rate if (i) the outbound dividend

distributed by the Danish company stems from dividends received from lower-tier foreign affiliates, (ii) the shareholder of the Danish company is not entitled to the E.U. Parent-Subsidiary Directive (“P.S.D.”), and (iii) the Danish company is not the beneficial owner of the dividends it received (known as a “conduit situation”) (See Paragraph I below)

- A broadly worded general anti-abuse rule (principal purpose test (“PPT”)) the application in practice of which is still subject to considerable uncertainty.

#### **B. 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 Paragraph K 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 taxes may be reduced (but not increased) under a relevant double tax treaty. No local income taxes are levied by cities or regions on companies or branches in Denmark.

#### **C. Withholding Tax in Foreign Subsidiary’s Country**

Dividends paid by a foreign subsidiary to a Danish holding company may be subject to withholding tax, which may be eliminated or reduced pursuant to the P.S.D. or a tax treaty concluded by Denmark and the foreign subsidiary country.

As of April 30, 2019, Denmark has income tax treaties in effect with the following jurisdictions:

Argentina	Armenia	Australia	Austria
Azerbaijan	Bangladesh	Belarus	Belgium
Bermuda	B.E.S. Is.	Brazil	B.V.I.
Bulgaria	Canada	Cayman Is.	Chile
China	Croatia	Curaçao	Cyprus
Czech Republic	Egypt	Estonia	Faeroe Is.
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	U.K.	U.S.A.	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 Is.	Costa Rica

Dominica	Gibraltar	Grenada	Guatemala
Liberia	Liechtenstein	Macao	Marshall Is.
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, and it was ratified by Denmark on 28 March 2019.

#### **D. 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 generally treated as a corporation if it is subject to the P.S.D. If for some reason the P.S.D. is inapplicable, the entity will be characterized under the four-pronged standard that generally applies.

#### E. **C.F.C. Taxation**

Danish tax law contains controlled financial company (“C.F.C.”)<sup>274</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.

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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.

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

- The Danish company and the foreign subsidiary are group-related (see Paragraph L below). Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary's voting rights.
- The C.F.C. income 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>275</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

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<sup>275</sup> Consequently, dividends and capital gains that benefit from the Danish participation exemption are not considered to be tainted income.

- 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 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.

A bill to amend the Danish CFC tax regime in accordance with the EU Anti Tax-Avoidance Directive (the "ATAD") has been proposed to the Danish parliament on 3 October 2018, but it has not

yet been passed. An amendment to the Danish CFC regime is, however, expected to be adopted during the course of 2019 and effective as of 1 January 2019.

#### **F. 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>276</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 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 Paragraph G.i.

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.

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<sup>276</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.

## **G. 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.

### **i. Thin Capitalization**

Denmark has enacted thin capitalization rules regarding intercompany debt, which may limit the deductibility of interest on debt owed to group-related entities ("Controlled Debt"). These thin capitalization restrictions apply only to the extent that the Danish company has Controlled Debt exceeding a *de minimis* threshold of DKK 10,000,000 (approximately €1,340,000 as of April 30, 2019). 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.

## **ii. 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 Paragraph G.i)
- A limitation based on the tax value of assets (“Asset Limitation Rule”), entailing that net financing expenses exceeding DKK 21,300,000 (approximately €2,855,200 as of April 30, 2019) are deductible up to a cap

of 2.7% (2019 figure) of the tax basis of the Danish operating assets

- A limitation based on annual profits (“E.B.I.T.D.A. Limitation Rule”), entailing a maximum interest deduction of 30% of E.B.I.T.D.A., which only applies if the excess debt funding costs exceed DKK 22,313,400 (approximately €2,991,100 as of April 30, 2019)

**iii. Calculation of Net Financial Expenses and Excess Debt Funding Costs**

For the purposes of the Asset Limitation Rule, net financial expenses are calculated as the sum of

- 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.

For the purpose of the E.B.I.T.D.A. Limitation Rule, Excess debt funding costs include

- 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);

Interest expense and interest income, which are disregarded under the thin capitalization rules, are also disregarded when computing the net financial expenses and the excess debt funding costs. The calculation of net financial expenses and excess debt funding costs is made on a group basis for Danish companies, which are subject to Danish tax consolidation. If the Danish company/group has net financial expenses exceeding the DKK 21,300,000 threshold (or as regards excess debt funding costs; DKK 22,313,400), such net financial expenses will be subject to restrictions under the Asset Limitation Rule and/or the E.B.I.T.D.A. Limitation Rule, as applicable, as discussed below.

#### **iv. 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 2.7% (2019) of the tax value of certain assets.

For the purposes of computing the 2.7% 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 2.7% ceiling. For companies subject to Danish tax consolidation, the computation of the 2.7% 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.

**v. Restrictions Under the E.B.I.T.D.A. Limitation Rule**

In addition to the limitations triggered by the thin capitalization rules and the Asset Limitation Rule, a company's or a group's excess debt funding costs must not exceed more than 30% of earnings before interest, tax, depreciations and amortizations ("E.B.I.T.D.A.").

Excess debt funding costs below DKK 22,313,400 will never be restricted under the E.B.I.T.D.A. Limitation Rule, but may be restricted under the Asset Limitation Rule or the thin capitalization rules as set out above. The DKK 22,313,400 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, excess debt funding costs that are restricted by the E.B.I.T.D.A. LimitationRule may be carried forward.

Further, a modification to the 30% restriction applies if the Danish company/group which is otherwise restricted from making deductions under the rule forms part of a group and the consolidated net financing expenses of the group as divided by the consolidated E.B.I.T.D.A. of the group is higher than 30%. In such case a corresponding higher percentage applies to determine the deductibility restriction under the E.B.I.T.D.A. Limitation Rule. Both the consolidated E.B.I.T.D.A. and the net financing expenses must be determined on the basis of an audited annual report which is prepared in accordance with the Danish Financial Statements Act (“årsregnskabsloven”)

#### **H. Withholding Tax on Outbound Dividends**

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the 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. Further, if a tax information exchange treaty has been entered into with the residence jurisdiction of the shareholder, Denmark refunds withholding tax down to an effective rate of 15%.

#### **I. Tightening of the Rules for Dividend Withholding Tax Exemption**

In recent years, the Danish tax authorities have sought to narrow the scope of the withholding tax exemption by limiting the benefit to corporate shareholders that qualify as “beneficial owners” of dividends. Now, the Danish Parliament has introduced an anti-avoidance provision under which the dividend withholding tax exemption will not apply where the Danish company acts as a

conduit from one foreign corporation to another. The provision is applicable when the dividend distributed by a Danish company to its foreign corporate shareholder constitutes an “on-payment” of dividends received from a foreign subsidiary. In that set of circumstances, the Danish company does not qualify as the beneficial owner of the dividend from the foreign subsidiary and the dividend paid to the foreign shareholder will not be exempt from tax, but will be subject to tax at the applicable treaty rate.

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

The provision is not applicable if the corporate shareholder of the Danish company is entitled to the benefits of the P.S.D. The new provision will therefore only affect corporate shareholders that do not qualify under the P.S.D. or that are resident in jurisdictions outside the EU that have a tax treaty with Denmark, such as the U.S.

#### **J. 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 Paragraph L 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 related 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 related 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 Paragraph E above. As described, Denmark has implemented detailed C.F.C. rules, which are generally wide in scope.

With respect to Action Item 4 on limiting base erosion via interest deductions, see Paragraph G 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 Paragraph K below, which outlines the contents of the Danish general anti-abuse clause. As the abuse rule were only recently adopted, the scope of their implementation and application is not yet clear.

With respect to Action Items 8, 9, and 10, see Paragraph M 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.

#### **K. General Anti-Abuse Clause**

Since 2015 Denmark has had in effect two general anti-abuse rules ("G.A.A.R.'s"): one is an E.U. tax directive G.A.A.R. and the other is a tax treaty G.A.A.R.

The E.U. tax directive G.A.A.R. applies to cross-border transactions that fall within the P.S.D. (2011/96/E.C.), the Interest and Royalty Directive (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.

As of 1 January 2019. The EU tax directive G.A.A.R. was replaced by a broader general anti-abuse rule which implements G.A.A.R. set out in the ATAD, and which applies to both domestic and cross-border arrangements.

The G.A.A.R.s entail that taxable persons will not benefit from Danish domestic tax rules, 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 relevant tax rules, 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 both the bill introducing the initial E.U. tax directive G.A.A.R. and the tax treaty G.A.A.R. as well as the most recent ATAD G.A.A.R. are quite vague and general in nature, and fail to specify in which situations the G.A.A.R.’s are applicable.

The G.A.A.R.’s raise serious uncertainty with respect to international tax planning, as it is unclear to what extent the Danish tax authorities can and will try to deny the benefit of Danish domestic rules, the E.U. tax directives and double tax treaties to taxable persons seeking to reduce tax liability.

It is expected that Danish tax authorities will issue further guidance on how the G.A.A.R.’s are to be applied in practice. Until then, great uncertainty remains.

As a potential “safety measure” to protect the tax payers against random application of the G.A.A.R.’s in any given situation, the most recent 2019 amendment to the G.A.A.R. explicitly require that prior to applying any G.A.A.R. in any given situation, the Danish

tax authorities must submit for approval any proposed amendment to the relevant tax assessment based on applying the G.A.A.R., to the Danish tax council (“Skatterådet”), which is a semi-independent administrative decision body within the Danish tax administration. However, it remains to be seen to which extent the Danish tax council will ultimately act as a true gate keeper to advance legal certainty.

**L. 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 Paragraph E 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 Paragraph G).
- 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.

#### M. **Transfer Pricing**

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

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

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

Small- and medium-sized companies are relieved of the obligation to prepare documentation. These businesses are only required to prepare documentation for transactions with related companies resident outside the E.U., and only if Denmark does not have a double tax treaty with the country in question. Small- and medium-sized companies include companies which, on a consolidated basis, have (i) less than 250 full time employees during a year, and (ii) either assets below DKK 125,000,000 (approximately €16,756,000 as of April 30, 2019) or turnover below DKK 250,000,000 (approximately €33,512,100 as of April 30, 2019).

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.

#### **N. 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 8,385,000 (2019 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.

#### **O. Interim Dividends**

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

#### **P. Binding Advance Ruling**

Binding rulings, including advance rulings, on the Danish tax treatment of specific proposed transactions can be obtained from the Danish Tax Authority. A fee (currently approximately €50 as of April 30, 2019) is charged for a binding ruling. Persons not subject to Danish tax liability are also entitled to ask for binding rulings. Binding rulings are generally issued within one to three months but may be issued much later for complex issues. Binding rulings can be appealed to either the National Tax Tribunal or to a tax appeal

committee, whose decisions can be appealed to the City Courts and the High Courts.

The binding ruling will be binding for the tax authorities for a period of five years. However, it is possible for the tax authorities to shorten the period if required by the circumstances. The ruling is binding to the extent that (i) the facts presented by the taxpayer upon submission of the request for the ruling do not differ from the actual facts of the transaction, (ii) tax relevant tax rules remain unchanged and (iii) the ruling is not deemed to be in conflict with applicable EU law.

## AUSTRIA<sup>277</sup>

### A. In General

Austria does not have a specific regime applicable only to holding companies. Rather, a holding company is taxed in the same way as any other company. Nevertheless, many features of its tax system make Austria a jurisdiction worth considering for international holding companies:

- An international participation exemption exists for dividends received from foreign subsidiaries and capital gains arising from the disposition of their shares.
- A group taxation system exists that also allows cross-border loss relief.
- No thin capitalization legislation rules exist.
- Full deductibility is provided for interest expense arising from debt incurred in connection with the acquisition of subsidiaries, subject to certain limitations.
- An extensive network of tax treaties exists, amounting to nearly 90 comprehensive treaties in force and effect.
- No withholding tax is due on interest paid to nonresidents
- No withholding tax is due on capital repayments made to nonresidents.
- The possibility to make use of the E.U. Parent-Subsidiary Directive (“P.S.D.”), the E.U. Merger Directive, and the E.U. Interest and Royalties Directive (“I.R.D.”) exists.

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<sup>277</sup> This portion of the article was written by Niklas Schmidt of Wolf Theiss in Vienna.

- The possibility of obtaining tax rulings on certain issues exists.

## **B. Capitalization of Austrian Companies**

### **i. Equity**

No taxes or stamp duties are levied on equity provided to Austrian companies.

### **ii. Debt**

No taxes or stamp duties are levied on debt provided to Austrian companies.

### **iii. Thin Capitalization**

Austria does not have a statutory thin capitalization rule. Loan arrangements between an Austrian company and its shareholders or affiliates are generally recognized for tax purposes, provided that the terms of the loan meet the conditions of an arm's length test (so that a third party would grant a similar loan in light of the financial situation of the company). If not, the loan capital would qualify as equity with the result that interest paid on the loan cannot be deducted as a business expense. Instead, interest payments would be treated as hidden distributions to the shareholder, triggering a withholding tax of 27.5%. In practice, debt/equity ratios of 4:1 are not uncommon.

## **C. Corporate Income Taxation**

### **i. Resident Companies**

A company is resident in Austria for tax purposes if it has its legal seat and/or its effective place of management in Austria. The legal seat of a corporation is the place defined as such by law, by contractual agreement, or in its articles of association. The place of effective management of a corporation is the place where all the measures are taken that are required and essential for the management of the corporation. Resident companies are taxable on their worldwide income, including capital gains, at a flat tax rate of

25%. Apart from corporate income tax, no other taxes or surcharges are levied on a corporation's income.

The tax base is generally the profit shown in the financial statements. Adjustments have to be made where mandatory tax provisions deviate from financial accounting rules. Profits are generally taxed on an accrual basis.

Expenses incurred in acquiring, securing, and maintaining taxable income are tax deductible. However, the following types of expenses are partly or fully non-deductible: (i) restaurant expenses, (ii) penalties and fines, (iii) income taxes, (iv) remunerations paid to supervisory board members, (v) remunerations paid to employees and managers exceeding €500,000 per person per year, and (vi) expenses in connection with earning tax-exempt income.

In general, interest – including interest incurred in connection with the acquisition of an Austrian or non-Austrian participation – may be fully deducted from a corporation's tax base. Two restrictions regarding deductibility apply. First, financing costs incurred in connection with the acquisition of shares that were directly or indirectly purchased from a group company or from a controlling shareholder are not deductible. Second, no deduction is possible for interest paid to a corporation if the payer and recipient are, directly or indirectly, part of the same group, or have, directly or indirectly, the same controlling shareholder, and at the level of the recipient or the beneficial owner, if different, the interest paid is: (i) not subject to corporate income tax owing to a comprehensive personal or material tax exemption, (ii) subject to corporate income tax at a rate of less than 10%, (iii) subject to an effective tax rate of less than 10% owing to an applicable reduction, or (iv) subject to a tax rate of less than 10% owing to a tax refund (here, tax refunds to the shareholder are also relevant). The latter provision also applies to royalties.

Assets subject to wear and tear are in general depreciated on a straight-line basis over their ordinary useful life. If in the tax year of purchase or construction an asset is used for more than six months, the full yearly depreciation deduction may be claimed. Otherwise, only half of the yearly depreciation deduction may be claimed for the year in which the asset is put into use. Depreciation

for extraordinary technical or economic loss in value is possible. For certain assets the statute mentions the depreciation rates to be used, namely buildings (generally 2.5% per annum), goodwill (6.67% per annum), and automobiles (12.5% per annum). Assets having an acquisition cost of no more than €400 can be fully depreciated in the year of purchase.

Only the following reserve provisions are deductible on a current basis: (i) provisions for severance payments, (ii) provisions for pension payments, (iii) provisions for other contingent liabilities, and (iv) provisions for anticipated losses from pending transactions.

Tax losses may be carried forward from past years to reduce the current year's corporate income tax base. The carry-forward that may be claimed in any year is limited to 75% of the income of that year. No time limit applies after which the loss cannot be further deducted. A carry-back of losses is not permitted. A corporation's tax loss carry-forwards are forfeited upon an ownership change if there is additionally a material change in its organizational (*e.g.*, replacement of all directors of the corporation), economic (*e.g.*, a new area of business is pursued by the corporation) and shareholder structure (*e.g.*, the majority of shareholders of the corporation are replaced).

Irrespective of taxable income, a minimum tax is levied. It amounts to €1,750 per annum for limited liability companies and to €3,500 per annum for stock companies (a special minimum tax of €5,452 applies to banks and insurance companies). During the first ten years after incorporation of a limited liability company, a reduced minimum tax applies. It is €500 for the first five years and €1,000 for the following five years. Minimum tax payments made can be offset against future corporate income tax assessed without any limitations.

As a special incentive, companies conducting qualified research and development activities may claim a credit (over and above the full deduction of the expense) equal to 14% of eligible expenses.

The tax year is generally the calendar year. Corporations may apply to the tax authorities for permission to use a different tax year if reasons other than tax considerations exist for such application. In

most cases, corporate income tax returns must be filed electronically by June 30 of the year following the tax year. Taxpayers being represented by tax advisers benefit from longer deadlines. An extension of the filing date is possible in justified cases. Failure to file generally triggers a penalty. Quarterly prepayments of corporate income tax are due on February 15, May 15, August 15, and November 15. Such prepayments are applied to the final amount of tax assessed. Any balance is payable within one month after receipt of the tax assessment notice.

**ii. Nonresident Companies**

A nonresident company is a company having its legal seat and 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 or a permanent representative in Austria. Income and capital gains from Austrian real estate are also taxable as business profits of the nonresident company, even if the real estate is not attributable to an Austrian permanent establishment. A nonresident company is further taxable on certain other items of income from Austrian sources, in particular, dividends from Austrian companies or royalties stemming from intellectual property registered in an Austrian register.

**iii. National Participation Exemption**

Under the national participation exemption, dividends which a resident company receives through a (direct or indirect) participation in an Austrian subsidiary are exempt from Austrian corporate income tax, regardless of the extent of the participation and regardless of the length of time during which the participation in the subsidiary has been held by the parent.

**iv. International Qualified Participation Exemption**

Under the international qualified participation exemption, dividends which an Austrian company receives through a (direct or indirect) participation in a foreign subsidiary (being an E.U. company listed in Article 2 of the P.S.D. or an entity comparable to an Austrian corporation) are exempt from Austrian corporate income tax, if the

parent has a participation of at least 10% of the stated share capital of the subsidiary which has been held for a minimum duration of one year. The exemption is not applicable if the payment received is deductible abroad.

Note that the international qualified participation exemption also applies to capital gains and capital losses realized on the disposal or writing-off to the lower fair market value of shares (*i.e.* capital gains are not taxable and capital losses are not tax deductible). However, capital losses resulting from the liquidation or insolvency of a non-Austrian subsidiary remain tax deductible to the extent they exceed the amount of any tax-exempt dividends received during the last five business years. Alternatively, instead of tax neutrality, the parent company may opt for treating capital gains and capital losses as tax effective. In such cases, capital gains are taxable, while capital losses are tax deductible (the deductible loss has to be spread over a period of seven years; no deductibility for capital losses that were directly caused by the prior distribution of profits). Such option may be exercised separately for each participation in the corporate income tax return filed for the year in which the participation is acquired. Once the option has been exercised it cannot be withdrawn.

#### **v. International Portfolio Participation Exemption**

Under the international portfolio participation exemption, dividends which an Austrian company receives through (direct or indirect) participation in a foreign subsidiary (being an E.U. company listed in Article 2 of the P.S.D. or an entity that is comparable to an Austrian corporation and that is resident in a state with which Austria has an agreement for the comprehensive exchange of information) are exempt from Austrian corporate income tax, if the international qualified participation exemption does not apply. The exemption is not applicable if the payment received is deductible abroad.

**vi. Controlled Foreign Corporation (“C.F.C.”) Rules**

**a. Prerequisites**

Under the Austrian C.F.C. rules, passive income of a foreign low-taxed subsidiary shall under certain circumstances be included in the tax base of the controlling corporation.

Passive income encompasses the following types of income:

- Interest or any other income generated by financial assets
- Royalties or any other income generated from intellectual property
- Dividends and income from the disposal of shares, insofar as these would be taxable at the level of the controlling corporation
- Income from financial leasing
- Income from insurance, banking and other financial activities
- Income from invoicing companies that earn sales and services income from goods and services purchased from, and sold to, associated enterprises and that add no or little economic value

A foreign company is low-taxed if its effective foreign tax rate is no more than 12.5%. In order to determine the effective foreign tax rate, the foreign company's income is to be calculated in line with Austrian tax provisions and contrasted to the foreign tax actually paid.

The C.F.C. rules apply if the following facts are present:

- The passive income of the C.F.C. exceeds a third of its total income. For this purpose, the income is to be calculated in line with Austrian tax provisions, except that tax-exempt

dividends and capital gains are taken into account when calculating the total income of the foreign corporation.

- The controlling corporation – alone or together with its associated enterprises – holds a direct or indirect participation of more than 50% of the voting rights or owns directly or indirectly more than 50% of the capital or is entitled to receive more than 50% of the profits of the foreign corporation.
- The foreign corporation does not carry out a substantive economic activity supported by staff, equipment, assets and premises. For this purpose, the burden of proof is on the controlling corporation.

The C.F.C. rules are not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

For purposes of the C.F.C. rules, an associated enterprise exists if: (i) the controlling corporation holds directly or indirectly a participation in terms of voting rights or capital ownership of at least 25% in an entity or is entitled to receive at least 25% of the profits of that entity or (ii) a legal person or individual or group of persons directly or indirectly holds a participation in terms of voting rights or capital ownership of at least 25% or is entitled to receive at least 25% of the profits of the corporation. If a legal person or individual or group of persons holds directly or indirectly a participation of at least 25% in the corporation and one or more other entities, all the entities are regarded as associated enterprises.

The C.F.C. rules also apply to Austrian corporations having their place of management outside of Austria and to foreign permanent establishments, even if an applicable double tax treaty provides for a tax exemption in Austria.

#### **b. Consequences**

When the C.F.C. provisions apply to a foreign corporation, the amount of the C.F.C.'s passive income that is included in the tax

base of the controlling corporation is calculated in proportion to the direct or indirect participation in the nominal capital of the C.F.C. If the profit entitlement deviates from the participation in the nominal capital, then the profit entitlement ratio is decisive. The passive income of the C.F.C. is included in that financial year of the controlling corporation in which the C.F.C.'s financial year ends. Losses of the controlled foreign company are not to be included.

In order to prevent double taxation, the following rules apply:

- A C.F.C.'s passive income is not included in the tax base of a controlling corporation that holds only an indirect participation in the C.F.C. in case such passive income is already included in the tax base of an Austrian controlling corporation holding a direct participation in the controlled foreign company.
- If the controlling corporation disposes of its participation in the C.F.C., any capital gains are tax exempt insofar as these have previously been included in the controlling corporation's tax base.
- When including the C.F.C.'s passive income in the controlling corporation's tax base, a foreign tax credit is allowed for (i) the corporate income tax imposed on the C.F.C. with regard to its passive income and (ii) the corporate income tax imposed on the C.F.C. in connection with the passive income of a lower-tier subsidiary. Foreign tax credits are allowed upon the making of an application to the Austrian tax authorities.
- If the foreign tax to be credited exceeds the controlling corporation's Austrian corporate income tax, tax credits can upon application also be claimed in the following years.

**vii. Switch-Over Rule**

The so-called switch-over rule applies to the following types of participations if the predominant focus of a low-taxed foreign corporation is on earning passive income: (i) participations falling under the international qualified participation exemption and (ii)

participations of at least 5% falling under the international portfolio participation exemption.

Where applicable, the switch-over rule eliminates the exemptions for dividends and capital gains. Instead, the income is taxable, and a foreign tax credit is given for the underlying taxes of the foreign subsidiary. The switch-over rule does not apply if passive income has been taken into account under the C.F.C. provision mentioned above. Also, it is not applicable to foreign financial institutions if not more than one third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

#### **viii. Group Taxation**

##### **a. Prerequisites**

Austrian tax law allows group taxation for affiliated companies. Affiliated companies are those that are connected through direct or indirect participation of more than 50% of the nominal capital and voting rights. This participation must exist throughout the entire fiscal year of the member of the tax group. The conclusion of a profit and loss transfer agreement is not necessary for the purpose of setting up a tax group. Whether the companies in a group earn active or passive income is irrelevant. Thus, pure holding companies are not precluded from participating in a tax group.

The top-tier company in a tax group may be (i) a resident company, (ii) a nonresident company (being either an E.U. company listed in Article 2 of the P.S.D. or an E.E.A. company comparable to an Austrian corporation) having a permanent establishment in Austria registered in the commercial register with the required participations being attributable to such permanent establishment, or (iii) a consortium consisting of two or more companies as specified above (whether structured on a company law basis or on a purely contractual basis), provided that one consortium partner has a participation of at least 40% and each of the other consortium partners has a participation of at least 15%.

Members of a tax group may be: (i) resident companies and (ii) nonresident companies that are legally comparable to an Austrian

corporation, have their seat in another E.U. Member State or a state with which Austria has an agreement for the comprehensive exchange of information and are being exclusively held by resident members of the tax group or the top-tier company of the tax group.

A tax group is not formed automatically. Rather, an application must be submitted to the tax authorities by the group parent. The application must be executed by the management boards of (i) the group parent and (ii) all Austrian group members. The tax authorities have to render a binding decision on whether the prerequisites necessary for establishing a tax group have been fulfilled. Further, it should be noted that a tax group must have a minimum duration of three years.

In addition, the application must contain a declaration stating that an agreement has been concluded between the affiliated companies regarding the compensation of group members for corporate income taxes paid or not paid as a result of establishing the tax group (it is, however, not necessary to set out the details of such agreement in the application). The application must disclose the respective voting and the participation rights held as well as the financial years of all the companies that wish to participate in the group.

#### **b. Consequences**

The setting up of a tax group results in 100% of the taxable income of each member of the group being attributed to the top-tier company in the tax group. The income of the various group members is calculated on a company-by-company basis and then attributed to the group parent company. Thus, in contrast to a consolidation, income resulting from intra-group transactions is not eliminated for the purpose of calculating group income. The setting up of a tax group in no way affects the profits of the companies involved under financial accounting rules.

The fiscal year for all members of the group need not align. Rather, the fiscal years of all members that end in or with the fiscal year of the group parent are reported by the group parent in the manner described above.

In the case of a tax group formed by a consortium, 100% of the taxable income of each member of the group is attributed to the consortium partners on a *pro rata* basis.

When nonresident companies are members of a tax group, only losses of such companies are attributed (on a *pro rata* basis) to the top-tier company. Thus, the losses of non-Austrian subsidiaries can be utilized in Austria even though, under general principles, their profits are taxable only in the respective foreign countries. The losses of nonresident group members must be computed in accordance with Austrian tax rules. Nonetheless, these losses cannot exceed the amount calculated pursuant to tax rules in the country of residence of the foreign member.

The aggregate losses of nonresident companies are subject to a ceiling that is similar to the rule for the carry forward of losses. The ceiling is 75% of the income of the top-tier Austrian company in a tax group and the Austrian-resident members.

Losses will be recaptured in Austria (*i.e.* the losses that were previously deducted will increase the group's taxable income) to the extent the non-Austrian subsidiary utilizes the losses abroad or drops out of the tax group other than as a result of a liquidation or insolvency.

Group member tax loss carry-forwards resulting from taxable years ending before the tax group was established and tax loss carry-forwards assumed by group members pursuant to a restructuring can be applied only against profits generated by the respective group member. On the other hand, tax loss carry-forwards of the top-tier company in a tax group can be applied against such company's own profits and also against the profits of group members.

No deductions are allowed for impairments in value of participations in companies that are part of a tax group.

#### **ix. Transfer Pricing**

Pursuant to the case law of the Austrian Supreme Administrative Court, agreements between related parties (such as a parent company and its subsidiary) are recognized for tax purposes only

when (i) the agreements have been concluded in writing, (ii) their content is unambiguous, and (iii) they have been concluded in accordance with the arm's-length principle (*i.e.*, on terms that would be agreed by unrelated parties). The Austrian tax authorities follow the O.E.C.D. Transfer Pricing Guidelines in this respect.

Pursuant to the Austrian Transfer Pricing Documentation Act, multinational groups with consolidated group revenues of at least €750 million in the preceding fiscal year are required to prepare a country-by-country report, which Austria will automatically exchange with other countries. Additionally, a separate business unit (that is tax-resident in Austria and reports revenues of at least €50 million in the two preceding fiscal years) of a multinational group must prepare transfer pricing documentation in the form of a master file and a local file.

#### **D. Withholding Tax on Outbound Payments**

##### **i. 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, no. 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 direct investment dividends. In some

cases, withholding tax may be eliminated entirely. Austria has nearly 90 income tax treaties currently in effect, including those contained in the following table:

Albania	Estonia	Luxembourg	Serbia
Algeria	Finland	Macedonia	Singapore
Armenia	France	Malaysia	Slovakia
Australia	Georgia	Malta	Slovenia
Azerbaijan	Germany	Mexico	South Africa
Bahrain	Greece	Moldova	South Korea
Barbados	Hong Kong	Mongolia	Spain
Belarus	Hungary	Montenegro	Sweden
Belgium	Iceland	Morocco	Switzerland
Belize	India	Nepal	Taiwan
Bosnia & Herzegovina	Indonesia	Netherlands	Tajikistan
Brazil	Iran	New Zealand	Thailand
Bulgaria	Ireland	Norway	Tunisia
Canada	Israel	Pakistan	Turkey
Chile	Italy	Philippines	Turkmenistan
China	Japan	Poland	Ukraine
Croatia	Kazakhstan	Portugal	U.A.E.
Cuba	Kuwait	Qatar	U.K.
Cyprus	Kyrgyzstan	Romania	U.S.
Czech Republic	Latvia	Russia	Uzbekistan
Denmark	Liechtenstein	San Marino	Venezuela
Egypt	Lithuania	Saudi Arabia	Vietnam

## ii. Repayment of Capital

In contrast to dividends from profits, the repayment of capital – whether resulting from a formal capital reduction or from the distribution of capital reserves – does not trigger withholding tax under Austrian domestic law. Such repayment of capital reduces

the tax basis of the shares. This may become relevant in the case of a later sale of the shares as the capital gain will be increased because of the reduction in basis. Austrian companies must keep a capital account for tax purposes to document the amount distributable as a repayment of capital.

### **iii. Capital Gains**

A nonresident shareholder is generally subject to taxation on the disposition of shares in an Austrian company if the shareholder has held 1% or more of the share capital at any point in time during the preceding five calendar years. If the participation does not exceed this threshold, capital gains are not taxable. For corporate shareholders, corporate income tax is levied at the regular rate of 25%. The tax is levied by way of assessment rather than by way of withholding.

However, Austria follows the O.E.C.D. Model Convention and generally has ceded its right to tax capital gains from the disposal of shares to the country of residence of the shareholder in most of its tax treaties. Only in case of “property-rich” companies does Austria retain its right to tax.<sup>278</sup>

### **iv. Royalties**

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%. Expenses do not reduce the tax base, thereby resulting in gross basis taxation. If the recipient of the royalties is resident in an E.U. or E.E.A. Member State, expenses directly connected to the royalty income may be deducted from the withholding tax base, resulting in net basis taxation. In this case, the withholding tax rate is increased to 25%.

No withholding tax applies within the scope of the I.R.D. Austria exempts intra-group royalty payments from withholding tax if (a) the payor is (i) a resident company or (ii) a permanent establishment of a company that is resident in another Member State and (b) the beneficial owner of the royalties is (i) an associated company that is

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<sup>278</sup> O.E.C.D., Model Tax Convention on Income and on Capital, paragraph 5 of article 13.

resident in another Member State or (ii) a permanent establishment situated in another Member State of an associated company that is resident in another Member State.

For purposes of applying these provisions, a company is an associated company of a second company if: (i) the first company has a direct minimum holding of 25% in the capital of the second company, (ii) the second company has a direct minimum holding of 25% in the capital of the first company, or (iii) a third company has a direct minimum holding of 25% both in the capital of the first company and in the capital of the second company.

The I.R.D. treatment is supplemented by the royalty provisions of Austria's income tax treaties. Under most tax treaties, the withholding tax is reduced or eliminated.

**v. Interest**

Interest payments on loans (not on bonds) to nonresident corporations are not subject to Austrian withholding tax.

**vi. Other Income**

A 20% withholding tax is levied on: (i) remunerations in connection with an occupation as an author, lecturer, artist, architect, sportsperson, or performer in Austria, (ii) payments for a right of use regarding works protected by copyrights or industrial property rights, (iii) supervisory board remunerations, and (iv) payments for commercial or technical consulting work. However, in many of these cases Austria would waive its taxing rights under provisions of various tax treaties.

**E. Other Tax Issues**

**i. 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.

**ii. Value Added Tax**

Austria levies value added tax in line with the pertinent E.U. directives at a standard rate of 20%. Reduced rates of 10% and 13% apply to certain supplies. A number of exemptions are applicable. Examples include financial services and health services for which no V.A.T. is imposed.

**iii. Real Estate Transfer Tax**

The transfer of Austrian real estate triggers real estate transfer tax. In the case of a sale of Austrian real estate the tax base is generally the purchase price, and the tax rate amounts to 3.5%. In addition, a 1.1% court registration fee is assessed, based on the fair market value of the property transferred.

Further, real estate transfer tax at a rate of 0.5% of the fair market value of the real estate is triggered if Austrian real estate is part of the assets of a corporation or a partnership, and at least 95% of the shares in the corporation or the interests in the partnership are pooled in the hand of a single buyer or in the hand of a tax group. The same applies in the case of a partnership holding Austrian real estate if at least 95% of the interests in the partnership are transferred to new partners within a period of five years.

**iv. Stamp Duty**

Austria levies stamp duties on a wide range of legal transactions, including: (i) assignment agreements, (ii) lease agreements, and (iii) surety agreements, if a written deed evidencing such stamp-dutiable transaction is signed and a certain Austrian nexus exists. However, these stamp duties can in many cases be avoided by way of careful structuring.

**v. Tax Rulings**

A legally binding formal tax ruling procedure exists in connection with questions concerning restructurings, tax groups, international tax law, value added taxation (as of January 1, 2020) and the existence of abuse of law. If certain formal prerequisites are met, the competent tax office must issue a tax ruling, generally within a

period of two months from application. This ruling must contain the facts and statutory provisions on which it is based, a legal evaluation of the facts, and the time frame during which it is valid. In addition, the applicant may be required to report on whether the facts of the case have been implemented and also on whether the implemented facts are different from those outlined in the request. A fee of between €1,500 and €20,000, depending on the applicant's annual turnover, is due in conjunction with any such request.

**vi. The General Anti-Avoidance Rule (“G.A.A.R.”)**

Taxpayers are free to arrange their economic affairs in the manner they deem most beneficial, which includes choosing those structures and approaches that incur the least tax cost. Nevertheless, Austrian law contains a G.A.A.R. provision that restricts overly aggressive tax planning. Pursuant to this provision, the tax liability cannot be avoided by abusing legal forms and methods available under civil law. If such an abuse has been established, the tax authorities may compute the tax as it would have been had a genuine legal arrangement been carried out.

Abuse is defined as a legal arrangement (consisting of one or multiple steps) or a series of legal arrangements that are not genuine in light of the commercial objective. Arrangements are not genuine when they do not make sense except for the tax-saving effect, because the main purpose or one of the main purposes is to obtain a tax advantage that defeats the object or purpose of the applicable tax law. In principle, no abuse exists if valid commercial reasons exist that reflect economic reality.

**vii. Foreign Tax Credit**

Pursuant to a decree issued by the Austrian Ministry of Finance, certain items of foreign-source income are exempt from Austrian taxation, including: (i) income from immovable property located in a foreign state, (ii) business income attributable to a foreign permanent establishment, and (iii) income derived from building sites or construction or installation projects. The decree applies if the following requirements are met:

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

The credit method applies to all foreign-source income that is neither exempt from taxation according to the foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to the part of the Austrian tax that is attributable to income from sources within the relevant foreign country. No “basket” rules exist for the foreign tax credit.

Where a tax treaty applies the credit method to foreign-source income, but does not cover local taxes, such local taxes may then be credited against Austrian tax under Austrian domestic law.

Application of the exemption method or the credit method pursuant to the decree requires the taxpayer to maintain proper documentation listing: (i) the foreign jurisdiction, (ii) the type of income, (iii) the amount of income, (iv) the average foreign tax rate, (v) the amount of creditable tax where the credit method applies, and (vi) the time period concerned.

## FRANCE<sup>279</sup>

### A. 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:

- For fiscal years opened 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%.
- For fiscal years opened 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%.
- For fiscal years opened in 2020, a single rate of 28% will apply.
- For fiscal years opened in 2021, a single rate of 26.5% will apply.
- For fiscal years opened 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>280</sup> This “exceptional” tax applied only

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<sup>279</sup> This portion of the article was written by Michel Collet of CMS-Francis Lefebvre Avocats in Paris.

<sup>280</sup> This applies to turnover on a stand-alone basis and/or aggregate turnover of tax-consolidated entities.

to fiscal years closed between December 31, 2017, and December 30, 2018.

**B. Net Operating Losses**

**i. 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.

**ii. 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.

**C. 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>281</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 Paragraph D).

Pursuant to several decisions of the Constitutional court, it is now clear that preferential shares with no or reduced voting rights are eligible.<sup>282</sup>

The exemption applies from the first day of the Qualifying Shareholding, provided that the shares are held for two years. Failure to maintain the shares for two years will result in a claw-back of the exemption. 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.

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

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<sup>281</sup> In accordance with recent French case law, Article 145 1-b of the French Tax Code (“F.T.C.”) has been amended to include both full ownership and bare ownership as qualifying for the 5% capital threshold.

<sup>282</sup> Cons. Const., February 3, 2016, no. 2015-520, QPC; Cons. Const., July 8, 2016, no. 2016-553 QPC.

disallowed amount is deemed to be the costs for management of the shareholding. N.O.L.'s can be offset 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>283</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 Paragraph E below) are not eligible for the D.R.D., except where the corporate shareholder justifies that its holding reflects a valid commercial purpose and is not driven by tax fraud.

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>284</sup>

Since January 1, 2019, dividends distributed by subsidiaries located in a Member State of the European Union or European Economic Area (E.E.A)<sup>285</sup> to a French company and eligible to the D.R.D. with a 99% exemption if (i) the French company is not in position to opt for a French tax consolidation (see Paragraph D below), and (ii) the

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<sup>283</sup> French Administrative Doctrine, BOI-RPPM-RCM-30-30-20-50, September 12, 2012.

<sup>284</sup> Council Directive 2014/86/E.U. amending Directive 2011/96/E.U. on the Common System of Taxation Applicable in the case of Parent Companies and Subsidiaries of Different Member States, 2014 O.J. L 219/40.

<sup>285</sup> Norway, Iceland, and Liechtenstein

distributing companies meet all the conditions to file a consolidated tax return in France as if they were established in France.

Until January 1, 2019, the D.R.D regime provided for a special anti-abuse provision, described below. This specific provision has been repealed and replaced by a general C.I.T. principal purpose test (“P.P.T.”) general anti-abuse rule (“G.A.A.R.,” see Paragraph I.iv). Since both provisions are inspired from the European standards and very similarly drafted, the comments below should remain applicable under the new P.P.T. G.A.A.R.

In addition, the D.R.D. does not apply to dividends received when the ownership structure has not been structured 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 pure holding companies. 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 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 contractually all its voting and financial rights on the stock.

This development allows the use of a *fiducie* for leveraged buyouts (“L.B.O.’s”) or debt restructuring and proves more flexible and less burdensome than the so-called “double Luxco structure,” which is not exempt from tax or legal challenges.<sup>286</sup>

#### D. 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>287</sup>), at least 95% of the capital and voting rights of other French companies or branches of foreign companies.

The following conditions must be met in order to file a consolidated tax return:

- All members of the tax-consolidated group are subject to French C.I.T. and have the same financial year.
- Another French company that is subject to C.I.T. does not hold 95% or more of the consolidating company, either directly or indirectly.<sup>288</sup>
- The parent company satisfies the 95% minimum holding, directly or indirectly, throughout the entire financial year.
- Adequate tax group elections have been filed in a timely manner.<sup>289</sup>

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<sup>286</sup> Amending Finance Law for 2014, no. 2014-1655 of December 29, 2014.

<sup>287</sup> Or companies situated in Norway, Iceland, or Liechtenstein.

<sup>288</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>289</sup> The filing deadline matches the deadline for filing C.I.T. annual returns.

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.

Several decisions of the European Court of Justice ("E.C.J.") have targeted the French tax consolidation regime as going beyond the mere consolidation of results. Consequently, the Finance Act for 2019 has repealed the tax neutralization of several transactions occurring within the tax consolidation:

- Debt waivers
- Subsidies
- Transfer of substantial shareholdings eligible to the participation-exemption regime (see Paragraph H)

These transactions are now treated as if they were realized on a standalone basis and trigger the recognition of income (*i.e.*, no longer neutralized).

Distributions made within the tax consolidation are tax exempt up to 99% of their amount, provided they are paid after the first consolidated fiscal year. This exemption also applies to dividends received from subsidiaries in the E.U. or E.E.A. that would have been qualified to file a consolidated return had they been located in France for tax purposes.

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>290</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>291</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>292</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>293</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.

#### **E. Non-Cooperative States and Territories**

Since 2010, a specific French tax legislation tackles French companies entering into transactions with non-cooperative jurisdictions, referred to as non-cooperative states or territories ("N.C.S.T.'s"). This legislation was revised by the Finance Act for 2019, enacted in December 2018.

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<sup>290</sup> Interest expense disallowed under the Charasse Amendment are determined using the following formula: (interest expense of all tax group members)  $\times$  (acquisition price  $\div$  average indebtedness of all tax group members).

<sup>291</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>292</sup> *SCA Group Holding and Others*, Joined Cases C-39-41/13, [2014] ECLI:EU:C:2014:1758.

<sup>293</sup> Companies held in Norway, Iceland, or Liechtenstein are also eligible.

Under this new version, the N.C.S.T.'s are defined (i) by reference to the French appreciation of the exchange of information, and (ii) by reference to the E.U. list of non-cooperative jurisdictions for tax purposes adopted by the Council of the E.U. conclusions on December 5, 2017.

For the needs of the French list, a country or territory is defined as an N.C.S.T. if it meets the following criteria:

- It is not a Member State of the E.U.
- It has been reviewed and monitored by the O.E.C.D. global forum on transparency and exchange of information.
- It has not concluded 12 or more Tax Information and Exchange Agreements ("T.I.E.A.'s").
- It has not signed a T.I.E.A. with France.

The N.C.S.T. list may be updated annually, but as of May 2019, the list published on June 15, 2016, has not been changed. Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue, and Panama are N.C.S.T.'s.

For the purposes of the E.U. list, reference is made to decisions of the Council of the E.U. Jurisdictions on the E.U. list are treated differently according to the rationale behind their rostering:

- Jurisdictions that facilitate offshore structures and arrangements aimed at attracting profits without real economic substance may receive extensive French anti-abuse treatment
- Jurisdictions that do not meet at least one of the criteria on tax transparency, fair taxation, and implementation of anti-B.E.P.S. measures may receive only limited French anti-abuse treatment (so-called "grey list")

On March 12, 2019, the Council of the E.U. revised the initial E.U. list of non-cooperative jurisdictions and added ten new jurisdictions.

These jurisdictions may be removed from the list in the future if they make significant efforts to meet E.U. tax standards.

The French tax consequences for transactions with N.C.S.T.'s are effective as from the first day of the third month following the publication of a specific governmental order. As of the last day of May 2019, no development concerning the ten new jurisdictions on the E.U. list has been taken.

The Finance Act for 2019 also introduced several safe harbors shielding transactions with an entity or an account located in an N.C.S.T. that are not mainly intended to attracting profits to an N.C.S.T.

Where one of these countries is involved, French tax law provides for a significantly increased tax rate, tightened anti-abuse of law provisions, or exclusion from favorable tax regimes.

#### **F. 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 canceled<sup>294</sup> within one year by the issuing company).

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<sup>294</sup> Through a share buyback program not aimed at purging losses of the company (under §§L225-207 of the Commercial Code).

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.

In 2016, the Constitutional Council determined that the exemption from the 3% surtax 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 revised to apply 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 Paragraph D above). The F.T.A. has begun to issue refunds.

Finally, the French government decided to repeal the tax effective January 1, 2018, in the Finance Amendment Bill for 2018 issued on

September 27, 2017, just a few days before the French Constitutional Court issued its ruling.

#### **G. 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 Paragraph G.ii below). However, dividend payments made to N.C.S.T.'s other than those on the grey list 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 in its own jurisdiction, subject to a 5% ownership test (the “5% E.U. Exemption”). In both cases, a two-year holding requirement applies.

Under certain conditions, withholding tax is not due when distributions are paid to collective investment funds established in the E.U. or in a country with which France has signed a convention on administrative assistance (which is the case with a large number of countries).

##### **i. Outbound Dividends Within the E.U.**

###### **a. 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. or E.E.A. Member State.
- The shareholder corporation is incorporated under one of the legal forms listed as an appendix to the E.U. Directive 2011/96/E.U. dated November 30, 2011.

- The shareholder corporation is the beneficial owner of the dividends distributed.
- The shareholder corporation is subject to C.I.T. in its E.U. or E.E.A. Member State of establishment, without option and exemption.
- The shareholder corporation holds directly 10% or more of the capital of the distributing company.<sup>295</sup>

The dividend may be paid to an E.U. or E.E.A. permanent establishment of an eligible shareholder corporation.

To comply with the provisions of the P.S.D., the exemption has been amended to reflect the E.U.-inspired anti-abuse provision already introduced for the French D.R.D. (see Paragraph C 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.

This anti-abuse provision is not modified by the introduction of a new P.P.T. G.A.A.R. for C.I.T. purposes, which does not cover the withholding taxes (see Paragraph I.iv).

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As previously mentioned, the shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.

### **b. 5% E.U. Exemption**

The 5% E.U. Exemption that was provided for in the F.T.A. guidelines<sup>296</sup> published in the wake of the E.C.J. *Denkavit* decision<sup>297</sup> has entered into law.

The following requirements must be met:

- The shareholder enjoys an exemption regime in its own country of residence. This is to say that the recipient shareholder is not able to credit the French withholding tax against its own tax.
- The shareholder is a resident of the E.U. or of Liechtenstein, Norway, or Iceland,<sup>298</sup> provided that the recipient shareholder's country of residence has entered into a qualifying tax treaty with France.
- The parties have not entered into an "artificial arrangement" for tax avoidance.
- The stock (i) constitutes 5% of the capital and voting rights of the distributing company, (ii) is in registered shares or be kept by a financial establishment, and (iii) is held for at least two years.

When the above requirements are met, the French withholding tax exemption automatically applies. In other words, if the qualifying shareholder is not taxed on the French-source dividends, as it is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or greater interest in the French distributing company. If the dividend is taxed in the jurisdiction of residence of the E.U. shareholder, the dividend may still be paid

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<sup>296</sup> French Administrative Doctrine, BOI-RPPM-RCM-30-30-20-40, April 1, 2015.

<sup>297</sup> *Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, Case C-170/05, [2006] ECLI:EU:C:2006:783.

<sup>298</sup> As members of the E.E.A.

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.

## **ii. 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). 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>299</sup> Consequently, distributions that are treated as dividends under tax law may not be covered by the dividend provision but, instead 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 the last day of May 2019, France has over 120 tax treaties currently in force, including the jurisdictions listed below:

Albania	Ethiopia	Macedonia	Saudi Arabia
Algeria	Finland	Madagascar	Senegal
Andorra	French Polynesia	Malawi	Serbia
Argentina	Gabon	Malaysia	Singapore
Armenia	Georgia	Mali	Slovakia
Australia	Germany	Malta	Slovenia
Austria	Greece	Mauritania	South Africa
Azerbaijan	Ghana	Mauritius	South Korea
Bahrain	Guinea	Mexico	Spain

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<sup>299</sup> CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 no. 1587.

Bangladesh	Hong Kong	Moldova	Sri Lanka
Belarus	Hungary	Monaco	St. Martin
Belgium	Iceland	Mongolia	St. Pierre & Miquelon
Benin	India	Montenegro	Sweden
Bolivia	Indonesia	Morocco	Switzerland
Bosnia & Herzegovina	Iran	Namibia	Syria
Botswana	Ireland	Netherlands	Taiwan
Brazil	Israel	New Caledonia	Thailand
Bulgaria	Italy	New Zealand	Togo
Burkina Faso	Ivory Coast	Niger	Trinidad & Tobago
Cameroon	Jamaica	Nigeria	Tunisia
Canada	Japan	Norway	Turkey
C.A.R.	Jordan	Oman	Turkmenistan
Chile	Kazakhstan	Pakistan	Ukraine
China	Kenya	Panama	U.A.E.
Congo (Rep.)	Kosovo	Philippines	U.K.
Croatia	Kuwait	Poland	U.S.A.
Cyprus	Latvia	Portugal	Uzbekistan
Czech Republic	Lebanon	Qatar	Venezuela
Ecuador	Libya	Québec	Vietnam
Egypt	Lithuania	Romania	Zambia
Estonia	Luxembourg	Russia	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.

#### H. 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 relief (“C.G.T.”). 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, meaning shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. They must give control of, or significant influence over, the company to the shareholder.

These tests are deemed satisfied if the shareholder holds a 10% or greater interest. Stock eligible for the D.R.D. (5% interest) and stock received within the course of a public offering are also eligible. Shareholdings in N.C.S.T.-resident entities cannot qualify.

If for a given year the capital losses on substantial shareholdings fully offset the capital gains on substantial shareholdings, no tax is due on the capital gains realized. However, in presence of a net capital gain on substantial shareholding, 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>300</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>301</sup> Disposal of shares of non-listed real estate holding companies are subject to the standard C.I.T. rate.

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<sup>300</sup> Based on a 33.33% standard C.I.T. rate increased by the 3.3% surcharge mentioned under Paragraph A above.

<sup>301</sup> This consists of the 19% tax rate increased by the 3.3% surcharge mentioned under Paragraph A above.

Capital gains resulting from the disposal of interests in venture capital funds or companies (“F.C.P.R.” or “S.C.R.”) that are held for at least five years are eligible for the C.G.T. exemption, but only in proportion to the investments made by the company and funds in qualifying substantial participations; otherwise, a 15% reduced C.I.T. rate applies (*i.e.*, a 15.45% effective tax rate).

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.

Capital gains realized on the transfer of French shares by foreign companies are taxable in France if the seller holds at a stake of at least 25% of the transferred company at some point in the five years preceding the transfer. If the applicable double tax treaty does not provide otherwise, such gain is taxable at normal C.I.T. rate.

However, companies having their place of effective management in an E.U. Member State, or a Member State of the E.E.A., may benefit from the C.G.T. exemption, provided that the French company is not a real estate company (see above).

Capital gains realized by foreign seller on transfer of shares in French real estate companies are taxable in France at normal C.I.T., subject to the application of a double tax treaty.

Capital gains realized by a seller located in a N.C.S.T. are subject to 75% tax, no matter the size of the stake maintained in the French company, subject to the application of a double tax treaty.

## **I. Other Tax Items**

### **i. 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 Paragraph F above) and C.G.T. relief (see Paragraph G above). This is, however, subject to several interest deductibility limitations.

Also, a specific anti-debt push-down mechanism restricts the deductibility of interest within tax consolidated groups (See the Charasse Amendment discussed in Paragraph D above).

**a. Interest Rate Test**

Only interest paid at an arm's length rate can be considered tax deductible.

Interest expense arising from debt issued to shareholders 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.*, 1.34% for the Q1 2019). Interest expenses exceeding this limit are deductible only to the extent that the company establishes that they are arm's length.

Interest expense arising from debt issued to affiliates other than shareholders is deductible only to the extent that they are arm's length.

Excess interest paid to affiliates is treated as a distribution eligible for benefits under the D.R.D. withholding tax (pursuant to the terms of specific tax treaties) may apply if the lender is a foreign resident. Some tax treaties do not encompass deemed distributions and therefore deny France the right to tax a deemed distribution (*e.g.*, the Netherlands).

**b. Anti-Hybrid Test**

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 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>302</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 and losses that reduce the taxable result of the foreign company are disregarded for this test. The same applies to foreign tax consolidation regimes. The guidelines do not provide for a case in which the recipient entity is itself indebted and serves a debt.

Success with the anti-hybrid test does not disallow the application of the French general anti-avoidance rules.

### **c. The General Interest Limitation Regime**

Interest expenses passing the tests above must go through the new rules limiting the deductibility of financial expenses developed hereinafter.

These rules are applicable under French tax law as from January 1, 2019, and are derived from the E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”). See Paragraph I.ix below for additional discussion on the A.T.A.D.

Former French thin capitalization and interest barrier rules (*i.e.*, the “*rabot*”) have been repealed and replaced by a new general limitation mechanism, pursuant to which deductible net financial expenses of a company (absent any tax group) are capped to the higher of:

- 30% of the company’s adjusted tax E.B.I.T.D.A., or
- €3 million

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<sup>302</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).

Non-deductible net financial expenses may be carried forward with no time limit. Unused deduction capacity may also be carried forward for five years.

Additionally, where the equity-to-assets ratio of the company is equal or superior to the equity-to-assets ratio of the accounting consolidated group to which the company belongs, 75% of the net financial expenses exceeding the 30% or €3 million thresholds may still be deducted.

The company's ratio is deemed to be equal to the accounting group's ratio if the difference between these two ratios does not exceed 2%. French law provides that this safe harbor will be applicable to companies consolidated in a global integration, under I.F.R.S. or French consolidation principles. Companies consolidated under U.S. G.A.A.P. currently fall outside the scope of this safe harbor although we may expect the French tax authorities to extend the scope of the safe harbor to U.S. G.A.A.P. when commenting on the new provisions, as they did for the repealed Carrez rules and the thin capitalization rules.

As an exception, special rules may apply if the company is thinly capitalized, *i.e.*, if its debt-to-equity ratio exceeds 1.5:1 (considering intragroup debt only, excluding any third-party debt irrespective of guarantees granted), unless this ratio is not higher than the debt-to-equity ratio of the accounting consolidation group to which the company belongs. The deduction thresholds are reduced to €1 million or 10% of the adjusted taxable profits with respect to interest expense relating to excessive indebtedness. The portion of the disallowed interest charge pursuant to the 10% or €1 million reduced limitation may be carried forward, but only 1/3 of the nondeductible amount may be carried forward. Additionally, thinly capitalized companies may not carry forward their unused deduction capacity.

Disallowed interest expenses under these limitations are not considered for the purpose of the calculation of the portion of non-deductible financial expenses under the general limitation.

Similar regimes apply to both individual entities (§212-*bis* of the F.T.C.) and French tax consolidated groups (§223 B-*bis* of the F.T.C.).

**d. M&A Context Limitation**

The Finance Act for 2019 also repealed the former limitation aiming at interest charges incurred by French investment vehicles in connection with the acquisition of substantial shareholdings in a French subsidiary. This provision limited the deductibility of interest charges unless the acquiring company evidenced its involvement within the management and strategy of the target company.

**e. 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. On the other hand, interest paid to N.C.S.T's are subject to 75% withholding tax in France, unless an income tax treaty provides for a lower rate.

Moving beyond domestic law, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments made by a French company. For example, French income tax treaties with Germany, Austria, the U.K., Ireland, and Sweden provide for zero withholding tax on interest.

**f. Interest on Loans**

For loans contracted on or after March 1, 2010, no withholding tax applies to interest paid by a French company to a nonresident company. This exemption does not apply to interest paid to an N.C.S.T. Instead, a 75% withholding tax is still applicable where the interest is paid on an account held in an N.C.S.T. which is not on the grey list (see Paragraph C above), unless the debtor justifies that the operations that gave rise to the interest do not principally aim at or result in shifting profits to the N.C.S.T.

For loans contracted before March 1, 2010, interest can be paid free of withholding tax in several circumstances:

- The initial lender is a nonresident individual or legal entity is established outside of France.
- The loan is documented by an agreement executed before the loan proceeds are transferred to the French company.
- The loan agreement sets forth the principal, the date of repayment, the interest rate, and any additional remuneration to the lender.

The subsequent sale or assignment of the receivable should not jeopardize the application of the exemption.

#### **g. 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*).

#### **h. 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 Paragraph G.i.a 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.

**ii. Controlled Foreign Corporation (“C.F.C.”) Legislation**

Section 209 B is the French counterpart to Subpart F of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d’Etat*, struck down §209 B as discriminatory under the French-Swiss Tax Treaty.<sup>303</sup> The *Conseil* found that §209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the income tax treaty applicable between France and Switzerland at that time. In addition, §209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The French C.F.C. rules were revised.

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<sup>303</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.

The law changed effective January 1, 2006. The C.F.C. rules apply both to permanent establishments outside France 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>304</sup> In the case of related enterprises, the 5% test applies even if the related enterprise is not established in France.

The new provisions do not replace the current anti-abuse provision, pursuant to which an interest held by “sister entities” (whether French or foreign) is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is effectively subject to C.I.T. at a rate lower than 50% of the French C.I.T. that a French company would have paid on the same income. This threshold will be reduced to 40% as of January 1, 2020.

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

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<sup>304</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.

*Cadbury Schweppes*.<sup>305</sup> In the *Cadbury Schweppes* case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in economic activity in the host country with the required substance and that the subjective intent of the establishment (*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 either case, the French taxpayer must demonstrate that the use of the foreign entity or enterprise does not primarily result in moving profits to a low-tax jurisdiction.

As of March 1, 2010, C.F.C.’s established in an N.C.S.T. do not benefit from the trade and business exclusion unless the taxpayer can justify the substance of the business carried out and comply with the 20% and 50% ratios.

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

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<sup>305</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).

would be treated as “deemed distributions.” The F.T.A. contend any conflict with tax treaties is 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. Also, taxes paid by the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company as credits to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

### **iii. New Industrial Property (“I.P.”) Box Regime**

Further to the O.E.C.D. B.E.P.S. Action 5 Report, France has amended its I.P. box regime.

The former French I.P. box regime consisted in a distinct taxation of I.P. income at a reduced rate of 15%. This regime did not reflect the nexus approach and the benefit of the reduced rate was not connected to the location of R&D expenditures in France. Therefore, the O.E.C.D. considered that this regime was not in line with the nexus approach.

As a result, France adopted the nexus approach which is intended to condition the I.P. box regime in a given jurisdiction to R&D activity resulting in expenditures in the same jurisdiction.

Moreover, the eligible net R&D income (after deduction of R&D expenditures) is taxable at a specific rate set at 10%.

The new regime has been introduced by the Finance Act for 2019 and is codified in §238 of the F.T.C. This regime is optional and applies to tax years beginning on or after January 1, 2019. Election is made for each asset, good or service or family of goods or services in the tax return for the financial year in respect of which it is exercised. Furthermore, election must be renewed each financial year, under penalty of definitive forfeiture. It applies to standalone entities and French tax consolidated groups.

**a. Eligible Intangible Assets**

The new regime applies to transactions involving I.P. assets – such as patents, utility certificates and supplementary protection certificates attached to a patent, software protected by copyright, industrial manufacturing process resulting from research operations, and non-patents assets whose patentability has been certified by the National Institute of Industrial Property (“N.I.I.P.”) – provided they have the character of fixed intangible assets.

**b. Application of the Nexus Approach**

According to §238 of the F.T.C., the qualifying I.P. income must be determined in three stages.

**1) Stage 1: Determination of the Net Profit**

The net profit is the gross incomes derived from the licensing, sub-licensing or transfer of an intangible asset for the financial year minus R&D expenditures directly linked to this asset, incurred directly or indirectly by the taxpayer during the same period.

**2) Stage 2: Determination of the Nexus Ratio**

The nexus ratio is calculated for each financial year and takes into account the expenditures incurred by the taxpayer for that year and prior years for both the numerator and denominator.

Consequently, the determination of the nexus ratio requires monitoring all R&D expenditures relating to qualifying assets that have been the subject of the election for this preferential regime.

$$\text{Nexus ratio} = \frac{\text{Qualifying expenditures}}{\text{Overall expenditures}}$$

Qualifying expenditures are R&D expenditures directly related to the creation and development of the intangible asset carried out directly by the taxpayer himself or, wherever they are carried out, outsourced to related entities. These expenditures should include salaries, direct costs, patent acquisition and maintenance costs, overhead costs directly related to R&D facilities, and supply costs.

Interest payments, building costs, and acquisition costs must be excluded.

Qualifying expenditures of the nexus ratio are increased by 30%. The ratio is rounded up to the next whole number and may not exceed 100 %.

Overall expenditures are qualifying expenditures included in the numerator as well as outsourcing expenditures to related companies and acquisition costs, excluding ancillary costs. Interest payments and costs relating to land and buildings are excluded. For sub-licensing, royalties paid by the sub-licensor company are treated as acquisition costs and must be included in the denominator.

The 30% buffer does not apply to the qualifying expenditures included in the overall expenditures.

### **3) Stage 3: Application of the Nexus Ratio to The Net Profit**

In the final stage, net profits are multiplied by the nexus ratio.

#### **c. Safeguard Clause for Exceptional Circumstances**

As allowed by the O.E.C.D., France treats the nexus ratio as a rebuttable presumption. It enables taxpayers to prove that more income should be permitted to benefit from the regime in exceptional circumstances.

#### **d. Filing Obligations**

The company must attach an appendix to the tax return each year, detailing the calculations used to determine the eligible income and the nexus ratio.

The companies must keep, at the disposal of the tax authorities, documentation including a general description of the organization of the R&D activities as well as specific information concerning the determination of taxable income.

Failure to produce the required full documentation within 30 days of receipt of formal notice triggers the imposition of a 5% fine for each audited year. The basis of the fine is equal to the income derived from qualifying assets that have been the subject of such breach.

**iv. Abuse of Law, G.A.A.R., and P.P.T.**

Finance Act for 2019 has introduced several new general anti-abuse provisions in the French tax system. The reforms aims at introducing the principal purpose test in French G.A.A.R. without being in breach of the Constitution.

**a. Article L. 64 of the Code of Tax Procedures  
(“B.T.P.”) – Existing Exclusive Motivation Test**

Under the existing motivation test, the F.T.A. may disregard a transaction on the grounds that (i) it has a fictitious character or (ii) it aims at obtaining a formal application of legal provisions or decisions in violation of their purpose and is exclusively motivated by the objective of reducing the taxes which would normally have applied to the actual transaction. Penalties may be imposed that range from 40% for gross misconduct to 80% for tax fraud under §1729 of the F.T.C.

**b. Article L. 64 A of the B.T.P. – Main Abuse of Law**

The Finance Act for 2019 introduced a new abuse of law provision under L.64 A of the B.T.P. that will apply to tax reassessments issued from January 1, 2021, relating to transactions carried out as from January 1, 2020. Under the new provisions, the F.T.A. may disregard a transaction on the grounds that the transaction aims at obtaining a formal application of legal provisions or decisions in violation of their purpose and is mainly motivated by the objective of reducing taxes which would “normally” have applied to an “actual” transaction. The scope of the new provision is broader than the scope of existing law. As mentioned above, §L. 64 of the B.T.P. applies only when the tax savings are the exclusive reason for entering the transaction. The threshold for applying §L. 64 A of the B.T.P. is lower because tax savings need be only a main purposes. In addition, §L. 64 A of the B.T.P. applies to all taxes. Article L. 64

A of the B.T.P. does not provide for specific penalties. However, normal penalties of 40% willful wrongdoing under Article 1729, a) of the F.T.C. should apply.

**c. Article 205 A of the F.T.C. – General C.I.T. Anti-Abuse Provision**

To comply with Article 6 of the A.T.A.D., France introduced a G.A.A.R. by enacting §205 A of the F.T.C. It applies only to corporate income tax. This provision is effective for financial years beginning on or after January 1, 2019. However, transactions initiated before January 1, 2019, may be subject to this new rule if these transactions have tax consequences for financial years beginning on or after effective date.

Under this provision, the F.T.A. may disregard an arrangement or series of arrangements are not set up for sound commercial reasons reflecting economic reality. As a result, the main purpose of the arrangements is to obtain a tax advantage. With the enactment of G.A.A.R., the specific anti-abuse provision concerning the D.R.D. that is discussed above was repealed.

In order for G.A.A.R. to be applicable, tax advantages must be a main purposes of the transaction. A parliamentary report issued in connection with the enactment of G.A.A.R. indicates that the term must be interpreted in the light of the case law of the E.C.J. In addition, a private ruling procedure has been introduced to help companies with securing their transactions.

**d. Other Specific Anti-Abuse Provisions**

Specific anti-abuse provisions apply to the withholding taxes on outbound dividends (§119<sup>ter</sup> of the F.T.C.) and the favorable roll-over tax regime applicable to mergers (§210-A of the F.T.C.). They are derived from the A.T.A.D. and have the same wording as §205 A of the F.T.C.).

As of the last day of May 2019, the exact demarcation between all newly enacted anti-abuse rules has not been clarified. Guidelines of the F.T.A. are expected in the near term.. The F.T.A. seems to have discretion as to which standard should be applied in attacking

abusive arrangements, with a choice between using the exclusive or the main abuse-of-law provision. In both cases the F.T.A. must initiate a specific procedure.

**v. Fraud Act**<sup>306</sup>

The Fraud Act of October 23, 2018, gives significant tools to the F.T.A. in its fight against tax avoidance and tax fraud.

**a. Name and Shame**

The F.T.A. may publish information regarding tax penalties imposed on a company, as a result of a fraudulent arrangement or abusive transaction, when the amount equals or exceeds €50,000. Before information on the penalties can be published, the F.T.A. must obtain the approval of a special commission that is empowered to review tax offences (“*commission des infractions fiscales*”). If approval is given, the corporation is allowed a period of 60 days to lodge an appeal, which suspends publication. If no appeal is lodged, the name of the taxpayer and the amount of penalties imposed will be listed on the F.T.A. website. The publication lasts no more than one year. The F.T.A. must also publish any court decision in favor of the company if the assessment is successfully challenged in court.

**b. Tax Offenses and Criminal Prosecution**

The Fraud Act, which came into effect on October 24, 2018, introduced major changes in the criminal prosecution of tax offenses. Under prior law, the F.T.A. exercised discretion in choosing the cases to transfer to the public prosecutor. Now, the F.T.A. must report all tax cases to the public prosecutor involving reassessments exceeding €100,000 (€50,000 for certain taxpayers) and the assertion of the following civil penalties:

- 100% tax penalties imposed because the taxpayer took steps to prevent the tax audit

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<sup>306</sup> *Renforcer Les Moyens Alloués À La Lutte Contre La Fraude Fiscale, Sociale Et Douanière*, LOI no. 2018- 898, October 23, 2018.

- 80% tax penalties imposed because the taxpayer took steps to hide assets or income, committed tax fraud, followed a plan that amounted to an abuse of law, failed to declare assets located abroad, or secretly placed assets in a foreign trust
- 40% tax penalties imposed because the taxpayer failed to pay tax within 30 days of a notice, took action amounting to deliberate misconduct or abuse of law

The public prosecutor decides whether to pursue a criminal investigation.

The F.T.A. retains discretion to report matters that do not fall within the foregoing categories.

Upon approval by the *commission des infractions fiscales*, the F.T.A. may recommend cases to the public prosecutor for criminal prosecution. In these cases, a criminal complaint must be lodged within six years of the close of year in which the offense was committed. Once the criminal investigation begins, the discovery of new facts of tax fraud committed by the same taxpayer, including those related to other years or other taxes, may expand the scope of the investigation.

Conviction of the criminal offense of tax fraud may result in a penalty of up to €500,000 penalty and a prison term of up to five years. The penalty may increase to €3 million in cases involving complex frauds and organized frauds. The criminal penalties are applied in addition to civil tax penalties.

The Fraud Act provides that the penalty may be increased to twice the financial benefit derived by the defendant.

### **c. Advisors Disclosure and Penalties**

#### **1) Law on Reinforcement of The Fight Against Fraud**

The Fraud Act introduced a disclosure obligation for legal and accounting advisors involved in the design or implementation of

aggressive tax planning arrangements. Advisors who assist taxpayers with transactions that result in the 80% civil penalty may face their own penalty exposure. The amount of the fine is the greater of 50% of the advisor's fees or €10,000.

## **2) Directive 2018/822**

E.U. Directive 2018/822<sup>307</sup> ("D.A.C.6") 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. This Directive adopts broad definitions of both intermediaries and reportable cross-border arrangements.

An intermediary is anyone who designs, markets, organizes, makes available, or implements a reportable arrangement or anyone who helps with reportable activities and knows or could reasonably be expected to know the effect of their advice. The targets are lawyers, in-house counsel, underwriters, capital providers, insurance brokers, accountants, and financial advisors.

Reportable cross-border arrangements contain at least one of the hallmarks listed in D.A.C.6 as indicative of a potential risk of tax avoidance. If an intermediary is unable to submit a report due to a professional privilege recognized under law, the obligation to disclose falls on the taxpayer. Advisors must inform clients involved in a reportable transaction of their obligation to disclose.

Arrangements implemented between June 25, 2018, and July 1, 2020, must be reported by August 31, 2020. E.U. Member States must exchange information by October 31, 2020.

France has not transposed D.A.C.6 into its national law. The French government submitted a draft transposition order to the National Bar Council ("N.B.C."). It provides for the introduction of a double declaration, including one directly concerning lawyers. A first declaration would be made by the intermediary subject to professional privilege, who would reveal the objective and technical

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<sup>307</sup> Council Directive 2018/822/E.U. Amending Directive 2011/16/E.U. on the Mandatory Automatic Exchange of Information in the Field of Taxation, 2018 O.J. L 139/1.

information of the scheme without revealing the name of the client. A second declaration would be the responsibility of the taxpayer who would make a declaration on the basis of the file number previously assigned to the lawyer. This draft transposition remains under review as of the last day of May 2019. France must enact transposition legislation by the end of calendar year 2019, for entry into force on July 1, 2020.

**vi. Transfer Pricing**

The arm's length principle applies to transactions between related parties. France follows the O.E.C.D. guidelines.

Transfer pricing documentation is mandatory in France for taxpayers that fit into one of several categories:

- French companies with a gross annual turnover or gross assets equal to or exceeding €400 million
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €400 million threshold
- French parent companies that directly or indirectly own at least 50% of companies meeting the €400 million threshold
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €400 million threshold within the perimeter)

The documentation – 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, such as a description of its activities and transactions, including a presentation of the transfer pricing method used to test controlled transactions. The latter is known as the country-specific file. This documentation must be presented to the F.T.A. when the company is audited.

If the company fails to provide the documentation, a fine amounting to the greatest of €10,000, 5% of adjusted profits,<sup>308</sup> or 0.5% of the amount of the transactions may be imposed.

Entities described below must electronically file an annual simplified transfer pricing form within the six-month period following the filing of their tax return.

- French companies with a gross annual turnover or gross assets equal to or exceeding €50 million.
- French subsidiaries of a foreign-based group if more than 50% of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €50 million threshold.
- French parent companies that directly or indirectly own at least 50% of companies meeting the €50 million threshold.
- Worldwide-consolidated (without any financial threshold) or tax-consolidated French companies (with at least one tax-consolidated entity meeting the €50 million criteria within the perimeter).

Where transactions carried over from affiliated companies involve an amount below €100,000 per type of transaction, the company the simplified transfer pricing documentation is not required.

The law does not provide a specific penalty for the failure to file. Therefore, the general penalty of €150 per document provided by Article 1729 B of the F.T.C. should apply for each document that is not filed. In cases where some items are missing or inaccurate in a document, the penalty is equal to €15 per item with a minimum penalty of €60.

For companies not subject to the mandatory transfer pricing documentation, the F.T.A. may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company, and details

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The actual rate will depend on the behavior of the company.

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 is efficient and pragmatic.

Finally, in accordance with the O.E.C.D.'s B.E.P.S. Action Plan, the Finance Bill for 2016 introduced country-by-country ("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. The taxpayer must report the activities and places of activity of the entities in the group and information about profit splitting among these entities. The goal of CbC reporting is to provide tax authorities with an overview of the states where expenses, income, and profits are located, and are likely to support future reassessments.

According to Article 223-*quinquies* C of the F.T.C., CbC reporting is mandatory for to international groups that meet the turnover threshold and have either a French permanent establishment or a French subsidiary except 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.

The reporting obligations must be fulfilled within 12 months after the closure of the annual accounts. Failure to comply with the requirements will trigger the imposition of a penalty which cannot exceed €100,000 for each violation.

A European directive<sup>309</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

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<sup>309</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.

to include the automatic exchange of information on the CbC Report.

**vii. 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>310</sup>

Taxable transactions involve French-issued equity securities, as defined above, and securities that may give rise to equity rights. Examples are preferred stocks, convertible bonds, and any other bonds that may give rise to equity rights. 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. This covers American Depository Receipts. Acquisitions of option contracts and futures contracts are not taxable.

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 must be negotiable on a regulated market in France, the E.E.A., or on limited non-E.U. regulated markets, such as the Bourse Suisse and the 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

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<sup>310</sup> This could affect about 100 French companies.

competitiveness. The project is controversial, as the U.K. is a major opponent of the F.T.T. That may change when and if Brexit occurs.

#### **viii. Transfer Taxes**

Transfers of shares and assets may give rise to transfer tax.

Regarding the sale of shares, the following rates generally apply:

- A fixed tax rate of 0.1% applies to transfers of 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. Also, intra-group transactions can benefit from a transfer tax exemption.
- Transfers of units issued by French partnerships, the capital of which is not divided into shares of stock are subject to a fixed transfer tax rate of 3%. A relief equal to €23,000 divided by the total number of units issued by the entity is applied to the taxable value of each unit.
- Transfers of shares issued by French real estate holding companies – irrespective of their legal form – are subject to a 5% transfer tax.
- Transfers of shares issued by foreign-deemed-French real estate holding companies are also subject to a 5% transfer tax. In addition, the transfer should be documented and executed by and before a French notary, unless the documentation is executed in France by the parties or their representatives.

Regarding the sale of assets, the following rates generally apply:

- Transfers of real property assets located in France are subject to tax at a rate of 5.09% or 5.81%.<sup>311</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

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<sup>311</sup> The tax rate applicable depends from the location of the asset.

located in the Île-de-France region (and in some cases, such transfers may be subject to V.A.T. instead).

- A progressive tax rate applies for transfers of business as going-concerns (“*fonds de commerce*”) or goodwill: (i) 0% for the portion of the transfer price below €23,000, (ii) 3% for the portion between €23,000 and €200,000, and (iii) 5% for the portion exceeding €200,000.

**ix. B.E.P.S., A.T.A.D., and France**

**a. B.E.P.S.**

France is one of the founding members of the O.E.C.D. and is highly involved in the O.E.C.D.’s work relating to the B.E.P.S. Project. Soon after the publication of the O.E.C.D. report entitled “Addressing Base Erosion and Profit Shifting” in February 2013, the Parliament Commission of Finances released a report on the same topic, which reaffirmed the prevention of tax evasion and tax fraud as a priority for the French government and formally endorsed the B.E.P.S. Project. The French government actively encourages the E.U. to act on these issues.

A report relating to the taxation of the digital economy, ordered by the French Ministry of Economy and Finance, was published in January 2013. In a related press release, the French government stated its intention to take more decisive action in the G-20, the O.E.C.D., and the E.U., in order to adapt international tax rules to the reality of the digital economy and, in particular, to seek a more efficient definition of “permanent establishment.” The report especially raised the possibility of tax on the digital economy in relation to personal data.

In the context of the digital economy, the French government places high priority on (i) the elimination of inappropriate double nontaxation, (ii) the reinforcement and effectiveness of anti-avoidance rules, and (iii) addressing profit shifting issues. B.E.P.S. issues are regularly debated in commissions and assemblies of French Parliament, and several legal provisions have been introduced in recent finance bills. These include the following:

- The modification of the abuse-of-law provisions from an *exclusively* tax-driven test to a *principally* tax-driven test
- The amendment of the I.P. box regime to comply with the “nexus approach” preconized by the O.E.C.D.
- The limitation of the D.R.D. regime to exclude dividends that were deducted from the distributing company’s taxable income<sup>312</sup>, or when the ownership structure cannot be considered genuine because it is not justified by a valid commercial reason (see Paragraph C 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 Paragraph I.i)
- The annual CbC Reporting requirements for French companies controlling foreign entities or having permanent establishments overseas (see Paragraph I.v)

The French government is highly involved in the B.E.P.S. Project at the level of the O.E.C.D., as well as at the level of the E.U., and it is expected to be a pioneer in implementing new regulations that may be proposed to combat B.E.P.S. within either organization, or at a federal level.

Recent experience in tax examinations indicates that tax examiners take positions based on the current work of the O.E.C.D. regarding B.E.P.S., even if those positions are not compliant with current tax law. Such action gives rise to questions of potential double taxation unless a multilateral policy is adopted.

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<sup>312</sup> Transposition of Council Directive 2014/86/E.U. of July 8, 2014, *supra* note 284.

**b. A.T.A.D**

On July 12, 2016, the European Council adopted the A.T.A.D.<sup>313</sup> The scope and the measures of this Directive regarding hybrid mismatches were further enlarged by the A.T.A.D. 2 of May 29, 2017.<sup>314</sup>

The A.T.A.D. builds on the principle that tax should be paid where profits are made. It includes legally-binding measures to block the methods most commonly used by companies to avoid paying tax. It also proposes common definitions of terms such as permanent establishment, tax havens, transfer prices, royalty costs, patent boxes, and letterbox companies.

The main measures of the A.T.A.D. include the following actions:

- A general interest limitation rule restricting the tax deductibility of net borrowing costs to 20% of the taxpayer's E.B.I.T.D.A. Net borrowing costs consist of all deductible interest expense reduced by taxable interest incomes.
- An anti-hybrid rule denying deductions for an expense in the state of the beneficiary when the same expense is deductible in the source state.
- A "switch-over" clause that eliminates an exemption and substitutes a tax credit for low-taxed foreign incomes, defined as income taxed at a rate that is than 15%.
- An exit tax for the transfer of assets under certain conditions.

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<sup>313</sup> Council Directive 2016/1164/E.U. Laying Down Rules Against Tax Avoidance Practices that Directly Affect the Functioning of the Internal Market, 2016 O.J. L 193/1.

<sup>314</sup> Council Directive 2017/952/E.U. Amending Directive 2016/1164/E.U. As Regards Hybrid Mismatches with Third Countries, 2017 O.J. L 144/1.

- 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.

France transposed several A.T.A.D. provisions through the Finance Bill for 2019. Article 4 of the A.T.A.D. on interest limitation was transposed in §212-*bis* of the F.T.C. This transposition also repealed the *rabot* (25% haircut limitation), the Carrez Amendment, and the thin capitalization rules. In addition, Article 6 of the A.T.A.D. regarding G.A.A.R. was transposed in §205 A of the F.T.C.

E.U. Member States were required to conform domestic legislation with the A.T.A.D. provisions by December 31, 2018. France has implemented comparable but not totally similar anti-abuse provisions regarding, *inter alia*, C.F.C. rules and exit taxation. A transitional extension is granted to E.U. Member States that have already implemented targeted rules for preventing B.E.P.S., provided those rules are equally effective as the A.T.A.D. provisions. France has taken advantage of this relief.

Member States may continue to apply existing rules until the end of the first fiscal year following the date of publication of an agreement among O.E.C.D. Member States on the adoption of a minimum standard regarding B.E.P.S. Action 4. In all events, the transitional relief will terminate on January 1, 2024.

## ITALY<sup>315</sup>

### A. 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>316</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>317</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>318</sup>

Starting in fiscal year 2018, a new definition of holding company was introduced in the new Article 162-*bis* of I.T.C., introducing a distinction between financial holding companies and non-financial holding companies for I.R.E.S. and I.R.A.P. purposes.<sup>319</sup>

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<sup>315</sup> This portion of the article was written by Luca Rossi of Facchini Rossi Michelutti in Milan.

<sup>316</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>317</sup> Legislative Decree dated December 15, 1997, n. 446.

<sup>318</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>319</sup> The Article 162-*bis* of I.T.C. was introduced by Article 5 of Legislative Decree n. 142 of November 29, 2018, which implemented the Anti-Tax Avoidance Directive (E.U.)

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 Paragraph O below).

## **B. Dividend Exemption**

### **i. 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>320</sup> There are no minimum ownership or holding period requirements.

For companies adopting I.A.S./I.F.R.S. accounting principles, profits received from shares, or other financial assets qualifying as “held for trading” are fully taxable.<sup>321</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

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2016/1164, as modified by the Directive (E.U.) 2017/952 (hereinafter, the “A.T.A.D. Decree”).

<sup>320</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% ( $0.05 \times 0.24 = 0.012$ ).

<sup>321</sup> Article 89(2-*bis*) I.T.C.

Italian Civil Code and Italian generally accepted accounting principles (“G.A.A.P”), with few exceptions.<sup>322</sup>

## **ii. Foreign Dividends**

According to Article 89(3) I.T.C., the 95% exemption is also applicable to foreign-source dividends provided that the payment is not deductible by the payer in its country of residence. Nondeductibility must be stated by the foreign company in a declaration or must result from other objective evidence.

Dividends derived by Italian companies from subsidiaries resident in a country or territory characterized as having a privileged tax regime (a Blacklist jurisdiction, as defined) are fully taxable, unless income has been already taxed in the hands of the Italian recipient under the applicable controlled foreign corporation (“C.F.C.”) rules<sup>323</sup> or a favorable ruling is obtained from the Italian tax authorities.

According to Article 47-*bis*,<sup>324</sup> a foreign tax regime – other than a tax regime of an E.U. Member State or an E.E.A. Member State that has signed an agreement with Italy allowing the effective exchange of information – is deemed to be a Blacklist jurisdiction. In the case of a C.F.C (as defined in Paragraph H.iii below) is subject to an effective tax rate which is lower than 50% of the effective tax rate which would be applicable if the same entity was resident in Italy; or. A non-controlled entity is subject to a nominal income tax rate less than 50% of the applicable Italian tax rate, taking into account special tax regimes.

To receive a favorable ruling, the taxpayer must demonstrate that the purpose of the investment was not to obtain the benefits of a preferential tax regime. Otherwise, only 50% of the dividend is

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<sup>322</sup> See Article 83, I.T.C. as modified by Article 13-*bis*(2) of the Law Decree n. 244 of December 30, 2016.

<sup>323</sup> In this case, a foreign tax credit will be available for taxes paid on C.F.C. income.

<sup>324</sup> This Article was introduced by Article 5 of the A.T.A.D. Decree and it entered into force in 2018.

included in the taxable base of the receiving company, if the taxpayer proves that the distributing company carries on a substantial economic activity supported by staff, equipment, assets, and premises.<sup>325</sup> Effective 2015, the advance ruling is no longer mandatory, provided that abovementioned conditions can be proved during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, dividends from Blacklist-resident entities must be disclosed on the relevant tax return.<sup>326</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 Paragraph H.iii).

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.

### C. Participation Exemption for Gains

The I.T.C. provides for a 95% exemption regime for gains derived from the sale of shares of a subsidiary. According to 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.

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<sup>325</sup> In this case, a foreign tax credit is granted to the controlling company pursuant to 165 I.T.C. (see Paragraph L. below). See Article 89(3) I.T.C., as substituted by Article 5 of Legislative Decree n. 142 of November 29, 2018.

<sup>326</sup> Article 89(3) I.T.C., as modified by Article 3 of Legislative Decree n. 147 of September 14, 2015.

- 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.
- The subsidiary must be tax resident in Italy or in a jurisdiction that is not a Blacklist country or territory (see Paragraph H.iii 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. Such condition must be continuously verified starting from the first period of participation's ownership (or, starting from the fifth fiscal years preceding the disposal of the participation, where such disposal occurred in favor of third parties).<sup>327</sup> As of 2015, an advance ruling is no longer mandatory provided that this condition can be proven during a tax audit. Where an advance ruling has not been requested or a positive ruling was not obtained, capital gains from Blacklist-resident entities must be disclosed on the relevant tax return.<sup>328</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%.

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<sup>327</sup> See Article 87(2), as modified by Article 5 of the A.T.A.D.

<sup>328</sup> *Id.*, Article 87(1).

#### D. **Interest Deduction**

The A.T.A.D. Decree recently redefined the interest deduction regime for companies subject to I.R.E.S, starting from 2019.

The new regime, in general, provides as follows:<sup>329</sup>

- Interest expense is fully deductible against interest income in each tax period.
- The interest expense in excess of interest income results in net interest expenses. The net interest expense can be deducted subject to a cap of 30% of an amount substantially corresponding to earnings before interest, taxes, depreciation, and amortization (“E.B.I.T.D.A.”). E.B.I.T.D.A. must be quantified on the basis of the relevant tax values, *i.e.*, reflecting the corporate income tax adjustments applied to E.B.I.T.D.A. computed for accounting purposes.
- The amount of interest expense that exceeds the 30% limit is not deductible in the tax period incurred, but may be carried forward indefinitely until it can be absorbed in a year when sufficient E.B.I.T.D.A. exists.
- The excess of interest income over interest expense in a fiscal year may be carried forward and applied when determining net interest expense of following periods.
- The excess debt capacity is the amount by which 30% of E.B.I.T.D.A. exceeds net interest expenses. This capacity may be carried forward and used to increase the debt capacity in the following five periods.<sup>330</sup>

Financial intermediaries such as banks and insurance companies, along with their holding companies and certain other financial

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<sup>329</sup> See *id.*, new Article 96.

<sup>330</sup> Specific grandfathering rules are provided with respect to deduction of interest of expense related to loans granted before June 17, 2016, (which are not subsequently modified).

institutions, are excluded from the interest deduction regime. Separate specific rules apply to banks and insurance companies. A holding company qualifies as a financial intermediary when more than 50% of its total assets consist of investments in shares of other financial intermediaries and related assets such as intercompany receivables. This determination is based on the holding company's audited financial statements.<sup>331</sup>

Consequently, the limitation regime applies to industrial holding companies, which are companies that hold participations in other entities that do not carry on lending activities or financial services to the public.<sup>332</sup> Industrial holding companies that participate in a domestic consolidation for tax purposes in Italy (see Paragraph H.i below) may compute the ceiling for deductible interest expense based on 30% of the E.B.I.T.D.A. of the group. The carry-forward of non-deductible interest expense is also computed on a consolidated basis if Italian corporate income tax is computed on that basis in the arising year and the carry-forward year.

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 in the following circumstances:

- The acquisition debt is functionally connected to the leveraged acquisition.
- The leveraged transaction is not considered abusive. This means that, based on specific circumstances, the debt was not incurred to obtain a tax advantage that is contrary to the spirit and objectives of the law. An example of an abusive transaction is a re-leveraging transaction in the absence of a change of control.

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<sup>331</sup> See Article 162-bis (2).

<sup>332</sup> *Id.*, Article 96(12).

#### E. **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:

- 2% of the total value of participations in resident and nonresident companies, bonds, other financial instruments, and financial credits
- 4% to 6% of the value of real estate and ships owned or leased by the company
- 15% of the value of other fixed assets

The calculation is made on the average values over a three-year period (*i.e.*, the tax period concerned and the two preceding periods). In the above computation, the relevant dividends are not considered and it is possible to exclude the shareholding into operative subsidiaries.

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>333</sup> Minimum income is calculated by applying a deemed return to the assets mentioned above. The deemed returns are

- 1.50% of participations, other financial instruments, and financial credits
- 4.75% of real estate values (reduced to a 3% to 4% rate for residential real estate assets and offices)
- 12% of other fixed assets

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<sup>333</sup> A surtax of 10.5% is applicable. See Article 2(36-*quinquies*) of Decree Law n. 138 of August 13, 2011.

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>334</sup>

There are also certain automatic exclusions from the scope of the general rule:

- The company is in the first year of activity.
- The shares of the company, its controlling shareholders, or one or more subsidiaries are traded on a stock exchange.
- The company had at least ten employees in the two preceding fiscal periods.
- The value of the company's production measured on the profit and loss statement is greater than the total value of assets reported on the balance sheet.
- The company in insolvency proceedings.

The non-operating company provisions are also applicable to companies under an alternative test. The alternative test looks at loss history of the company in two scenarios. The first is that the company has incurred tax losses for at least five consecutive tax years. The second is that the company has incurred tax losses for only four out of five tax years and in one year has reported income that is lower than the minimum income that typically triggers non-operating company status (see above). In either scenario, the company will be deemed to be non-operating company effective at the beginning of the sixth year.

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<sup>334</sup> Article 30(4-*quater*) of Law n. 724/1994, as modified by Article 7 of Legislative Decree n. 156 of September 24, 2015.

#### **F. Allowance for Corporate Equity**

Effective for the fiscal year 2019, Article 1 (1080) of Law n. 145 of December 30, 2018, (“Budget Law 2019”) abolished the Allowance for Corporate Equity (“A.C.E.”), which provided a notional interest deduction for the increases in equity after 2010.<sup>335</sup> Under a grandfathering rule, the amount of A.C.E. that exceeds the net taxable income of the year 2018 can be carried forward and used to offset the net tax base of a subsequent tax period, or it can be converted into a tax credit equal to 24% of the notional yield to offset the I.R.A.P. due for each five succeeding tax years.

#### **G. Mini-I.R.E.S. regime**

The Law Decree n. 34 of April 30, 2019, (“Growth Decree”)<sup>336</sup> introduced an allowance for undistributed profits of corporate entities (“Mini-I.R.E.S. regime”). Companies that do not distribute their profits are eligible to apply for lower corporate income tax rate on the portion of the taxable base corresponding to the amount of profits allocated to disposable reserves. The benefit is limited to the company’s net equity increase from December 31, 2018, without taking in account the profits and the losses of the same year.

Instead of applying the ordinary income tax rate at 24% on the profits of an Italian company, the portion of the taxable income equal to the reserve, is subject to reduced corporate tax rates:

- 22.5% for the fiscal year 2019
- 21.5% for the fiscal years 2020
- 21% for the fiscal year 2021
- 20.5% for the fiscal year 2022 onwards

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<sup>335</sup> Article 1(2) of Law Decree n. 201 of December 6, 2011.

<sup>336</sup> Please note that the Growth Decree shall be further converted into Law and could be subject to modifications. Moreover, its implementing provisions will be provided by a Decree to be issued by the Italian Ministry of Finance.

The net equity increase is computed without taking into account the profit and loss of the current year and by deducting from the amount so calculated the profits that have already benefitted from the allowance. The allowance does not have a cumulative effect. Unless the net equity has been increased by way of a share capital increase, the amount that may benefit from the reduced tax rate is equal to the portion of the profit of the previous year that is allocated to disposable reserves.

In case the profits allocated to disposable reserve are higher than taxable profits for the year, the excess can be carried forward and added to the taxable profits of the following years. In simple terms, the mechanism allows for the excess profits not subject to preferential tax rates to be carried forward to following years where it can enhance eligible earnings. Special rules apply to companies that report income under the domestic and worldwide tax consolidation regime. Those regimes are described below in Paragraphs H.i and H.ii.

## **H. 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>337</sup> and the other is the international or worldwide consolidation regime.<sup>338</sup>

### **i. Domestic Consolidation**

For the purpose of the domestic consolidation regime, a group of companies includes a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two factors exist. First, the common parent must, directly or indirectly, have more than 50% of the voting rights at the subsidiary's general shareholders' meeting. Second, the common parent must, directly or indirectly, be entitled to more than 50% of

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<sup>337</sup> Article 117-129, I.T.C.

<sup>338</sup> *Id.*, Article 130-142.

the subsidiary's profits. The "de-multiplier effect" must be considered in both cases.

In certain circumstances, a nonresident company may participate in a domestic consolidation as the common parent of the group. First, the foreign parent must be a resident in a country that has a tax treaty in effect with Italy. Second, 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. Member State that has signed an agreement with Italy allowing the effective exchange of information to designate an Italian-resident subsidiary or permanent establishment as a "consolidating" entity. The consolidating entity may then form a single fiscal unit with another direct or indirect subsidiary of the same parent company. Legislative Decree n. 147 also introduced legislation allowing Italian permanent establishments of E.U./E.E.A. companies to be included in the fiscal unit as consolidated entities with other Italian-resident companies of the same group.

The domestic consolidation regime 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 a separate company basis, according to the ordinary rules, and submits its own tax return (without computing the relative income tax or credit). Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The total taxable income or loss of each controlled subsidiary is considered regardless of the percentage held by the common parent.

Domestic consolidated groups may take advantage of a rule that allows for a combined computation of E.B.I.T.D.A. and interest expense (see Paragraph D 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.

## **ii. 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>339</sup>

Several differences exist between the domestic consolidation regime and the worldwide regime. First, the worldwide regime is not selective among group members. The option must be exercised by *all* of the nonresident controlled subsidiaries. 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.

## **iii. C.F.C. Legislation**

Profits realized by a C.F.C. are deemed to be the profits of an Italian company if the following conditions are met:

- The resident company directly or indirectly controls the nonresident entity.
- At least one third of the revenue of the foreign company is passive income (as defined below).
- The foreign subsidiary is subject to an effective tax rate which is lower than 50% of the effective tax rate which

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<sup>339</sup> *Id.*, Article 132(3).

would be applicable if the same entity were resident in Italy.<sup>340</sup>

For purposes of the C.F.C. regime, a company may be deemed to be controlled in one of these circumstances:

- The Italian resident has the control of the foreign company according to Article 2359 of the Italian Civil Code, holding, directly or indirectly, the majority of the voting rights exercised at the general shareholders' meeting of the company or sufficient votes to exert a decisive influence in the shareholders' meeting of the company or a dominant influence over the company due to contractual relationships.
- The Italian resident holds, directly or indirectly (also by one or more companies controlled according to Article 2359 of the Italian Civil Code) more than 50% of the profit rights of the foreign company.

Moreover, the following entities are considered controlled for C.F.C. purposes:

- The foreign permanent establishment of the abovementioned controlled companies
- The foreign permanent establishment of a resident company which opted for branch exemption regime (see Paragraph K below)

The following types of revenue are deemed to be passive income:

- Interest or any other income deriving from financial assets
- Royalties or any other income arising from intellectual property
- Dividends and income deriving from the disposal of shares

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<sup>340</sup> *Id.*, Article 167, as recently modified by Article 4 of A.T.A.D.

- Income from financial leasing
- Income deriving from insurance, banking and other financial activities
- Revenues deriving from sales of low-value goods and supply of low-value services, carried out with associated companies

In order to avoid the application of the C.F.C. regime, an Italian-resident company may request a ruling from the Italian tax authorities and provide evidence that the nonresident company carries out a substantial economic activity supported by staff, equipment, assets, and premises. From 2015, an advance ruling is no longer mandatory, provided that the taxpayer can prove during a tax audit that the abovementioned condition has been met. Where an advance ruling has not been requested or a positive ruling was not obtained, the existence of C.F.C. subsidiaries must be disclosed on the relevant tax return.

If the C.F.C. rules apply, the profits of the C.F.C. are deemed to be the profits of the Italian resident. These profits are attributed *pro rata* (based on profit participation) to the Italian controlling company and are taxed separately at the average tax rate for Italian-resident corporations, which is 24%.

Italian law provides for the concept of “previously-taxed income.” 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.

#### **I. Treaty Protection**

Italy has tax treaties in effect with over 90 jurisdictions, including many developed countries and significant trading partners. In general, the treaties provide for reduced withholding tax rates in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the current treaty with the U.S., the withholding tax rate on interest income is 10%.

Listed below are the jurisdictions that have income tax treaties with Italy that are currently in force and effect:

Albania	Ethiopia	Malta	Slovenia
Algeria	Finland	Mauritius	South Africa
Argentina	France	Mexico	South Korea
Armenia	Georgia	Moldova	Spain
Australia	Germany	Montenegro	Sri Lanka
Austria	Ghana	Morocco	Sweden
Azerbaijan	Greece	Mozambique	Switzerland
Bangladesh	Hong Kong	Netherlands	Syria
Barbados	Hungary	New Zealand	Taiwan
Belarus	Iceland	Norway	Tajikistan
Belgium	India	Oman	Tanzania
Bosnia & Herzegovina	Indonesia	Pakistan	Thailand
Brazil	Ireland	Panama	Trinidad & Tobago
Bulgaria	Israel	Philippines	Tunisia
Canada	Ivory Coast	Poland	Turkey
Chile	Japan	Portugal	Uganda
China	Jordan	Qatar	Ukraine
Congo (Rep.)	Kazakhstan	Romania	U.A.E.
Croatia	Kuwait	Russia	U.K.
Cyprus	Latvia	San Marino	U.S.A.
Czech Republic	Lebanon	Saudi Arabia	Uzbekistan
Denmark	Lithuania	Senegal	Venezuela
Ecuador	Luxembourg	Serbia	Vietnam
Egypt	Macedonia	Singapore	Zambia
Estonia	Malaysia	Slovakia	

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

## **J. Withholding Taxes on Outbound Payments**

### **i. Dividend Withholding – Domestic Law**

In general, Italian law provides that dividends distributed by Italian companies are subject to a 26% withholding tax.<sup>341</sup> The rate may be reduced to 11% for dividends paid out to pension funds established in E.U. Member States or E.E.A. Member States (*i.e.*, Iceland, Liechtenstein, and Norway) listed in Ministerial Decree September 4, 1996. The recipient can claim a refund of up to eleven twenty-sixths of the withholding tax incurred, if taxes have been paid on the same income in its country of residence.<sup>342</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.A. Member States included on the abovementioned list, a reduced 1.2% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions made to domestic companies (see Paragraph B above). If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (subject to a 95% exemption).

### **ii. 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>343</sup> the required minimum for direct shareholding in the Italian company was reduced to 10%.

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<sup>341</sup> Law Decree n. 66/2014, converted into Law n. 89 of June 23, 2014.

<sup>342</sup> Article 27(3) of Presidential Decree n. 600/1973.

<sup>343</sup> Implemented in Italy by Legislative Decree dated February 6, 2007, n. 49. Article 27-*bis* of Presidential Decree n. 600/1973.

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>344</sup>

As clarified in Circular Letter n. 6/E of March 30, 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 and does not carry out real economic activity or has little or no discretion in the decision-making process (a “conduit entity”). A light organization exists where employees, offices, and equipment of the intermediary are made available by third companies through management service agreements).
- The intermediate entity acts merely as a financial conduit in the context of a specific arrangement (*e.g.*, inbound and

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<sup>344</sup> See the last paragraph of Article 27-*bis* of Presidential Decree n. 600/1973.

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>345</sup>

### iii. 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>346</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>347</sup>

Two companies may be deemed to be associated under one of two tests. Under the first test, one of the companies directly holds at least 25% of the voting rights at the general shareholders’ meeting of the other company. Under the second test, 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;

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<sup>345</sup> See Circular Letter n. 6/E, issued by the Italian Revenue Agency on March 30, 2016.

<sup>346</sup> Article 26-*quater*, Presidential Decree n. 600/1973.

<sup>347</sup> For the definition of “beneficial owner” see *id.*, Article 26-*quater* (4).

- 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>348</sup>

In the so-called Danish Cases, the European Court of Justice (“E.C.J.”) issued its judgments in joined cases C-115/16, C-118/16, C-119/16 and C-299/16 and in joined cases C-116/16 and C-117/16, respectively concerning the Interest and Royalty Directive and the P.S.D. The question submitted to the E.C.J. was whether dividend and interest payments were exempt from withholding tax when the payment was made to an E.U. company that subsequently passed the income to an ultimate parent company resident in a third country.

The E.C.J. first stated that based on the general principle of E.U. law, that E.U. law cannot be relied on for abusive or fraudulent ends. Exemption from withholding shall be denied if the transaction has been put in place with the essential (even if not exclusive) aim to benefit from the tax advantages.

The E.C.J. provided further guidance in order to assess the existence of abuse in case of intermediary holding companies, stating that an arrangement may be considered as artificial when:

- The company receiving the dividends passes all or almost all of such income, very soon after their receipt, to entities that do not fulfill the conditions for the application of the P.S.D. or the Interest and Royalties Directive. In this respect it is not necessary that the receiving company has a contractual or legal obligation to pass the dividends/interest on to a third party, but it may be sufficient to demonstrate based on the factual circumstances that the company does

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For more details, see *id.*, Article 26-*quater* (8-*bis*).

not have the right to enjoy the income received because *de facto* it acts as a conduit company.

- The intermediate holding company lacks economic substance and carries out very limited activities. In opinion of the E.C.J., the “absence of actual economic activity must, in the light of the specific features of the economic activity in question, be inferred from an analysis of all the relevant factors relating, in particular, to the management of the company, to its balance sheet, to the structure of its costs and to expenditure actually incurred, to the staff that it employs and to the premises and equipment that it has.”

The E.C.J. further stated that when the beneficial owner of dividends/interest paid is resident for tax purposes in a third state, exemption may be refused regardless of the existence of an abusive practice.

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.

However, according to paragraph 5-*bis*<sup>349</sup> of the same Article, final withholding tax does not apply to interest payments on medium-long term loans<sup>350</sup> granted to commercial entities by any of the following entities:

- Credit institutions established in E.U. Member States
- Insurance companies incorporated and authorized under the law of E.U. Member States

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<sup>349</sup> Introduced by Article 22(1) of Law Decree n. 91 of June 24, 2014.

<sup>350</sup> Medium-long term loans are loans that have a contractual duration of more than 18 months and one day, and do not provide a prepayment option for the lender.

- Foreign institutional investors, regardless their tax status, established in Whitelist jurisdictions and subject to regulatory supervision therein
- Certain non-banking, state-owned entities (such as the U.K. National Savings Bank)

The abovementioned exemption is available only when the laws governing lending activities to the public are not infringed. Therefore, to benefit from the exemption, the lender must comply with all of the regulatory requirements for lending to the public. In 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 60 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.

In case facilities are partially or totally funded by back-to-back or other similar risk sharing agreements entered into between the fronting lender and the participants (or sub-participant), payment of interest under such facilities will be subject to withholding tax depending on the status of the participant (or sub-participant) that is the beneficial owner of a particular interest in the loan, while the fronting lender will be disregarded, save for that part of the

financing which has been funded by the fronting lender with its own financial resources. Therefore, the borrower will make interest payments without tax deduction to the extent that the relevant participant or sub-participant meets and properly communicates the conditions requested to benefit from the withholding tax exemption pursuant to Article 26, para. 5-*bis*, Presidential Decree 600/1973 and that the participant or sub-participant complies with the regulatory provisions on reserved banking or lending activities.

In a recent criminal case law (Case No. 12777/2019), the Italian Supreme Court ruled that a fronting structure whereby an Italian licensed bank granted loans to Italian customers using the funds made available by a foreign bank based on an undisclosed mandate was in breach of the regulatory prohibition of financial operations in the absence of authorization. Based on the Court reasoning, even though from a formal point of view the financing relationship was structured based on two separate contracts, for the purpose of the regulatory restrictions on lending, the concrete substance of the transaction controls, not the legal form. That being stated, the Court reported a list of criteria that may lead to the conclusion that the financing has been actually granted by the foreign bank and that the legal structure aims at hiding the real activity carried out by the foreign non-licensed bank. The criteria are as follows:

- The sharing of the insolvency risk between the fronting lender and the foreign bank
- The independent assessment of customers' credit standing by the foreign bank
- The acknowledgment by the customers of the involvement of the foreign bank by signing the intercreditor agreement with the latter
- The right of the foreign bank to be informed and to approve all circumstances that may affect the borrower's credit rating
- The fact that the commitment of the foreign bank exceeds the commitment of the fronting lender

- The fact that the fronting bank reported to the Central risk data base only its own exposure and not the overall amount of the loan

The Court further observed that from a purely legal point of view the undisclosed mandate provides the principal with some rights of action versus the customers, thus confirming that in substance the principal is the real lender. Moreover, in the case in question the intercreditor agreement provided the principal with further rights of direct action versus the customers.

#### **iv. 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 Paragraph C). 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 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).

**v. 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>351</sup> In particular, they are deemed not to have business income.

Due to the changes introduced by the Budget Law for 2018,<sup>352</sup> as of January 1, 2019,<sup>353</sup> capital gains realized by foreign corporations upon the disposal of an interest in an Italian subsidiary will be subject to a 26% substitute tax,<sup>354</sup> regardless of the size of the participation (*i.e.*, qualified and not qualified).

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>355</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>356</sup>

A participation in a listed company is deemed to be qualified if the total interest sold during a 12-month period is greater than 2% of the company's voting rights or 5% of the capital of the listed company. If the company is not listed, a participation is qualified if the total interest sold during a 12-month period is greater than 20% of the company's voting rights or 25% of the capital of the company.

These rules are subject to modification under an applicable treaty.

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<sup>351</sup> Article 151(3), I.T.C.

<sup>352</sup> Article 1(999) of Law n. 205 of December 27, 2017.

<sup>353</sup> *Id.*, Article 1(1005).

<sup>354</sup> Article 5(2) of Legislative Decree n. 461 of November 21, 1997.

<sup>355</sup> Article 23(1)(f) I.T.C.

<sup>356</sup> Article 5(5)(a), Legislative Decree n. 461/1997.

#### K. **Branch Exemption Regime**

The International Tax Decree introduced the “branch exemption regime.”<sup>357</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 the condition for C.F.C. exemption is met (see Paragraph H.iii).

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.

#### L. **Foreign Tax Credit**

A foreign tax credit is granted to avoid international double taxation.<sup>358</sup> The tax credit limitation is calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period.<sup>359</sup>

#### M. **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.

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<sup>357</sup> See the new Article 168-*ter* I.T.C., introduced by Article 14 of Legislative Decree n. 147/2015.

<sup>358</sup> Article 165, I.T.C.

<sup>359</sup> *Id.*, Article 165(6).

Pursuant to Article 110(7),<sup>360</sup> business income of an Italian-resident enterprise is assessed on the basis of conditions and prices that would be agreed upon by independent parties operating at arm's length conditions and in comparable circumstances when derived from (i) transactions with a nonresident company<sup>361</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.

Following certain amendments,<sup>362</sup> Article 110(7) no longer refers to the "normal value" of goods and services as defined in Article 9(3) I.T.C. as a criterion for determining intercompany transfer prices. It now refers instead to the "arm's length value," which can be compared to the arm's length value as defined by the O.E.C.D. Transfer Pricing Guidelines<sup>363</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

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<sup>360</sup> As amended by Article 59 of the Law Decree n. 50 of April 24, 2017.

<sup>361</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>362</sup> See Article 59 of Law Decree n. 50 of April 24, 2017.

<sup>363</sup> As approved by the O.E.C.D. Council on July 10, 2017.

- rulings requested by the taxpayer in which the tax authorities of a Contracting State with which an adequate exchange of information with Italy exists 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.

#### N. **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>364</sup> and enacted by Ministerial Decree dated July 30, 2015.

The exercise of this option is binding for a period of five years and 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").

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<sup>364</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 Paragraph N).

According to Article 56 of the Law Decree n. 50 of April 24, 2017 (enacted by Ministerial Decree dated November 28, 2017), trademarks are no longer considered eligible I.P. assets. The new provisions affect applications to the Patent Box regime submitted after December 31, 2016, while applications submitted before December 31, 2016, are covered by grandfathering provisions and the terms of the previous regime will continue to be valid for the entire five-year duration of the Patent Box election. The provisions making trademarks ineligible were introduced in order to align the Italian Patent Box regime with O.E.C.D. Guidelines.

The Patent Box regime also applies to income derived from the joint use of intangible assets, linked to each other by complementary constraints, with the purpose of realizing a product (or a family of products) or a process (or a group of processes). In the latter case, all the jointly used intangibles must be assets eligible for the regime. I.P. income – which is eligible for the exemption – is determined using a specific ratio of “qualifying expenses” (*i.e.*, certain research and development expenditures related to I.P. assets) to “overall expenses” (*i.e.*, the sum of the qualifying expenses and the acquisition costs of I.P. assets).<sup>365</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.

#### **O. 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

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<sup>365</sup> Article 9 of Ministerial Decree dated July 30, 2015.

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.
- The reporting deadline for information related to tax year 2018 is June 20, 2019.

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>366</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;

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<sup>366</sup> For exchanges between E.U. Member States, the E.U. has implemented the C.R.S. through D.A.C.2.

account balances; and sales proceeds from financial assets) to the relevant tax authorities.

**P. Italian Measures to Combat B.E.P.S.**

Fifteen specific actions have been or are being developed in the context of the O.E.C.D./G-20 project to combat base erosion and profit shifting (the “B.E.P.S. Project”). In substance, these actions cover all the principal aspects of international taxation – as they relate to C.F.C. rules, interest deductibility, artificial avoidance of permanent establishment status, transfer pricing rules, curbing harmful tax practices, data collection, mandatory disclosure rules, and dispute resolution.<sup>367</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 Paragraph M 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.

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<sup>367</sup> For a list of all B.E.P.S. Actions, see Chapter 3 of this text, “B.E.P.S. and Holding Companies.”

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 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>368</sup> New rules have also been introduced to prevent the artificial avoidance of permanent establishment status through *commissionaire* arrangements.<sup>369</sup> An anti-fragmentation rule<sup>370</sup> and a new definition of “closely-related person” were also introduced.<sup>371</sup>

Moreover, many of the new tax rules provided by the International Tax Decree and the A.T.A.D. Decree are closely linked to B.E.P.S. Project reports released in 2014 and 2015,<sup>372</sup> such as the following:

- The modification of advance ruling procedures for international companies related to (i) transfer pricing

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<sup>368</sup> Article 162(4-4-*bis*) I.T.C.

<sup>369</sup> *Id.*, Article 162(6-7).

<sup>370</sup> *Id.*, Article 162(5).

<sup>371</sup> *Id.*, Article 162(7-*bis*).

<sup>372</sup> Other tax measures provided by the International Tax Decree, such as the new rules regarding domestic tax consolidation, which extend the option to apply the Italian consolidation regime to “sister” companies (including permanent establishments) that are controlled by the same foreign company resident in an E.U. Member State or E.E.A. Member State, allowing adequate exchange of information, are intended to comply with rulings of the E.C.J. “SCA Group Holding and Others,” Joined Cases C-39-41/13, delivered June 12, 2014 (see Paragraph H.i above).

operations, (ii) the existence of a permanent establishment, and (iii) the attribution of profits to a permanent establishment, in order to provide for the spontaneous exchange of information by the Italian tax authorities (see new Article 5(1-*bis*) of Legislative Decree n. 29 of March 4, 2014, introduced by Article 1(2) of the Legislative Decree n. 32 of March 15, 2017).

- The (i) adoption of an “effectively connected income concept” for permanent establishments, repealing the so-called force of attraction rules, which, pursuant to previous rules, 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 Paragraph J.iv above).
- The reform of the interest deduction discipline in order to discourage artificial debt arrangements designed to minimize taxes (see Paragraph H.iii above) and the revision of the C.F.C. rules in order to deter profit shifting to a low/no tax countries (see Paragraph H.iii above). In consideration of the close connection of the C.F.C. regulation and the tax treatment of dividends and capital gains, the tax regime of profits distributions and capital gains/losses arising from sales of investments in non-resident companies was modified as well (see Paragraphs B and C above).
- The modification of the regime for outbound and inbound transfers of tax residence to prevent companies from avoiding tax when relocating assets (see, respectively, Article 166 and 166-*bis* of I.T.C) and the introduction of specific rules to neutralize the effects of hybrid mismatch arrangements aimed at preventing double deduction and deduction without inclusion outcomes. Such rules provide, *inter alia*, that to the extent that a hybrid mismatch results in a double deduction a (i) deduction is not allowed in Italy in case the Italian entity is the recipient and (ii) in case the Italian entity is the payer, the deduction is not allowed where the deduction of such payment is not denied in the other relevant jurisdiction. Other rules are introduced with

reference to the case hybrid mismatches resulting from a deduction without inclusion, implementing the Article 9(2) of the A.T.A.D., which provides that to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer will deny the claimed deduction for the payment. Moreover, specific rules are provided with reference to the case of reverse hybrids and dual residence mismatches.<sup>373</sup>

The A.T.A.D. Decree did not modify the anti-avoidance rules and anti-abuse regime (see the Article 10-*bis* of Law n. 212 of July 27, 2000) as recently reviewed by the Legislative Decree n. 128 of August 5, 2015 (the “Certainty Decree”), since it was considered in compliance with the A.T.A.D.

**Q. 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

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The above-mentioned provisions related to hybrid mismatches will generally be effective starting from tax year 2020, instead the rules addressing reverse hybrid arrangements will enter into force starting from tax year 2022.

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>374</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. A S.I.C.A.F. is defined to be 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 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. Consequently, the absence of specific transitional rules exposes a holding company to risk of transformation into a S.I.C.A.F. This could lead to immediate taxation of all unrealized gains on its assets because the transformation of a corporation into a “non-commercial” entity is a taxable event in Italy.

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Article 4 of the A.I.F.M. Decree and A.I.F.M. Directive.

## GERMANY<sup>375</sup>

### A. Introduction

In the past few years, several steps have been taken to make Germany a more attractive jurisdiction for holding companies, especially within the E.U. At the same time, efforts have been made to prevent multinational businesses from using international financing structures which treat interest paid to shareholders as business expenses in Germany while leaving the profits of business operations taxable in tax havens. Germany has implemented all measures recommended under the E.U. Anti-Tax Avoidance Directive (the “A.T.A.D.”) and the recommendations of the O.E.C.D. B.E.P.S. Project.

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.

### B. 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

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<sup>375</sup> This portion of the article was written by Dr. Wolf-Georg von Rechenberg of BRL Böge Rohde Lübbekhusen in Berlin.

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.

### **C. General Participation and Dividend Exemption**

#### **i. Background**

In Germany, corporate tax is levied on the profit of a corporation as computed in the company's commercial balance sheet 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 rate gains for individuals is basically a

flat tax rate (irrespective of the individual tax rate), no further tax is due. In the case of business income, 60% of the income derived from dividends and capital gains is subject to the regular tax rate resulting from the tax assessment. Again, the withholding tax will fully be credited against the respective income tax liability.

## **ii. 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>376</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>377</sup>
- The exemption does not apply to shares held as current assets by a company engaged in financial business (“*Finanzunternehmen*”) that is more than 50% directly or indirectly owned by a financial institution.

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<sup>376</sup> *Körperschaftsteuergesetz* (“KStG,” or the German Corporation Tax Act), §8b, ¶6.

<sup>377</sup> *Id.*, §8b, ¶2, sent. 4.

- 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.

### **iii. Dividend Exemption**

The dividend exemption applies to dividends received from domestic and foreign participations.<sup>378</sup> For corporate tax purposes,

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<sup>378</sup> *Id.*, §8b, ¶1.

there is no holding period. However, the dividend exemption applies only if the corporation holds a minimum participation of 10%.<sup>379</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 nondeductible expenses. In principle, this applies regardless of the amount of effective business expenses related to the dividend. The hybrid mismatch rule applies as explained above under Paragraph C.i.

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.

#### **iv. 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 Paragraph E 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>380</sup>

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<sup>379</sup> *Id.*, §8b, ¶4.

<sup>380</sup> *Einkommensteuergesetz* (“EStG,” or the German Income Tax Act), §3c, ¶1.

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.

#### **D. Trade Tax Add-Backs and Deductions**

The income computed for corporate tax purposes is adjusted for trade tax purposes by various add-backs and deductions.

The add-backs include 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 immoveable fixed assets
- 25% of payments to obtain license rights for a limited time period, except for licenses that merely confer entitlement to license to third parties the rights derived thereunder

The additional deductions include

- 1.2% of 140% of the assessed value (“*Einheitswert*”) of real property;
- the distributive share of profits from an investment in a domestic or foreign partnership;
- dividends from a domestic corporation in which the Taxpayer holds an interest of at least 15% since the beginning of the tax year; and

- dividends from a foreign corporation in which the taxpayer holds an interest of at least 15% (10% in a case where the E.U. Parent-Subsidiary Directive is applicable) since the beginning of the tax year, provided this corporation (almost exclusively) generates active income.<sup>381</sup>

## E. Earnings Stripping Rules

### i. 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>382</sup> The earnings stripping rules apply in general to all types of debt financing for sole entrepreneurships, partnerships, and corporations. The scope of the rules is far broader than the former thin capitalization rules, as any third-party debt financing (whether or not there is back-to-back financing) will be included. Interest expense is completely deductible from the tax base only to the extent the taxpayer earns positive interest income in the corresponding financial year. Interest expense in excess of interest revenue (net interest expense) is deductible only up to 30% of tax E.B.I.T.D.A. (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.

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<sup>381</sup> The active business requirement is not applicable to companies resident in an E.U. Member State.

<sup>382</sup> EStG, §4h; KStG, §8a.

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.

## **ii. Exemptions**

A *de minimis* rule applies to the earnings stripping limitations on the deductibility of net interest expense. The earnings stripping rules apply only when interest expense exceeds positive interest income by at least €3 million (the “tax threshold”). Thus, small- and medium-sized business enterprises are generally exempt from the scope of the earnings stripping rules, provided the tax threshold for a year is not reached or exceeded.

The earnings stripping rules also do not apply to businesses that are not members of a controlled group. A business is regarded as part of a controlled group if it is or at least may be included in consolidated financial statements in accordance with I.F.R.S., E.U. G.A.A.P. (G.A.A.P. of an E.U. Member State), or U.S. G.A.A.P. Consolidated financial statements in principle have to be drawn up in accordance with I.F.R.S. Consolidated financial statements in accordance with any E.U. G.A.A.P. can be used if there is no obligation to prepare I.F.R.S. consolidated financial statements and no I.F.R.S. consolidated financial statements have been prepared in the five preceding years. Consolidated financial statements in accordance with U.S. G.A.A.P. can be used if there is neither an obligation to prepare I.F.R.S. consolidated financial statements nor consolidated financial statements according to the G.A.A.P. of any E.U. Member State.

Furthermore, there is an escape clause for businesses that are part of a controlled group. Provided that the entity in question’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>383</sup> Shareholder debt is defined as debt that is granted by a substantial shareholder,<sup>384</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.

#### **F. Restricting Tax Deductions on License Payments**

There is a deduction limit on license payments.<sup>385</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 the B.E.P.S. Report on Action Item 5, and (ii) subject to an effective tax rate of less than 25%. A safe harbor exists for royalty payments to a company that carries on substantial research and development activities.

The percentage of the payment that will be nondeductible is calculated by making reference to the percentage shortfall between the effective rate and 25%. Stated mathematically, the formula is  $(25\% - \text{effective tax rate}) \div 25\%$ . For instance, if the effective

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<sup>383</sup> KStG, §8a, ¶2.

<sup>384</sup> Shareholder of more than 25%.

<sup>385</sup> EStG, §4j.

foreign preferential tax rate is 10%, German law would regard 60% of all royalty payments as nondeductible. Because 10% amounts to 40% of 25%, the shortfall between the effective rate and 25% is 15% – which is 60% of 25%.

This also captures indirect license payments and will apply irrespective of any tax treaties (*i.e.*, treaty override).

#### **G. 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>386</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. The rules in Germany’s KStG address the following situations:

- Losses are cancelled in full if more than 50% of the shares of a corporation are transferred within a period of five years. This rule has been questioned in court with regard to its possible violation of constitutional law. The lower Tax Court of Hamburg has submitted a case to the Constitutional Court and is awaiting a final decision.<sup>387</sup>

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<sup>386</sup> *Id.*, §10b.

<sup>387</sup> FG Hamburg, Beschluss v. 11.4.2018, 2 V 20/18, EFG 2018 S. 1128.

- In the past, losses were cancelled in proportion to the percentage of shares transferred if more than 25% but less than 50% of the shares in a corporation were transferred within a period of five years. As a consequence of another decision of the Constitutional Court, this rule was abolished.<sup>388</sup>

A special rule was incorporated into §8c KStG in order to facilitate the preservation of losses during the takeover of a crisis-stricken company. An attempt by the European Commission to classify this as illegal State Aid was rejected by the European Court of Justice (“E.C.J.”).<sup>389</sup> Therefore, §8d KStG, which relaxes the rules regarding cancellation of losses carried forward for share transfers within groups of companies or if the company’s business continues without major changes following the transfer, is applicable for share transfers of 50% or more.

Existing losses can be preserved following a share transfer aimed at avoiding a company’s bankruptcy if the essential operating structures of the business remain, which requires that one of the following prerequisites is met:<sup>390</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.

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<sup>388</sup> Beschluss v. 29.3.2017, 2 BvL 6/11, BGBl I 2017 S. 1289.

<sup>389</sup> EuGH, Urteil v. 28.6.2018, C-203/16 P, C-208/16 P, C-219/16 P, C-209/16 P.

<sup>390</sup> KStG, §8c.

A company's losses may also be preserved following a change in ownership where the losses cannot be used otherwise.<sup>391</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.

#### H. Real Estate Transfer Tax on Share Transfer Transactions

For share transfers of more than 95%, tax may be levied if the company or its subsidiaries own real estate. The rule is applicable if the transaction causes an indirect change of 95% of the shares in a company holding real estate no matter at which level the share transfers occurs. The tax rate varies between 5% and 6.5% depending on the respective Federal state. A specific anti-avoidance rule exists.

The tax base is not calculated based on market value or book value but through a special assessment procedure. It is expected that these rules will be tightened in 2019.

#### I. 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>392</sup> The C.F.C. rules apply if

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<sup>391</sup> *Id.*, §8d.

<sup>392</sup> *Außensteuergesetz* ("AStG," or the German Law on Taxation in Foreign Relations), §7.

- 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>393</sup>

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>394</sup> Genuine economic activities require a full-fledged business with an appropriate office, employees, and technical equipment. Generally, “genuine economic activities” are determined by the criteria stated by the E.C.J. in the *Cadbury Schweppes* decision. Only such income that is attributable to the genuine economic activity and that is derived by that particular activity is exempt from the C.F.C. rules, and only for amounts that do not exceed arm’s length consideration.

**J. Dividend Withholding Tax; Treaty Network; Anti-Abuse Provisions**

**i. 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>395</sup>

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<sup>393</sup> Foreign Relations Taxation Act, §10, ¶2, sent. 3 (“F.R.T.A.”).

<sup>394</sup> *Id.*, §8, ¶2.

<sup>395</sup> EStG, §43b, ¶2.

## ii. Treaty Network

Germany has an extensive income tax treaty network with almost 100 income tax treaties in force and effect as of May 2019.

Albania	France	Lithuania	South Africa
Algeria	Georgia	Luxembourg	South Korea
Argentina	Ghana	Macedonia	Spain
Armenia	Greece	Malaysia	Sri Lanka
Australia	Hungary	Malta	Sweden
Austria	Iceland	Mauritius	Switzerland
Azerbaijan	India	Mexico	Syria
Bangladesh	Indonesia	Moldova	Taiwan
Belarus	Iran	Mongolia	Tajikistan
Belgium	Ireland	Montenegro	Thailand
Bolivia	Israel	Morocco	Trinidad & Tobago
Bosnia & Herzegovina	Italy	Namibia	Tunisia
Bulgaria	Ivory Coast	Netherlands	Turkey
Canada	Jamaica	New Zealand	Turkmenistan
China	Japan	Norway	Ukraine
Costa Rica	Jersey	Pakistan	U.A.E.
Croatia	Kazakhstan	Poland	U.K.
Cyprus	Kenya	Portugal	U.S.A.
Czech Republic	Kosovo	Romania	Uruguay
Denmark	Kuwait	Russia	Uzbekistan
Ecuador	Kyrgyzstan	Serbia	Venezuela
Egypt	Latvia	Singapore	Vietnam
Estonia	Liberia	Slovakia	Zambia
Finland	Liechtenstein	Slovenia	Zimbabwe

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

### **iii. Anti-Abuse Provisions**

Germany has enacted anti-treaty/anti-directive-shopping rules regarding the use of intermediate holding companies.<sup>396</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.

## **K. Transfer Pricing**

### **i. German Administrative Principles**

German tax authorities are empowered to adjust reported income from transactions between related parties that are not carried out on

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<sup>396</sup> *Id.*, §50d, ¶3.

an arm's length basis if the transfer price otherwise agreed upon by the parties would lead to lower taxable income in Germany.

The standard transfer pricing methods that have been confirmed by the legislature are the comparable uncontrolled price method, the resale price method, and the cost-plus-method. In practice, these standard methods may be extended to include other elements, such as global cost allocations. Under certain circumstances, profit-based global methods, such as the profit split method and the transactional net margin method, are accepted by the German tax authorities, whereas the comparable-profit method is not accepted. A hypothetical arm's length test will be applied if it is not possible to determine arm's length transfer prices using a recognized transfer pricing method.

It should be noted that whether or not the requirements of the arm's length principle are met, business expenses in favor of majority shareholders are only tax deductible if the expenditures are made on the basis of clear and unambiguous agreements concluded in advance of the transaction. Charges made to German corporations without a clear and unambiguous advance agreement will be treated as a 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.

## **ii. 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.

### **iii. 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.

### **L. 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.

## CYPRUS<sup>397</sup>

### A. 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

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<sup>397</sup> This portion of the article was written by Nairy Der Arakelian-Merheje of Der Arakelian-Merheje LLC in Nicosia.

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.

**B. Income Tax**

**i. Tax Rate**

The flat-rate tax on annual net profit is 12.5%.

**ii. 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.

### **iii. Residence**

#### **a. Corporations**

The concept of residency status for corporations was adopted in 2003, and tax liability in Cyprus is dependent upon the status of a company as a resident. This is determined by examining the exercise of management and control in Cyprus.

Although “management and control” is not defined in Cypriot tax legislation, it is generally accepted to be in line with international tax principles, namely, that the following conditions should be considered when determining if a company qualifies as a resident of Cyprus for tax purposes:

- All strategic (and preferably also day-to-day) management decisions are made in Cyprus by directors exercising their duties from Cyprus. This is usually achieved by holding meetings of the board of directors in Cyprus and signing written resolutions, contracts, agreements, and other relevant company documents relating to the management, control, and administrative functions of the company in

Cyprus. All transactions are scrutinized very carefully, including the qualifications of the directors.

- The majority of the directors of the company are tax-resident in Cyprus and exercise their duties from Cyprus.
- A physical (administrative) office is maintained in Cyprus, from which actual management and control of the business is exercised.
- Hard copies of commercial documentation (*e.g.*, agreements and invoices) are stored in the company's office facilities in Cyprus.
- Accounting records of the company are prepared and kept in Cyprus.
- Bank accounts of the company are operated from Cyprus, even if the accounts are maintained with banks established outside Cyprus.

**b. 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.

### **1) 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 they were a tax resident of Cyprus during (i) three out of the five years preceding the year in which employment commences, or (ii) in the year directly preceding the year in which employment commences.

A 20% exemption applies to remuneration received in connection with any corporate office or employment held in Cyprus by an individual who was resident outside of Cyprus prior to the commencement of employment. This exemption applies to employment beginning during or after 2012, for a period of five years beginning on January 1 of the following year. This exemption will apply through 2020 and is not available to individuals who claim the 50% exemption.

### **2) 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.

#### **iv. E.U. Anti-Tax Avoidance Directive (“A.T.A.D.”)**

On April 5, 2019, Cyprus passed legislation implementing the A.T.A.D. in the form of interest limitations to discourage artificial debt arrangements. Deductibility of interest has been limited so as not to exceed 30% of taxable income before excess interest cost, taxes, depreciation and amortization of assets (“E.B.I.T.D.A.”).

The total of net taxable income as per Cyprus income tax calculations increased by the exceeding borrowing costs, depreciation and amortization of fixed assets and intangibles, and the notional deduction of 80% on the gross profit as a result of the Intellectual Property Box Regime.

The detailed rules apply to interest under intra-group as well as third party loans in the same manner. There are some exemptions in the following instances:

- There is a threshold of €3,000,000.00 per taxpayer.
- This does not apply to companies that do not form part of a group and without related profit participation of at least 25%.

Exempt entities include, *inter alia*, credit institutions, investment firms, undertakings for collective investments in transferable securities (“U.C.I.T.S.”), insurance business, and pension institutions.

A taxpayer may fully deduct exceeding borrowing costs if they can demonstrate that the ratio of its equity over its total assets is equal to or higher than the equivalent ratio of the group (this is subject to conditions).

#### **a. Controlled Foreign Company (“C.F.C.”) Rules**

These rules deter profit shifting to a low/no tax country. A C.F.C. is defined as an entity or a permanent establishment (“P.E.”) whose income is not taxable or exempt in Cyprus if the following conditions are met:

- In case of a non-Cypriot tax resident entity, the Cypriot tax resident company, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights, or the entitlement to profits.
- The company or P.E. is low-taxed, *i.e.*, the income tax it pays is lower than 50% of the Cypriot corporate income tax that it would have paid by applying the provisions of the Cypriot income tax law.
- When a company is a C.F.C., then the undistributed profits which result from non-genuine arrangements, which have been put in place in order to secure a tax advantage are added to the taxable person resident in Cyprus who holds the shares in the C.F.C.

For the purpose of the bullet item above, an arrangement or a series thereof shall be regarded as non-genuine to the extent that the entity would not own the assets or would not have undertaken the risks which generate all, or part of, its income if it were not controlled by a company where the significant employees' functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income.

C.F.C. rules are limited to entities which were not able to generate income themselves and in relation to which the significant employee functions are carried out by the controlling Cyprus entity.

Computation of C.F.C. income is in accordance with Cyprus tax laws and in proportion to the taxpayer's profit share entitlement. Calculations adopted ensure there is no double taxation. Any foreign tax paid is granted as a tax credit on the basis of the Income Tax Law ss 35 and 36.

#### **b. General Anti-Abuse ("G.A.A.R.") Rule**

These rules counteract aggressive tax planning. For the purposes of calculating corporate tax liability, Cyprus will disregard an arrangement or a series of arrangements that has been put into place

the main purpose or one of its main purposes being to obtain a tax advantage contrary to the object or purpose of the tax laws. Such an arrangement is deemed to be nongenuine having taken into account all relevant facts and circumstances. In this context, an arrangement may be comprised of more than one step or part.

An arrangement or a series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality. Where arrangements are ignored in accordance with the paragraphs above, the tax liability is calculated in accordance with the Cypriot income tax law.

**v. 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.

**vi. 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:

**a. Notional Interest Deduction on Equity**

**1) 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.

## **2) 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.

### **3) 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.

### **4) Practical Uses**

Taking advantage of the new incentive for deemed interest deductions would result in various benefits and eliminate potential issues. These include the following scenarios:

- Higher share capital, rather than large loans, would be more beneficial from a business operational perspective.
- Under the participation exemption rules, it may benefit the parent company to receive dividends rather than interest, which would be taxable.
- For example, rather than lending its own funds to a subsidiary, a parent company (“Company A”) may make an

equity contribution to its subsidiary (“Company B”). In the case of an equity contribution, Company A will not have taxable interest income, whereas Company B will get a deemed interest deduction. If Company B distributes the profits (without any actual interest cost) to Company A, then dividends received by Company A could be exempt from taxation.

- In cases where funds are used on back-to-back loans, beneficial ownership issues for interest received under an income tax treaty are subject to strict scrutiny. As a result, back-to-back loans are being phased out.

To illustrate, assume Company A, a resident of Country A, borrows funds from Company B, a resident of Country B. Company A lends the same funds to Company C, a resident of Country C. In this case, the tax authorities of Country C may refuse tax treaty benefits when Company C makes payments to Company A because Company A is obligated to pay to Company B all or most of the interest received. In these circumstances, Company A is not the ultimate beneficial owner of the interest because of its own obligation to pay the amount received to Company B.

Compare the foregoing result with a fact pattern in which Company A issues capital stock to Company B in return for a capital contribution. Company A then lends funds to Company C. Since Company A has no legal or contractual obligation to use the interest received from Company C to pay interest to Company B, no beneficial ownership issues should arise in Country C regarding payments to Company A.

#### **vii. 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 Paragraph B.ii above would be subject to tax at the rate of 5%.

#### **viii. 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.

#### **ix. 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.

#### **x. 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 Paragraph E below.

#### **xi. Specific Income Tax Benefits**

Certain types of income that may be subject to favorable tax treatments are discussed in the following sections.

##### **a. 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.

#### **b. 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.

##### **1) 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.

### **2) 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.

### **3) 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.

### **4) Transitional Arrangements**

Transitional arrangements for persons qualifying under the existing I.P. Box regime are in place with respect to intangibles that were

- acquired before January 2, 2016,

- acquired directly or indirectly from a related person during the period from January 2, 2016, to June 30, 2016, and were at the time of their acquisition benefiting under the I.P. Box regime or similar scheme for intangible assets in another state, or
- acquired from an unrelated person or developed during the period from January 2, 2016, to June 30, 2016 – but such benefits lapse on June 30, 2021.

## **xii. 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 Paragraph C 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 or forwards on titles
- Preference shares
- Swaps on titles
- Repurchase agreements or repos on titles
- Depositary receipts on titles
- Participations in companies
- Shares in L.L.C.'s registered in the U.S.

Dividends paid into a Cypriot holding company are exempt from income tax, and no withholding tax is payable when dividends are paid by a Cypriot holding company to its nonresident shareholders. The combination of an exemption for share gains and an absence of tax on dividend income received or paid by a Cypriot holding company likely accounts for the notable increase in the number of nonresident-owned holding companies in Cyprus since its accession to the E.U. However, 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.

### **xiii. 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.

#### **xiv. Anti-Avoidance Provisions for Hybrid Instruments and Artificial Transactions for Dividends**

Under current law, dividends are exempt from income tax but are subject to defense tax for tax-resident Cypriot individuals and, in a number of cases, for companies.

In some cases, a payment received by a Cypriot company from a company located outside of Cyprus may be considered a dividend in Cyprus, while also being treated as a tax-deductible expense in

the country of the company making the payment. These are known as “hybrid instruments.”

An example of a hybrid instrument may arise where dividends are paid on preferred shares. In Cyprus, these payments are considered dividend income, whereas in the payer’s country of residence (*e.g.*, Luxembourg), these payments may be considered interest paid, and therefore, they may be allowed as a tax-deductible expense.

The P.S.D. was amended in 2016 to exclude these payments from benefits, and Member States must introduce legislation to avoid the double nontaxation of these dividends. Cypriot tax law has been amended so that dividends that fall under the above provisions will no longer be exempt from income tax when received by a Cyprus-resident company. Instead, these dividends will be taxed as normal business income subject to income tax but exempt from defense tax.

In addition, the P.S.D. has been amended so that it does not apply in cases where there is an arrangement, or series of arrangements, between the dividend-paying company and the dividend-receiving company that have been put into place where the main purpose or one of the main purposes relates to a tax advantage that defeats the object or purpose of the P.S.D. This type of arrangement is not regarded as genuine unless put in place for valid commercial reasons which reflect economic reality.

The tax law has been amended to incorporate the above changes into the Cypriot tax legislation. The changes apply as of January 1, 2016.

### **C. 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.

**i. Penalties**

New amendments impose much higher and stricter penalties for noncompliance with the provisions of the Special Contribution for the Defense of the Republic.

**D. Other Taxes**

**i. 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.

**a. 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.

**b. 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.

**c. 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.

**ii. Inheritance and Estate Taxes**

There are no such taxes on shares held in a Cypriot company.

**iii. 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.”

**E. Arm’s Length Transfer Pricing**

Section 33 of the tax law provides specific rules to address business structures where

- (v) 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
- (vi) 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.

**F. 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.

#### **G. 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.

**i. 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.

**ii. 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.

## H. 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.

## I. Double Tax Treaties

### i. In General

Cyprus has developed an extensive network of double tax treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of jurisdictions.

Andorra	Armenia	Austria	Bahrain
Barbados	Belarus	Belgium	Bosnia & Herzegovina
Bulgaria	Canada	China	C.I.S. <sup>398</sup>
Czech Republic	Denmark	Egypt	Estonia
Ethiopia	Finland	France	Georgia
Germany	Greece	Guernsey	Hungary
Iceland	India	Iran	Ireland
Italy	Jersey	Kuwait	Kyrgyzstan
	Lebanon	Lithuania	Luxembourg

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<sup>398</sup> The treaty concluded between Cyprus and the former U.S.S.R. is applicable to Azerbaijan, Uzbekistan, and Republics of the Commonwealth of Independent States ("C.I.S.") until such time they wish to abrogate the treaty.

Latvia	Malta	Mauritius	Moldova
Macedonia	Norway	Poland	Portugal
Montenegro	Romania	Russia	Saudi Arabia
Qatar	Serbia	Seychelles	Singapore
San Marino	Slovakia	South Africa	Spain
Slovenia	Sweden	Syria	Switzerland
Tajikistan	Thailand	Turkmenistan	Ukraine
U.K.	U.S.A.	U.A.E.	

## **ii. Cyprus U.K. Income Tax Treaty**

A new double tax treaty between Cyprus and the U.K. took effect on January 1, 2019, replacing the treaty of 1974. The treaty provides for zero withholding taxes on dividends, as long as the recipient is the beneficial owner of the income. The same will also apply to withholding taxes on interest and royalty payments. Gains from the sale of real estate owned by a company will be taxed in the country where the property is located (except for shares of companies traded on a stock exchange).

In determining the tax residency of a company that qualifies as a tax resident in both countries under 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.

**J. 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.

**i. B.E.P.S. Action 2 (Hybrid Mismatches)**

The effects of B.E.P.S. Action 2 have been discussed in Paragraph B.xiv above.

**ii. B.E.P.S. Action 3 (Effective C.F.C. Rules)**

C.F.C. rules have now been introduced.

**iii. 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.

**iv. B.E.P.S. Actions 5 (Transparency and Substance)**

As previously discussed in Paragraph B.xi.b, 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.

**v. 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 Paragraph I 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.

**vi. 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.

**vii. 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:

- 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.

**viii. 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<sup>399</sup>

### A. General Overview of Business Forms and Responsibilities

#### i. Forms of Business

Malta is distinctive for its hybrid body of law, which blends traditional civil law and U.K. common law principles and has been further refined by E.U. regulations and directives. The result is a unique body of pragmatic law with international application.

The Companies Act envisages three forms of commercial arrangements as vehicles for conducting business: the partnership *en nom collectif*, the partnership *en commandite*, and the limited liability company.<sup>400</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.

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<sup>399</sup> This portion of the article was written by Dr. Stefan P. Gauci of Malta.

<sup>400</sup> Since joining the E.U., Maltese company law offers a fourth type of vehicle, the European Economic Interest Grouping (“E.E.I.G.”).

- 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. An infinite number of segregated cells may be established for the performance of securitization transactions. The assets and liabilities of each cell are considered to be contained separately and distinctly within that cell and are protected from the general assets of the securitization company and the assets and liabilities of the other cells. Cells are not vested with separate juridical personality, which is vested in the securitization company, itself. All cells are managed and administered by the board of directors or by holders of special mandates to manage and administer the securitization transaction executed by a particular cell.

## **ii. 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>401</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

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<sup>401</sup> Lower registration fees ranging between €100 and €1,900 are imposed if the incorporation documents are submitted electronically.

€100 to €1,400, depending on the company's authorized share capital.<sup>402</sup>

### **iii. Governance and Responsibilities**

The management of a Maltese company rests with its board of directors. Members of the board may be individuals or corporate entities. Directors are not required to be resident in Malta. However, with respect to companies engaging in licensed activities, such as the provision of investment services, the appointment of Maltese-resident directors is required by the Malta Financial Services Authority ("M.F.S.A.").

The M.F.S.A. has issued corporate governance guidelines with respect to the management of public companies, listed companies, investment companies, and collective investment schemes. The guidelines are intended to promote a desired standard for members sitting on the board of directors of such companies. For private companies, the guidelines represent best practices and are recommended for the management and administration of larger private companies.

The directors of a Maltese company are personally responsible for the company's compliance with Maltese tax law and are personally liable for both direct and indirect taxes owed by the company. Although court decisions vary, the prevalent view is that the responsibility extends to all directors and officers of a company, including the company secretary and persons occupying managerial positions. Comparable liability is also imposed 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>402</sup> Lower registration fees ranging between €85 and €1,200 are imposed if the annual return is submitted electronically.

#### **iv. Audit Requirements**

In Malta, the preparation of mandatory audited financial statements is regulated by the Companies Act, the Maltese Income Tax Acts,<sup>403</sup> 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>404</sup> and “small groups”<sup>405</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

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<sup>403</sup> *I.e.*, the Income Tax Act (Chapter 123 of the Laws of Malta) and the Income Tax Management Act (Chapter 372 of the Laws of Malta).

<sup>404</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>405</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.

offices of the subsidiaries are located. Certain exemptions apply to (i) private exempt companies, and (ii) single-member companies.

**v. Specific Industry Incentives**

The Maltese Aircraft Registry was launched in 2010, building on the success of the Maltese Shipping Registry, which was established in 1973. 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, held with companies registered in Malta.<sup>406</sup> This includes a 15% flat rate taxation for income derived from a qualifying contract.

Through Malta Enterprise, fiscal and business assistance is provided to businesses that establish companies or factories on Maltese territory for production activities in sector-specific industries, as well as research and development.

Malta is a center for international credit institutions that operate as limited liability companies registered under the provisions of the Companies Act and licensed under the Maltese Banking Act or the Financial Institutions Act by the M.F.S.A. These entities conduct

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<sup>406</sup> In this respect, one may refer to the Highly Qualified Persons Rules (Subsidiary Legislation 123.126), the Qualifying Employment in Aviation (Personal Tax) Rules (Subsidiary Legislation 123.168), and the Qualifying Employment in Maritime Activities and the Servicing of Offshore Oil and Gas Activities (Personal Tax) Rules (Subsidiary Legislation 123.182).

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 has been actively promoting Malta as the “Blockchain Island” for a number of years. Malta has been among the first jurisdictions to enact legislation providing a robust, yet flexible, regulatory framework for distributed ledger technology, cryptocurrencies, and artificial intelligence. The establishment of the Malta Digital Innovation Authority, closely followed by the enactment of the Innovative Technology Arrangements and Services Act and the Virtual Financial Assets (“V.F.A.”) Act towards the end of 2018, and the issuance of the first V.F.A. Licenses by the M.F.S.A. in 2019 paved the way for Maltese companies to enter into this new, fast growing sector. It is expected that these innovations will continue to support the growth of the Maltese economy in the years to come.

#### **B. 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 transfers, which are taxed immediately upon publication of the final deed of transfer. In the latter case, the tax is collected, on behalf of the Inland Revenue Department, by the Notary Public publishing the deed of transfer.

The tax is levied on the taxable income of a company earned in the fiscal year being assessed, after accounting for deductible expenses that are wholly and exclusively incurred in the production of the income. Losses from prior years may be carried forward to offset

the profits of the current year. Capital losses may not offset operating profits. Such losses may be used only to offset capital gains. The Income Tax Acts also allow for the benefit of group loss relief in those circumstances where the applicable criteria are met.

Malta applies the full imputation system of taxation, meaning that tax paid by a company is allowed as a credit when dividends are received by its shareholders.

Upon written request, companies that are in compliance with their tax submission and payment obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner for Revenue proving that their residence for tax purposes is Malta and, at the same time, confirming their fiscal good standing in accordance with Maltese law.

#### **C. Tax Accounting**

Profits generated by a company are allocated to the final taxed account, foreign income account, immovable property account, the Maltese taxed account, 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
- (iv) Profits allocated to the Maltese taxed account
- (v) Profits allocated to the untaxed account

#### **D. 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.

In the last few years, Malta's tax system has been under attack in a series of articles published in the international press, particularly in the wake of the Panama Papers and Paradise Papers exposés. 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.”). All Member States approved the A.T.A.D. 2 in February 2017. The A.T.A.D. entered into force as part of Malta’s body of law on January 1, 2019 (Subsidiary Legislation 123.187). Specific provisions dealing with exit taxation,<sup>407</sup> controlled foreign company (“C.F.C.”) rules, as well as a general anti-abuse provision, have also been introduced into Maltese law.

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<sup>407</sup> Entering into force on January 1, 2020.

In sum, the debate revolves around the morality of setting up companies in a low-tax E.U. jurisdiction. These issues have already been addressed in detail by the E.C.J. in the *Cadbury Schweppes* decision. The E.C.J. held that anti-avoidance provisions such as C.F.C. provisions cannot hinder the fundamental freedom of establishment of the E.U., and that profits of a subsidiary in another Member State with a lower rate of taxation can only be taxed in the country of residence of the parent company if the subsidiary is wholly artificial.

#### E. **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>408</sup>

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<sup>408</sup>

For this purpose, the holding of shares by a Maltese-resident company in a company not resident in Malta that derives more

- The passive interest, or its royalties, have been subject to foreign tax at a rate which is not less than 5%.

An investment qualifies as a participation where any of the following conditions are met:

- A company holds directly 10% or more of the equity of a company whose capital is wholly or partly divided into shares, and the shareholding confers an entitlement to at least 10% of any two of the following:
  - Voting rights
  - Profits available for distribution
  - Assets available to shareholders upon liquidation
- A company is a shareholder in another company (the “target company”) and is entitled, at its option, to acquire the entire balance of the issued and outstanding shares in the other company.
- A company is a shareholder in the target company and holds a right of first refusal over all shares in the target company that are owned by others in the event of a proposed disposal, redemption, or cancellation.
- A company is a shareholder in the target company and is entitled to board participation.<sup>409</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.

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than 50% of its income from portfolio investments is itself deemed to be a portfolio investment.

<sup>409</sup>

To be considered a participation, the right to nominate members of the board of directors should be a majority right.

- A company is a shareholder in the target company where the investment was made for the furtherance of its own business and the holding is not maintained for the purposes of a trade.

#### F. **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>410</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.

#### G. **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

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<sup>410</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.

behalf of, an individual who is ordinarily resident and domiciled in Malta.

**H. 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.

**I. 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.

**J. 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.

#### K. **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.

##### i. **Treaty Relief**

Treaty Relief is available if all the following criteria are satisfied:

- Under the relevant double tax treaty, the foreign tax paid in the other state is allowed as a credit against tax payable in Malta.
- The foreign tax is of a similar character to the tax imposed in Malta.
- The person making the claim is a resident of Malta during the year immediately preceding the year of assessment, and tax is payable on such income.

A person may elect to forego the credit in any given year. A claim for treaty relief must be made not later than two years after the end of the year of assessment to which the claim relates. If there is an adjustment to tax in Malta or the foreign country, the two-year period begins on the date of the adjustment.

Malta's double tax treaty network is made up of treaties in force with more than 70 states.<sup>411</sup> These treaties are by and large modeled

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<sup>411</sup> *I.e.*, Albania, Andorra, Australia, Austria, Azerbaijan, Bahrain, Barbados, Belgium, Botswana, Bulgaria, Canada, China, Croatia, Cyprus, Czech Republic, Denmark, Egypt, Estonia, Finland, France, Georgia, Germany, Greece, Guernsey, Hong Kong, Hungary, Iceland, India, Ireland, Isle of Man, Israel, Italy, Jersey, Jordan, Kuwait, Latvia, Lebanon, Libya, Liechtenstein,

after the O.E.C.D. Model Convention provisions and treaty interpretations as per the Commentaries.

Malta has also signed double taxation treaties with Curacao, Ethiopia, Ghana, Kosovo, and Monaco, but these have not yet entered into force. The treaties with Bosnia and Herzegovina, Oman, and Thailand are currently in various stages of negotiation.

Malta has also signed the Multilateral Instrument to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, which automatically amended a number of existing double taxation treaties with regard to exchange of information.<sup>412</sup>

## **ii. 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

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Lithuania, Luxembourg, Malaysia, Mauritius, Mexico, Moldova, Montenegro, Morocco, the 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, the Ukraine, the United Arab Emirates, the United Kingdom, the United States of America, Uruguay, and Vietnam.

<sup>412</sup> *I.e.*, the treaties with Australia, Austria, France, Ireland, Isle of Man, Israel, Jersey, Lithuania, Poland, Serbia, Singapore, Slovakia, Slovenia, Sweden, and the United Kingdom.

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.

### **iii. Flat Rate Foreign Tax Credit**

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief 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.

#### **L. 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>413</sup> Maltese implementation of the F.A.T.C.A. provisions was published on March 7, 2014.<sup>414</sup> The first exchanges between the two states under the I.G.A. took place in the third quarter of 2015.

Malta is also an active participant in the B.E.P.S. Project. It is a member of the *ad hoc* group of countries mandated by the O.E.C.D. and the G-20 in February 2015 to complete work on B.E.P.S. Malta signed the Multilateral Convention to Implement Tax Treaty Measures to Prevent Base Erosion and Profit Shifting (the “M.L.I.”) on June 7, 2017. The M.L.I. was enacted in Maltese legislation on April 27, 2018.<sup>415</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.

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<sup>413</sup> Malta and the U.S. signed a Model 1 I.G.A. on December 16, 2013.

<sup>414</sup> See Exchange of Information (United States of America) (F.A.T.C.A.) Order, Subsidiary Legislation 123.156.

<sup>415</sup> See Multilateral Convention (Implementing Tax Treaty Measures to Prevent Base Erosion and Profit Shifting) Order, Subsidiary Legislation 12.183.

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>416</sup> Malta has implemented the Ultimate Beneficial Ownership Register via the enactment of the Companies Act (Register of Beneficial Owners) Regulations.<sup>417</sup> The Ultimate Beneficial Ownership Register is maintained by the Registrar of Companies and is accessible to certain tax and anti-financial crime agencies, as well as any party demonstrating a legitimate interest in the information requested.

#### **M. Conclusions Applicable to Malta**

The legal framework in Malta offers several key advantages for those seeking to conduct international business in a sound and reputable jurisdiction.

Maltese transfer pricing rules are relatively flexible, and there are no thin capitalization rules. Several anti-abuse rules are contained in Article 51 of the Income Tax Act, and Malta now applies the general anti-abuse provision in the A.T.A.D., which is designed to combat artificial and fictitious schemes.

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<sup>416</sup> See Directive (E.U.) 2015/849 of the European Parliament and of the European Council of May 20, 2015.

<sup>417</sup> See Subsidiary Legislation 386.19. These regulations were enacted as part of wider legislation creating separate Ultimate Beneficial Ownership Registers for the purposes of the Trusts and Trustees Act (Subsidiary Legislation 331.10) and the Civil Code with respect to foundations (Subsidiary Legislation 16.15), all intended to ensure compliance with the provisions of the Fourth Anti-Money Laundering Directive.

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.