

OUTBOUND ACQUISITIONS:
EUROPEAN HOLDING COMPANY STRUCTURES

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1. INTRODUCTION

When a U.S. company acquires foreign targets, the use of a holding company structure abroad may provide certain global tax benefits. The emphasis is on “global” because standard U.S. benefits such as deferral of income while funds remain off-shore may not be available without further planning once a holding company derives dividends and capital gains. Moreover the tax proposals for fiscal 2011 that appear in the Administration’s Green Book are designed to raise taxes for most U.S. based multinational groups by, among other things, denying deductions for certain expenses attributable to deferred foreign source income, in particular, interest expense. This reflects a step back from proposals under which all expenses attributable to deferred income would be deferred. Also absent from the current version of the Administration’s proposal for international tax reform is a provision that would prevent the use of a “check-the-box” election for single member foreign entities below the level of a first-tier foreign subsidiary as a means of reducing U.S. tax. If an election is made, a subsidiary is viewed to be a branch of its sole shareholder to the extent that characterization is relevant for U.S. tax purposes.

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

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

Although the foreign tax credit is often described as a “dollar-for-dollar reduction of U.S. tax” when foreign taxes are paid or deemed to be paid by a U.S. parent company, the reality is quite

¹ Section 301.7701-3(a) of the Income Tax Regulations.

² There are exceptions to the general characterization of a dividend as an item of Foreign Personal Holding Company Income that might apply. One relates to dividends received from a related person which (i) is a corporation created or organized under the laws of the same foreign country as the recipient C.F.C. and (i) has a substantial part of its assets used in its trade or business located in that foreign country. See Code §954(c)(3)(A)(i). For a temporary period of time, a look-through rule is provided in Code Code §954(c)(6) under which dividends received by a C.F.C. from a related C.F.C. is treated as active income rather than Foreign Personal Holding Company Income to the extent the earnings of the entity making the payment are attributable to active income. This provision terminated at the beginning of 2010.

different. Only taxes that are imposed on items of “foreign source taxable income” may be claimed as a credit.³ This rule, known as “the foreign tax credit limitation,” is intended to prevent foreign income taxes from being claimed as a credit against U.S. tax on U.S. taxable income. The U.S., as do most countries that eliminate double taxation through a credit system, maintains that it has primary tax jurisdiction over domestic taxable income. It also prevents so-called “cross crediting” under which high taxes on operating income may be used to offset U.S. tax on lightly taxed investment income. For many years, the limitation was applied separately with regard to eight different categories of baskets of income designed to prevent the absorption of excess foreign tax credits by low tax foreign source income. In substance, this eviscerated the benefit of the foreign tax credit when looked at on an overall basis. The problem has been eased now because the number of foreign tax credit baskets has been reduced from eight to two, passive and general. On the other hand, the Administration’s tax proposals would impair the ability of U.S. based multinational groups to choose whether to receive dividends from highly taxed or lightly taxed foreign corporations by putting all earnings and all taxes of foreign subsidiaries into common pools so that only a blended rate of foreign tax may be claimed as a foreign tax credit.

The benefit of the foreign tax credit is reduced for dividends received from foreign corporations that, in the hands of the recipient, benefit from reduced rates of tax in the U.S. A portion of foreign dividends received by U.S. individuals that qualify for the 15% tax rate under Code §1(h)(11) (i) are removed from the numerator and denominator of the foreign tax credit limitation to reflect the reduced tax rate. See Code §§1(h)(11)(iv) and 904(b)(2)(B). This treatment reduces the foreign tax credit limitation when a U.S. resident individual receives both qualifying dividends from a foreign corporation and other items of foreign source income within the same basket that are subject to ordinary tax rates.

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

U.S. income tax regulations require expenses of the U.S. parent company to be allocated and apportioned to all income, including foreign dividend income.⁴ The allocation and apportionment procedures set forth in the regulations are exhaustive and tend to maximize the apportionment of expenses to foreign source income. For example, all interest expense of the U.S. parent corporation and the U.S. members of its affiliated group must be allocated and apportioned under a set of rules that allocates interest expense on an asset-based basis to all income of the group. Direct tracing of interest expense to income derived from a particular asset is permitted in only limited circumstances. Research and development expenses, stewardship expenses, charitable deductions, and state franchise taxes also must be allocated and apportioned. These rules tend to reduce the amount of foreign source taxable income in a particular category and may even eliminate that category altogether. The problem is worsened by carryovers of an overall foreign

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

⁴ See Sections 1.861-8 through 17 of the Income Tax Regulations.

loss account.⁵ This is an “off-book” account that arises when expenses incurred in a particular prior year are allocable and apportionable to foreign source income and those expenses exceed the amount of foreign source gross income of the year. Where that occurs, the loss is carried over to future years and reduces the foreign source taxable income of the subsequent year.

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

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

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

In the European context, many countries have tax laws that provide favorable income tax treatment for intercompany dividends paid across borders. Among these countries are Luxembourg, Denmark, Switzerland, England, Belgium, Spain, Cyprus, and the Netherlands. In Ireland, the tax rate is extremely low for trading profits of Irish corporations. Dividends received by Irish corporations out of earnings of foreign subsidiaries that arise from trading activities may

⁵ Section 904(f) of the Internal Revenue Code of 1986.

be exempt from tax. The rules in place cause these jurisdictions to be popular locations for the formation of a holding company by a U.S. based group. Often, however, these countries have other provisions that may be considered less favorable to a holding company. Capital tax imposed on the issuance of shares and stamp tax on the transfer of shares are examples of unfavorable provisions. Other countries that have certain favorable features include Austria, France, and Germany, although none is typically thought of as a holding company location.

This paper examines the tax treatment of holding companies in each of the foregoing jurisdictions. The goal is to determine whether the country provides tax treatment – alone or in conjunction with a second jurisdiction – that makes the formation of a holding company attractive to a U.S.-based group of companies.

2. LUXEMBOURG

Over the last decades, Luxembourg has been extremely popular as a holding and financing jurisdiction for E.U. or non-E.U. investors. Its position as an important financial center, the professional environment it is able to offer, combined with advantageous tax treatment and corporate flexibilities give Luxembourg a leading role. More recently, Luxembourg has also adopted favorable measures to stimulate investments in intellectual property and to further enhance its position with respect to regulated and non-regulated investment funds.

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

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

Besides the SOPARFI, Luxembourg law provides for two collective investment vehicles, both of which were introduced by new legislation in 2004.

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

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

The investment fund platforms like the SICAF/SICAV, F.C.P. and the S.I.F. regime, are not discussed herein.

A. General / Participation Exemption

A SOPARFI established in the city of Luxembourg is subject to Luxembourg corporate income tax at a combined top rate of 28.59% (national income tax, plus municipal business tax, plus surcharge for an unemployment fund). The rate for 2011 it is expected to be 28.80%.

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

i. Dividends

According to Article 166 of the Luxembourg Income Tax Act (“ITA”), dividends (including liquidation dividends) received by a SOPARFI, are exempt from Luxembourg corporate income tax if the following requirements are met:

- (1) The SOPARFI holds 10% or more of the issued share capital of the subsidiary (which may be held via a tax transparent entity), or the participation has an acquisition price of at least €1.2 million;
- (2) The subsidiary is a company with a capital divided into shares and is (i) a resident of Luxembourg and fully subject to Luxembourg tax; or (ii) subject in its country of residence to an income tax that is comparable to the Luxembourg corporate income tax (see below); or (iii) is covered by Article 2 of the modified E.C. Parent/Subsidiary Directive (90/435/EEC) (hereinafter: the “Parent/Subsidiary Directive”); and
- (3) At the time of distribution, the SOPARFI must have held, or must commit itself to continue to hold, the participation for an uninterrupted period of at least 12 months; and during this period, its interest in the subsidiary may not drop below the threshold mentioned under (1) above (10% or acquisition value of € 1.2 million).

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

ii. Capital Gains

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

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

B. Subject to Tax

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

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

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

C. Dividends or Capital Gains after Share Exchange

The Luxembourg ITA provides for some tax-exempt exchange operations. A tax neutral exchange can under circumstances be allowed in case of (i) conversions of a loan whereby securities are allocated to the creditor, (ii) transformation of a capital company into another capital company, (iii) mergers or divisions of capital companies or companies resident in an E.U. Member State, and (iv) certain other mergers. In order to benefit from the tax-exempt exchange operations, the book value of the transferred shares, or the book value of a loan in case of its

conversion, must also be continued in the commercial accounts on the shares received in exchange.

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

D. Luxembourg Permanent Establishment

The participation exemption also applies to dividends and gains on participations earned by, or attributed to, a Luxembourg permanent establishment of a nonresident taxpayer who is a resident of an E.U. Member State or a treaty country. Since Luxembourg does not levy (withholding) tax on the remittance of branch profits, this may be an interesting planning tool. It is not entirely clear what level of substance the Luxembourg authorities will require in order to allocate participations to such permanent establishment, but in a given situation, an advance tax clearance may be obtained on a case-by-case basis in order to ascertain the allocation.

i. Partial participation Exemption

An interest in a subsidiary of less than 10% with an acquisition price of less than €1.2 million and/or an interest in a subsidiary for which the twelve-month holding-period requirement is not and will not be met, will not qualify for the participation exemption described above. However, dividend income derived from such interest may nevertheless be eligible for a 50% exemption, provided that the other conditions for the participation exemption above under paragraph 2.A.i are met.

E. Withholding Tax in Foreign Subsidiary's Country

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

Luxembourg currently has income tax treaties in effect (and more (21) under negotiation) with the following countries:

Austria	Indonesia	Romania
Azerbaijan	Ireland	Russia
Belgium	Israel	San Marino
Brazil	Italy	Singapore
Bulgaria	Japan	Slovak Republic

Canada	Korea (ROK)	Slovenia
China (PRC)	Latvia	South Africa
Czech Republic	Lithuania	Spain
Denmark	Malaysia	Sweden
Estonia	Malta	Switzerland
Finland	Mauritius	Thailand
France	Mexico	Trinidad and Tobago
Germany	Mongolia	Tunisia
Georgia	Morocco	Turkey
Greece	Moldova	United Arab Emirates
Hong Kong	The Netherlands	United Kingdom
Hungary	Norway	United States
Iceland	Poland	Uzbekistan
India	Portugal	Vietnam

F. Deduction of Costs

i. Write-offs

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

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

ii. Financial Costs

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

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

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

iii. Liquidation Losses

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

G. Withholding Tax on Outbound Dividends/Capital Gains

i. Dividend Payment

Dividends distributed by a SOPARFI are subject to Luxembourg dividend withholding tax at the rate of 15%, unless an exemption or a lower treaty rate applies (*see also infra* in respect of liquidation dividends). Dividends paid by a Luxembourg company are exempt from Luxembourg dividend withholding tax if certain conditions are met and the dividend is paid to (i) an E.U. resident parent company eligible for benefits under the Parent/Subsidiary Directive, (ii) a Swiss resident company, (iii) a Luxembourg or E.U. branch of an E.U. company, (iv) a Luxembourg branch of a company that is a resident of a treaty country, or (v) effective January 1, 2009, a parent company that is considered as a tax resident in a treaty country and is subject to tax comparable to the Luxembourg corporate income tax. The conditions that must be met are that (a) the dividend is paid in respect of shares forming part of at least a 10% interest in the subsidiary or of an interest with an acquisition price of at least € 1.2 million and (b) the shares have been held continuously for a period of at least twelve months immediately prior to the dividend payment, or the recipient commits itself to continue to hold those shares for at least twelve months.

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

ii. Interest Payment on (Hybrid) Debt

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

In connection with the E.C. Savings Directive, Luxembourg introduced on July 1, 2005, a withholding tax, which currently is levied at a rate of 20% on interest paid through a

Luxembourg paying agent (usually a bank) generally to E.U. resident individuals or so-called residual entities. For Luxembourg resident individuals, other rules apply.

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

H. Capital Gains in Hands of Shareholders

Resident individual shareholders (entrepreneurs whose business assets do not include shares) are taxable on the alienation of shares (including by way of liquidation) in a SOPARFI where:

- The alienation takes place within 6 months after acquisition (speculation gain) or
- The alienator holds, either directly or indirectly, a substantial interest in the SOPARFI. In very broad terms, a substantial interest exists if a shareholder either alone or together with certain close relatives has held a shareholding of more than 10% in a Luxembourg company at any time during the five-year period preceding the alienation. A gain realized on the alienation of convertible debt is subject to Luxembourg income tax if the holder has a substantial interest in the debtor.

Nonresident shareholders who do not have a Luxembourg permanent establishment to which the shares and/or the income/gains from the shares in a SOPARFI belong are only subject to Luxembourg tax where they hold, either directly or indirectly, a substantial interest and (1) the alienation (including liquidation) takes place within 6 months after acquisition (speculation gain) or (2) in case of an alienation after 6 months, they have been a Luxembourg resident taxpayer for more than 15 years and have become a non-Luxembourg taxpayer less than 5 years before the alienation takes place. Note however, that Luxembourg, in general, will not be entitled to tax this gain under applicable tax treaties.

I. Liquidation of a SOPARFI

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

J. Repurchase of Shares in a SOPARFI

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

K. Other Tax Issues

i. Debt-Equity Ratio

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

ii. Capital Duty

Effective January 1, 2009, the 0.5% Luxembourg capital duty is abolished. Instead, a fixed registration duty of € 75 is introduced for (i) incorporation of Luxembourg entities, (ii) amendment of the bylaws of Luxembourg entities, and (iii) the transfer of the statutory or actual seat to Luxembourg.

iii. Annual Net Worth Tax

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

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

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

L. SICAR

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

The SICAR can be incorporated in the form of a capital company, such as an S.à r.l. or an S.A., or a transparent entity, such as an S.C.S. It is a regulated entity, though in a relatively light manner in ordinary investment funds, such as Undertakings for Collective Investments in

Transferable Securities, (“UCITS”). It is more heavily regulated than the S.I.F., which is a form of entity introduced in 2007. The SICAR is authorized by the *Commission de Surveillance de Secteur Financier* (“CSSF”). At the same time, it benefits from flexible legal rules required for investment in private equity and venture capital.

The SICAR also benefits from a favorable tax treatment, similar to a SOPARFI. In principle, a SICAR is fully taxable for corporate income tax purposes. However, income realized in connection with its investments in risk capital is fully exempt from corporate income tax. Other income, such as interest accrued on bank deposits, management fees, and the like, is normally taxed. Therefore, a SICAR differs from a 1929 Holding Company and in principle is entitled to the benefits of Luxembourg tax treaties and the Parent Subsidiary Directive. Furthermore, a SICAR is exempt from net worth tax and from withholding tax on dividend distributions it makes. Nonresident investors in a SICAR will not be subject to Luxembourg taxes on dividends distributed or capital gains realized on the disposal of the shares in a SICAR.

M. Securitization Vehicle

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

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

A securitization vehicle can either be set up in the form of a capital company, such as an S.à.r.l., S.A., S.C.A. or S.C., or in the form of a fund managed by a management company. Securitizations with Luxembourg SPVs outside the scope of the S.V. Law remain possible.

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

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

The S.V. Law also introduces a new type of financial sector professional, the fiduciary representative (“*représentant-fiduciaire*”), which may be appointed to represent and manage the

interests of investors and creditors of a securitization vehicle. A fiduciary representative must apply for a prior approval from the CSSF.

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

The above-described flexible legal and regulatory aspects are coupled with an attractive tax regime. Securitization companies are in principle fully subject to Luxembourg corporate income tax at the standard combined rate of 28.59%. However, the securitization company may deduct from its taxable base all “commitments” owed to investors and creditors. These provisions should be interpreted so that all payments, either in the form of interest or dividend, made by the securitization company to its investors and creditors are tax deductible. The taxable result of the company could, therefore, virtually be reduced to nil. Securitization funds are considered as transparent for corporate income tax purposes

Due to the deductibility of its distributions (as part of the company’s commitments to its investors), a securitization company is precluded from the participation exemption regime with respect to dividends, liquidation distributions as well as capital gains realized on its participations even if they are qualifying for the participation exemption regime. Dividend distributions by a securitization company are not subject to withholding tax in Luxembourg as they are treated as “interest” for tax purposes. Therefore, a Luxembourg normally taxable parent company is not entitled to the participation exemption with respect to dividends and capital gains it realizes in connection to a participation in a securitization company.

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

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

3. DENMARK⁶

A. In General

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

⁶ The author acknowledges the contribution of his colleague, Anne Becker-Christensen, in the preparation of this portion of the article.

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

The investor friendly environment is supported by a corporate tax regime primarily designed for operating entities and resulting in a regime (the “Danish Holding Regime”), including:

- Zero corporate taxation of inbound dividends levied on a Danish Holdco with a participation of at least 10% in a subsidiary situated in the EU or in a country which has a double taxation treaty with Denmark or if the Danish Holdco and the subsidiary are eligible for tax consolidation (no holding period requirement as of 2010)
- Zero withholding tax on outbound dividends to E.U./E.E.A. and treaty corporate parents, subject to a foreign participation of at least 10%,(no holding period requirement as of 2010), and
- Zero or reduced withholding tax on inbound dividends as a result of strong network of tax treaties with over 80 countries.

As of 2010, the Danish Holding Regime has been improved by introducing a general distinction of companies that hold 10% or more of the shares in a subsidiary (“Subsidiary Investments”), versus companies that hold less than 10% of the shares (“Portfolio Investments”). For companies that hold 10% or more of the shares in a subsidiary, the amendments provide an exemption from tax on all dividends and capital gains. Thus, the exemption from tax will no longer be limited by the period of ownership. Certain anti-avoidance provisions have been introduced to prevent holding structures established for the sole purpose of meeting the 10% threshold.

The Danish Holding Regime enhances on an already attractive set of corporate tax rules including:

- No capital duty on capital contributions,
- No stamp or transfer duty (save (in the form of registration charges) in respect of fixed property, ships and aircraft),
- No capital gains taxation on share profit at the level of Danish Holdco, provided that the Danish Holdco owns at least 10% of the shares in the subsidiary,
- No wealth tax on foreign investors within holding period,

- ❑ No exit tax on foreign investors (foreign investors are not subject to limited Danish tax liability on their disposal of shares in a Danish company), and
- ❑ A flexible, fast and easy to operate corporation law regime with no red tape.

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

- Danish controlled foreign corporation rules under which investments in foreign finance companies do not benefit from the Danish Holding Regime,
- Corporate law restrictions on up-streaming of cash flow to foreign investors through loans from a Danish holding company or through the provision of security for the indebtedness of a foreign investor, and
- Legislation targeting debt leveraged acquisitions of Danish companies, in particular international tax planning strategies involving U.S.-Danish check-the-box structures and offshore financing structures.

B. Corporate Income Tax

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

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

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

C. Withholding Tax in Foreign Subsidiary’s Country

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

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

Argentina	Armenia	Australia
Austria	Azerbaijan	Bangladesh
Belarus	Belgium	Brazil
Bulgaria	Canada	Chile
Croatia	Cyprus	Czech Republic
China	Egypt	Estonia
The Faeroe Islands	Finland	Georgia
Germany	Greece	Greenland
Hong Kong	Hungary	Iceland
India	Indonesia	Ireland
Israel	Italy	Jamaica
Japan	Kenya	Kyrgyzstan
Latvia	Lithuania	Luxembourg
Macedonia	Malaysia	Malta
Mexico	Montenegro	Morocco
Netherlands	New Zealand	Norway
Pakistan	The Philippines	Poland
Portugal	Rumania	Russia
Serbia	Singapore	Slovakia
South Africa	Spain	Sri Lanka
Slovenia	South Korea	Sweden
Switzerland	Tanzania	Thailand
Trinidad and Tobago	Tunisia	Uganda
Ukraine	United Kingdom	Turkey
USA	Venezuela	Viet Nam
Yugoslavia	Zambia	

Limited tax information exchange agreements (“TIEA”s) have been concluded with a number of other countries.

D. Corporate Taxation of Inbound Dividends

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

- o The Danish company holds at least 10% of the shares of the foreign subsidiary,
- o The foreign subsidiary qualifies as a “company” under Danish law, and
- o One of the following conditions is met:
 - The foreign subsidiary must be domiciled in E.U., E.E.A., Faroe Islands, Greenland or a state that has concluded a double taxation treaty with Denmark, or

- The subsidiary must form part of an international joint taxation according to Danish corporate tax law, or
- The parent company controls the subsidiary either directly or indirectly (group relation as described in paragraph 3.K, below).

If the Danish company holds less than 10% of the foreign subsidiary, the dividend payment will be subject to a 25 % corporate taxation

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

E. C.F.C. Taxation

i. C.F.C.

Danish tax law contains controlled foreign corporation (“C.F.C.”) provisions that until July 1, 2007, were applicable only to financial subsidiaries resident in low tax jurisdictions. As of July 1, 2007, the Danish C.F.C. regime was changed dramatically to ensure its compatibility with E.U. law after the decision in the *Cadbury Schweppes* case. The C.F.C regime now applies to financial subsidiaries in all jurisdictions including Denmark, with no regard to the subsidiary’s tax burden.

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

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

- The Danish company and the foreign subsidiary are group-related (*see* paragraph 3.k, below). Generally, group-relation exists if the Danish company directly or indirectly holds more than 50% of the foreign subsidiary’s voting rights,
- The C.F.C. income comprise more than half of the aggregate taxable income of the foreign subsidiary, and
- The subsidiary’s financial assets represent more than 10% of its total assets.

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

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

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

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

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

- The financial assets on which the yield/gains are tax exempt, such as Subsidiary Investments where the subsidiary owns at least 10% of the share capital, and the subsidiary is not considered as a trader in securities, and
- The shares in lower-tier subsidiaries, which are controlled by the subsidiary and located in the same jurisdiction as the subsidiary. Instead, the financial assets in the lower-tier subsidiaries are included proportionately in accordance with the subsidiary's direct or indirect ownership share.

F. Capital Gains Taxation

Only an entity subject to full or limited Danish taxation is taxed on capital gains. A corporation incorporated in Denmark or having its seat of effective management in Denmark is subject to full Danish taxation. An entity with a permanent establishment in Denmark is subject to limited Danish taxation on general income and capital gains if generated in Denmark.

The general rule is that a Danish company is not taxed on any gains (including foreign exchange gains) realized on sale of Subsidiary Investments (where the Danish company holds at least 10% of the shares in the subsidiary). However, the general rule does not apply if the Danish company is a trader in securities.

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.

G. Interest Deductibility Limitations

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

i. Thin Capitalization

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

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

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

Control means that more than 50% of the shares or voting rights are owned or controlled, directly or indirectly. When determining whether the lender *controls* the Danish Debtor (or *vice*

versa), votes and shares held by all group-related entities are taken into account. Votes and shares held by unrelated shareholders may also be taken into account if an agreement has been made between the lender and the unrelated shareholders for the purpose of “*exercising a common controlling influence*” over the Danish Debtor.

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

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

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

ii. Additional Limitations

Effective as of July 1, 2007, the Danish corporate tax regime was amended and two additional limitations on the deductibility of financial expenses were adopted. As a result, the deductibility of interest expenses and other financial expenses incurred by Danish companies are subject to the following three limitations (in chronological order):

- A limitation based on debt/equity ratio (existing thin capitalization rules, *see* paragraph 3.G.i, above);
- A limitation based on the tax value of assets (“Asset Limitation Rule”) entailing that net financing expenses exceeding DKK 21.3 million (approximately €2.762 million, (2010 figure)) are deductible up to a cap equal to the combined value of (i) 5.0% (2010 figure) of the tax base of Danish operating assets and (ii) 20% of the value of foreign subsidiaries; and
- A limitation based on annual profits (“EBIT Limitation Rule”) entailing a maximum interest deduction of 80% of EBIT. The limitation only applies if the net financing expenses exceed DKK 21.3 million (approximately €2.762 million, (2010 figure)).

iii. Calculation of Net Financial Expense

For the purpose of the Asset Limitation Rule and the EBIT Limitation Rule, net financial expenses are calculated as the sum of:

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

- o Loan commission fees and similar expenses;
- o Taxable capital gains and losses on claims, debts, bonds, financial instruments (excluding gains/losses on claims acquired in trade if the contracting party is a related party);
- o Gains/losses on forward contracts relating to the hedging of operating income (provided that the forward contracts are not acquired in trade);
- o Deemed finance charges relating to financial leasing arrangements (defined in accordance with IAS 17);
- o Taxable capital gains and deductible capital losses; and
- o Taxable dividends.

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

iv. Restrictions under the Asset Limitation Rule

Net financial expenses in excess of DKK 21.3 million will only be deductible by an amount corresponding to 5.0% of the tax value of certain assets.

For the purpose of computing the 5.0% ceiling, only certain qualifying assets are considered, including inter alia:

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

Shares are not considered as qualifying assets except as for shares in directly owned foreign subsidiaries which may be included up to 20% of the acquisition price (subject to certain price adjustments).

Claims, notes and financial instruments are not considered as qualifying assets either. This means that the value of the FX notes to be purchased by Danish Newco will not be included in the computation of the 5.0% ceiling. For companies that are subject to Danish tax consolidation, the computation of the 5.0% ceiling will be made on a consolidated basis.

Net financing expenses that are restricted under the Asset Limitation Rule will generally be lost in that they cannot be carried forward. However, restricted losses on claims, notes and financial

instruments may be carried forward and set off against future capital gains of a similar nature realized within the following three accounting periods.

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

Net financing expenses below DKK 21.3 million will never be restricted under the EBIT Limitation Rule (but may be restricted under the thin capitalization rules). The DKK 21.3 million ceiling (which is adjusted annually) is calculated on a group basis for Danish companies that are subject to Danish tax consolidation.

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

H. Withholding Tax on Outbound Dividends

Outbound dividends from a Danish company to a foreign parent company will be exempt from withholding tax if the foreign parent company holds at least 10% of the shares of the Danish company, and the parent company qualifies for an elimination or reduction of the Danish withholding tax by virtue of the E.U. Parent/Subsidiary Directive or a tax treaty between Denmark and the parent company's state of residence. If these conditions are not met, a 28% withholding tax is levied, subject, however, to subsequent refund if a lower rate is provided by treaty.

I. Interest Withholding Tax Check-the-Box Countermeasures

As a starting point, a 25% withholding tax applies to certain interest payments made by a Danish company to a foreign related entity (*see* definition of related legal entity above in paragraph 3.E.i.). However, a foreign related lender will be exempt from Danish interest withholding tax if it falls into one of the following categories:

- o The foreign related lender has a permanent establishment in Denmark to which such interest income is attributed, or
- o The foreign related lender is protected under the Interest/Royalty Directive (2003/49/E.U.) (no tax is levied and no withholding tax applies), or
- o The foreign related lender is protected under a tax treaty with Denmark (irrespective of treaty rate), or
- o The foreign related lender is controlled (as defined under Danish C.F.C. rules) by a Danish entity, or
- o The foreign related lender is controlled by a party resident in a country that has concluded a tax treaty with Denmark, and further that such country may tax the lender on such interest payments pursuant to C.F.C. taxation rules of that country, or

- o The foreign controlling or group related lender can demonstrate that it has paid foreign income tax on the interest received at a rate of at least 18.75% (2010) and further provided that it has not entered into a back-to-back loan with an entity that that has paid foreign income tax on the interest received at a rate of less than 18.75% (2010)

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

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

- The Danish company according to the rules of a foreign state is treated as a fiscally transparent entity, whereby the income of the company is included in the taxable income of a controlling foreign legal entity, *i.e.*, an entity that owns directly or indirectly more than 50% of the Danish company or holds more than 50% of the voting rights (*see* the definition of control in paragraph 3.g), and
- The foreign state in question is an E.U./E.E.A. member state or has a tax treaty with Denmark

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

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

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

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

J. 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 the English language.

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

K. 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 (*see* definition 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 (*see* immediately below).

With respect to cross-border tax consolidation, the all-or-none principle applies. While tax consolidation with foreign group companies is voluntary, the all-or-none principle means that either (i) all group entities (Danish and foreign) are included in the tax consolidation scheme or (ii) none of them is included. The decision to form a cross border tax consolidation group is binding for a period of 10 years. In the event the consolidation is terminated within the 10-year period, foreign tax losses that were deducted are fully recaptured.

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

- o Has the majority of the voting rights in another company; or
- o Is a shareholder and has the right to appoint or dismiss a majority of the members of another company's management; or
- o Is a shareholder and is entitled to exercise control over another company's operational and financial management on the basis of the articles of association or agreement with that other company; or
- o Is a shareholder and controls the majority of the voting rights in another company on basis of a shareholder's agreement; or
- o 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 taxable income of the consolidated group is computed company by company. The consolidated income is created by netting out the taxable results, so that losses in one company offset profits in another. Losses incurred by a group company before entering into the tax consolidation scheme cannot be set off against the taxable profits of other group companies, but only against its own future profits. Tax consolidation does not eliminate capital gains that arise from the transfer of fixed assets between group companies and there are no other special provisions exempting such gains from corporate income tax.

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

L. Interim Dividends

Danish corporate law allows for distribution of interim dividends. Interim dividends may be distributed several times a year. Interim dividends may be distributed out of the free reserves and the profits realized in the current year as of the date of the interim balance sheet. While ordinary annual dividends are distributed upon the decision of the general shareholders' meeting, the decision to distribute interim dividends is made by the board of directors pursuant to an authorization given in the articles of association.

M. Binding Advance Ruling

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

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

4. SWITZERLAND

A. In General

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

The general federal income tax for ordinary taxed companies is 8.5%, computed before tax expense, and approximately 7.8%, computed on an after tax basis. The cantonal/communal income taxes depend on the company's location: the rates vary between approximately 16% in Zug, before deduction of taxes, to approximately 20% in Zurich and 21% in Geneva, both before deduction of taxes. Before deduction of taxes, the cantons of Obwalden and Appenzell Auser rhoden have the lowest ordinary Swiss corporate tax rate of approximately 12.7% (incl. federal, cantonal and communal income taxes).

In addition to the income tax, wealth taxes must be considered. On the cantonal/communal level, holding companies have to pay a wealth tax in the range of 0.01 %-0.18 %, *i.e.*, CHF 115 up to CHF 1,755 per CHF 1 million taxable capital. The respective tax rates have been reduced dramatically in the last year and in some cantons there exists the possibility to credit income taxes against the wealth tax. There is no federal wealth tax.

B. Taxation of Holding Companies

i. Income Tax

If a company qualifies as a holding company for tax purposes, it will be fully exempt from cantonal/communal income taxes. To qualify as a holding company, one of two tests has to be met. Either two-thirds of the company's total income must be derived from qualifying participations⁷ or two-thirds of the assets reported on the company's balance sheet must be qualifying participations (at book values, or, if the test can be fulfilled at fair market values, at those higher values).

On the federal level, the general income tax is 8.5% (before taxes) and, generally speaking, only income other than dividend income from qualifying participations will be taxable. In other words, the participation Exemption which reduces the taxation of dividends income to almost zero applies to dividends from qualified participation meaning a participation of at least 20% of the capital right in another company or participation with a fair market value of at least CHF 2 million. To further mitigate the double taxation burden on the business profit, participations of

⁷ A qualifying participation is either at least 20% of the capital rights in another company or the fair market value of such participation is at least CHF 2 million. As of January 1, 2011, 10 % or CHF 1 million are sufficient.

at least 10% or with a fair market value of at least CHF 1 million will qualify as qualifying participations as of January 1, 2011. However, the tax on dividends can be somewhat higher than zero if the participations have been financed with loans by the holding company and the holding company receives interest payments from its participation. The effective income tax rate on dividend income is in many cases virtually nil and almost never greater than 2%.

ii. Wealth Tax

As already described, there is no federal wealth tax. In most cantons holding companies have to pay a substantially reduced wealth tax, *i.e.*, in the canton of Obwalden the wealth tax for holding companies amounts up to only 0.001% of the company's total wealth (at book values), *i.e.*, CHF 10 per CHF 1,0 million capital, with a minimum capital tax of CHF 500 per annum. Most of the other cantons have also reduced their wealth tax or intend to do so in the near future.

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

iii. Stamp Duty at Formation

An incorporation which entails a cash contribution to a Swiss company (company limited by shares, "Aktiengesellschaft") or a limited liability company ("GmbH") is subject to a 1% stamp duty on the amount of share capital or equity contributed. The first CHF 1,0 million of share capital are tax free.

However, Swiss holding companies are frequently incorporated by way of reorganization, which is free of the 1% stamp duty. To qualify as a reorganization for stamp duty purposes certain conditions must be met. First, at least one 50 % participation has to be contributed in form of a quasi-merger. Second, the nominal share capital of the new holding company must not exceed the total nominal share capital of the contributed companies. If the contributed companies have low nominal share capitals (*e.g.*, U.S. or U.K. companies having shares with no or only a very low nominal value), the Swiss debt/equity rules (as described below in paragraph 4.C.iii) apply vice versa, *i.e.*, for Swiss stamp duty purposes a "normal" share capital will be calculated and applied as the contributed nominal capital of such company. Normally 30% of the fair market value of the contributed company/ies can be reflected as nominal share capital in the acquiring company.

iv. Capital Gains Tax

Capital gains realized by a corporation, whether or not a holding company, might be subject to the participation exemption on the federal level. To qualify for the exemption, the selling corporation must dispose of at least a 20% participation and the participation must have been held for at least one year. In contrast to the dividend exemption, the alternative market value test of CHF 2m is not applicable. As from January 1, 2011, capital gains realized by a Swiss company upon sale of a portion of at least 10% of a participation (per sale) or, in some cases, also less than 10% of a participation will be subject to the participation reduction provided the value of the participation in the latter case had a fair market value of at least CHF 1 million at the end of the tax period prior to the sale. In both cases a holding period of at least one year is

necessary. Furthermore, holding companies continue to be exempt from cantonal and communal taxes on capital gains.

v. **Value-Added Tax (“V.A.T.”)**

A Swiss holding company might be subject to VAT at the present rate of 7.6% if it provides services and receives management fees from affiliates or other service income in excess of CHF 75,000 per year. As of January 1, 2011, this rate will be increased to 8.0 %. On the other hand, the input VAT could in these cases be recovered partially or completely.

As of January 1, 2010 every holding company can register as a VAT payer if certain conditions are met. This would entitle such holding companies to a full (or at least reduced) refund of any input VAT (*e.g.*, on advisor’s or auditor’s fees etc.).

vi. **Securities Turnover Tax**

Swiss companies holding securities with a book value of at least CHF 10m will be categorized as a securities dealer for securities turnover tax purposes. Once categorized (which normally is the case six months after the first financial statement shows securities of at least CHF 10m), the acquisition and disposition of securities will be taxable at a total rate of 0.15% for Swiss securities and 0.30% for foreign securities (normally born each 50% by seller and acquirer).

vii. **Swiss Withholding Tax**

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

For dividends due after December 31, 2004 and paid to any E.U. parent company controlling at least 20% in the Swiss subsidiary (or such lower percentage provided in an applicable treaty), the refund system for withholding tax has been abolished and is now replaced by a general exemption system. Before paying a dividend without deduction of the full 35% Swiss withholding tax, the Swiss subsidiary must file a special request with the Swiss federal tax administration and must receive a permit to pay at the reduced treaty rate.

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

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

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

Until the end of 2010, Swiss withholding tax law follows the so called “nominal value principle,” under which only the repayment of the nominal share capital of a Swiss company is exempt from Swiss withholding tax. This long-criticized law will be changed and each Swiss company will be entitled to show all equity contributions since January 1, 1997 in its financial statement in the first financial statement ending after December 31, 2010.

Examples for so qualifying “new” equity are shareholder’s contributions to a Swiss company’s capital surplus and other contributions which were subject to the Swiss stamp duty. Every Swiss company therefore has to analyze its balance sheets and activities since January 1, 1997, in order to fulfill the required bookkeeping adjustments.

The value of such “new” capital is equal to the reduction of withholding tax, viz., 35% of the capital that would be subject at the nonrefundable Swiss withholding tax under the old law.

viii. Tax Credit for Foreign Withholding Taxes

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

ix. Swiss Tax Treaty Network

Switzerland has income tax treaties with 111 countries, including all old and new E.U. countries and with most of the important trading partners of Switzerland, and a number of limited treaties for sea and air enterprises.

x. 1962 Decree on Misuse of Treaties

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

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

To illustrate the working of the 1962 decree, assume that a Swiss holding company owned by foreign shareholders, receives dividends, interest and royalties from third treaty countries with which Switzerland has income tax treaties in effect. Assume further that the total of those items

of gross income is CHF 100. In these circumstances, a maximum of CHF 50 may be booked as a deductible expense paid to third parties outside Switzerland. In addition, a minimum dividend of CHF 25 must be distributed to the Swiss company's shareholders.

xi. 1998 Circular Letter

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

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

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

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

xiii. Holding Company Activities

A Swiss holding company might generally be attractive, because its activities are not strictly limited to holding activities. Thus, as long as (i) the main purposes of the holding company are holding activities (reflected in the articles and in fact) and (ii) either the income or the asset test as described above in paragraph 3.B.i are met, the holding company can perform additional functions as follows:

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

As a consequence, a Swiss holding company can employ personnel and it may rent office space. Due to the tax exemption on the cantonal/communal level, income derived from the foregoing activities (*i.e.*, interest, royalty and management income) is only taxable on the federal level, *i.e.*, 8.5% (before taxes) or approximately 7.9% after taxes. Nonetheless, because the law does not

contain total clarity, it is viewed to be prudent to obtain a ruling from the tax authorities with regard to substantially other than holding company functions.

C. Additional Tax Related Issues

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

In Switzerland, companies are in most cases incorporated either as an Aktiengesellschaft or as a GmbH. Since the Swiss Aktiengesellschaft qualifies as a per se corporation for the U.S. check-the-box-rules, these rules can only be used in connection with a Swiss GmbH. Swiss holding companies can be set up in form of a Swiss GmbH. Before the revision of the GmbH law, there was a limitation of a GmbH's share capital of CHF 2 m. As of January 1, 2008, a GmbH's share capital does not have a limitation. Although the new law brought substantial changes, the "new" Swiss GmbH is still applicable for the U.S. check-the-box-rules.

ii. Swiss Ruling Policy

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

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

iii. Swiss Debt-Equity Rules

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

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

iv. Use of Swiss Holding Companies

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

No activity clause is requested for investments, *i.e.*, participations owned by a Swiss holding company can also be qualified as a portfolio investment;

No "subject to tax clause" exists for underlying participations;

No holding period is requested for investments in connection with dividend distributions;

No capital gains tax upon sale of at least 20% participations (10% as of January 1, 2011);

Income other than dividend income is only subject to the 8.5% federal income tax (7.9% after taxes), whereas such income is fully taxable at rates between 30-40% in other E.U. Member States, and

Switzerland does not have any C.F.C. legislation.

v. **Possible Future Holding Company Taxation**

With regard to the future taxation of Swiss holding companies, the Swiss federal tax administration recently made revolutionary proposals to eliminate the complicated participation exemption system and adopt a complete exemption system. Dividends and capital gains on any sort of shareholdings should be completely income tax exempt in any kind of company, independent of the number or shares (today 20%, as from January 1, 2011 10% shareholdings are required) and independent of the holding period (today one year is required). These changes are designed to make the holding location Switzerland more attractive.

5. **BELGIUM**

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

This portion of the paper focuses on the Belgian company as a holding company, but under certain circumstances, a Belgian branch of a foreign company could be a valuable alternative.

A. **Corporate Income Tax**

i. **General Regime**

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

ii. Participation Exemption – General

Under the participation exemption, qualifying dividends received by a Belgian company are eligible for a 95% deduction and capital gains realized on the disposition of qualifying shares of stock are eligible for a 100% exemption.

iii. Dividends Received Deduction

The full amount of all dividends received – net of foreign withholding tax – is first included in taxable income with the other taxable income items of the Belgian company. Ninety-five percent of qualifying dividends are subsequently deducted, but only in case and to the extent that the initial computation results in a positive balance. In principle, the remaining 5% of dividends received is part of the taxable income of the Belgian company. If the net result of the Belgian company's other activities in the current year is negative, none or only part of the qualifying dividends can be deducted. Moreover, in certain instances, any negative result of the Belgian company derived from other activities may be wholly or partially "absorbed" by dividends qualifying for the participation exemption. In those instances, the absorbed portion of operating losses is not eligible for carryover to subsequent tax years. The "unused" portion of the dividends received deduction would then be permanently lost, as no carryforward or carryback is available. While this was the general rule until the *Cobelfret* case was decided (see below), the situation is now more nuanced.

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

The ECJ delivered a ruling in *Cobelfret v. Belgium*, case C-138/07, on 12 February 2009. In line with the Advocate General's opinion of May 2008, the ECJ concluded that Belgium failed to refrain from taxing qualifying dividends, as is required under Article 4(1) of the Parent/Subsidiary Directive. The other two pending cases were decided by "reasoned order" of the ECJ on 4 June 2009 (*KBC v. Belgium*, case C-439/07 and *Beleggen, Risicokapitaal, Beheer NV*, case C-499/07) and deal not only with E.U.-source dividends, but also with Belgian domestic dividends as well as third-country dividends. In its order, the ECJ referred the matter back to the Belgian national tax courts because the ECJ did not see a direct infringement of E.U. rules. Consequently, the national courts must decide whether there is discrimination in the treatment of nonresident taxpayers compared with resident taxpayers. On 11 May 2009, the Belgian Council of Ministers approved Finance minister Reynders' proposal for a Practice Note, allowing the tax administration to apply the principles laid down in *Cobelfret* with no specific limitations in terms of retroactivity. On 23 June 2009, 12 October 2009 and 19 May 2010, the Belgian Tax Administration issued in aggregate four circular letters (including one addendum) on the matter. Meanwhile, the statute was amended by the Law of 21 December 2009, effective January 1, 2010. The position can now be summarized as follows.

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

- In a Member State of the European Economic Area (“EEA”), including Belgium, but for dividends declared before 1994, non-E.U. Member States of the EEA are not taken into consideration as the EEA entered into effect on 1 January 1994; or
- In a country with which Belgium has concluded a bilateral tax treaty that contains an equal treatment clause (functional equivalent of Article 22(1)(c) of the Belgium-U.S. Income Tax Treaty currently in effect); or
- In another country, provided that Article 56 of the E.U. Treaty applies (free movement of capital) to the (share) capital represented by the shares that produce the dividends.

In addition, Belgium disallows the dividends received deduction for dividends received by a Belgian company to the extent that its taxable income (profit) consists of certain non-deductible expenses. However, according to Article 205, §2, Sections 2 and 3 ITC, the disallowance does not apply to dividends stemming from qualifying subsidiaries established in E.U. Member States. In its Circular Letter of 19 May 2010, the carve out is extended to dividends from sources mentioned in the first two bullets, above.

a. Minimum Value of participation

Dividends distributed by a subsidiary are eligible for the dividends received deduction if the corporate recipient owns at least 10% of the nominal share capital of the subsidiary or, alternatively, the acquisition price (value) for the holding in the subsidiary was at least €2.5 million.⁸ The shares generating the dividend income must be booked as a “financial fixed asset” in the commercial balance sheet.⁹ Note that specific rules exist for Belgian companies subject to particular accounting regulations, *i.e.*, banks and insurance companies.

⁸ Threshold increased to €2.5 million (up from €1.2 million) pursuant to Article 130 of the Program Law of 23 December 2009, applicable to dividends declared or paid on or after 1 January 2010. Pursuant to Article 54 of the Law of 22 December 2009 (effective tax assessment year 2010; financial years ending on or after 31 December 2009) the exception to the minimum-participation requirement that was available for credit institutions, insurance companies and stock exchange traders was repealed.

⁹ In November 2009, the E.U. Commission issued a reasoned opinion (*i.e.*, the second step of an infringement procedure) asserting that the requirement imposed by Belgium – that dividends received are 95% exempt only if the income-producing shares pertain to a “financial fixed assets” – runs afoul of the E.U. Parent-Subsidiary Directive in that it adds a condition to the dividends received deduction that is not permissible under the Directive. In all likelihood, Belgium will be forced to give up this condition, at least for dividends from participations as defined in the Directive. As was the case in other, similar situations, Belgium will likely make no distinction between qualifying dividends under the Directive and other dividends. Hence, it is expected that Belgium will drop the “financial fixed asset” test. See press release No. IP/09/1770 of 20 November 2009. E.U. Commission’s case reference No. 2007/4333.

b. Minimum Holding Period

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

c. Subject to Comparable Tax

To qualify for the dividends received deduction, the subsidiary paying the dividend must meet a “subject-to-tax requirement.” If the subject-tax-requirement is not met, the dividends are not exempt in the hands of the corporate shareholder. Consequently, the dividends received deduction is not available for dividends distributed by a company that (i) is neither subject to Belgian corporate income tax nor to a foreign tax similar to the Belgian corporate income tax or (ii) is resident for tax purposes in a country that has in effect a normal tax regime which is substantially more advantageous than the Belgian normal tax regime. Pursuant to the Commentary on the Belgian Income Tax Code (margin nos. 199/34 and 199/35), the following countries do not have a tax similar to the Belgian corporate income tax: Andorra, Anguilla, Bahamas, Bahrain, Bermuda, Campione, Cayman Islands, Ciskei, Grenada, Nauru, St. Pierre de Miquelon, Sark, Tonga, Turks and Caicos, and Vanuatu. A foreign tax is not considered similar to Belgian corporate income tax if it is substantially more advantageous than that of Belgium, *i.e.*, below 15 percent (nominal or effective rate). A Royal Decree dated January 27, 2010, updates the list of countries that must be regarded as having tax regimes that are substantially more advantageous than the Belgian normal tax regime. This list is subject to periodical update and countries appearing on this list can still qualify for the Subject to Comparable Tax-test if the taxpayer can prove that the participation is subject to a comparable tax.¹⁰ This list includes the following 26 jurisdictions, which may be modified from time to time:

Abu Dhabi, Ajman, Albania, Aldernay, Bosnia and Herzegovina, Dubai, Guernsey, Herm, Kyrgyzstan, Macau, Macedonia, Isle of Man, Jersey, North Korea, Marshall Islands, Federated States of Micronesia, Moldova, Montenegro, Oman, Uzbekistan, Paraguay, Pitcairn Island, Ras al- Khaimah, Serbia, Sharjah and Umm al-Qaiwain.

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

d. Proscribed Business Activities

The dividends received deduction is not available for dividends distributed by a company defined as a finance company, a treasury company, or an investment company, which although

¹⁰ Prior to the Royal Decree of January 27, 2010, Panama was on this list, but the Belgian Ruling Commission had confirmed, in a specific case, that a Panamanian subsidiary of a Belgian corporation satisfied the subject to comparable tax-test (Ruling No. 700.383 of 13 November 2007).

in principle is subject to a tax regime that meets the standards set out above in the country where it is a resident for tax purposes, enjoys a tax regime that deviates from the normal tax regime.

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

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

An “investment company” is defined as a company the purpose of which is the collective investment of capital funds, *e.g.*, SICAVs, SICAFs and comparable entities.

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

e. Offshore Activity

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

f. Certain Foreign Branch Income

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

Under the 2002 Belgian corporate tax reform, 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 percent corporate income tax, or the company and its branch are located in another E.U. jurisdiction.

g. Intermediary Companies

The dividends received deduction is not available for dividends distributed by an intermediary company, other than an investment company, that redistributes dividend income derived from tainted participations. As a result, if at least 90% of a dividend received from an intermediary

company is funded by its own receipt of dividends from subsidiaries located in third countries, the dividends received deduction may be disallowed if no deduction would have been permitted had the lower-tier companies paid dividends directly to the Belgian corporation. In other words, a group cannot “launder” tainted dividends by washing them through an intermediary located in an acceptable jurisdiction.

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

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

h. Other Aspects

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

Pursuant to the law of 23 June 2005, Belgian corporations are entitled to a notional interest deduction (“N.I.D.”). The N.I.D. is a tax deduction for fictitious interest owed on the corporation’s equity as it appears in its commercial balance sheet. The notional interest rate is restated every year; for fiscal year 2009, the notional interest rate was set at 4.473%. As of 2010, the notional interest rate is capped at 3.8%. To curb perceived abuses, the amount of equity that serves as the basis for computation of the N.I.D. is adjusted by deducting the commercial book value of participations that qualify for the participation exemption.

The law of 27 April 2007 has introduced a new tax deduction for Patent income, amounting to 80% of the gross income deriving from the patent, thereby resulting in effective taxation of the income at the rate of 6.8% (rounded). This new tax incentive is aimed at encouraging Belgian companies and establishments to play an active role in patent research and development, patent ownership and manufacturing of products based on those patents. The tax deduction applies to new¹¹ patent income and come into force as of tax year 2008, *i.e.*, financial years ending on or after 31 December 2007.

¹¹ In order to be new, the income in relation to patents must not have not been used by the company, a licensee or a related enterprise for the purpose of the supply of goods or services to third parties prior to January 1, 2007.

i. Ruling Practice

The Belgian tax administration must, upon the taxpayer's request, issue an advance tax ruling on, *i.e.*, the availability of the dividends received deduction and especially on the question whether one or more anti-abuse provisions apply in a particular case. No such ruling will be granted, however, with respect to jurisdictions or types of companies listed as non-qualifying in the official tax haven list (*see*, paragraph 5.A.iii.c above). In principle, the tax authorities must issue their ruling within three months of receipt of a complete and exhaustive ruling application.

iv. Capital Gain Exemption

Under the participation exemption, net capital gains realized by a Belgian resident company (or the Belgian branch of a foreign company) on shares in a Belgian or a foreign subsidiary are fully exempt from Belgian corporate income tax, provided the dividends on the shares qualify for the tests described above under paragraph 5.A.iii through 5.A.vii of the dividends received deduction. However, if a foreign subsidiary derives dividends (directly or indirectly) from one or more companies not meeting the anti-abuse requirements for the dividends received deduction, the entire capital gain on the disposition of the shares of the subsidiary would be taxable.¹² Only the net amount of eligible capital gains is exempt from tax, in other words, costs and expenses incurred by the corporate shareholder in connection with the realization of the shares of stock, must be deducted from the exempt amount of capital gains. Hence, such costs and expenses cannot be deducted from ordinarily taxed income and save additional corporate income tax. See also paragraph 5.A.v. below.

a. No Minimum Ownership or Holding Period Requirement

The minimum participation requirement that exists for dividends (10% of the capital or acquisition value of not less than €1.2 million) and the minimum holding period requirement (one year) do not apply for capital gains. The exemption applies only to the extent that the capital gain realized on the shares exceeds the tax book value of these shares. The capital gain exemption is granted by a direct elimination of the net gains from taxable income. Consequently, the limitation connected with the method used for granting the dividends received deduction does not come into play and loss utilization is not adversely affected. This means that losses derived from other activities of the Belgian holding company do not absorb the participation exemption on capital gains.

b. Options

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

¹² This is the official view of the Belgian Revenue; however, this view is contested.

c. Unrealized Gains

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

d. Capital Losses

As a counterpart to the exemption of capital gains, capital losses on the disposition of shares are not tax deductible. However, the loss incurred in connection with the liquidation of a subsidiary company remains deductible up to the amount of the paid-up share capital of that subsidiary.

v. Deductible Expenses

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

Pursuant to the Law of 23 June 2005, capital gains are exempt only for their net amount, *i.e.*, the gross capital gain minus costs and expenses incurred in connection with the realization of the gain (*e.g.*, brokerage fees, stamp duties, etc.).

B. Withholding Tax on Distributions

i. To Belgium

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

ii. From Belgium

In principle, all dividends distributed by Belgian companies to both resident and nonresident shareholders are subject to withholding tax of 25%. A reduced rate of 15% is available for dividends relating to shares issued on or after 1 January 1994, provided that (i) the shares are publicly issued or (ii) if the shares are not publicly traded, a number of conditions are met.

A full exemption of Belgian withholding tax applies on the distribution of dividends to a parent company established (i) within the E.U. (including Belgian companies) or in a country with which Belgium has concluded a bilateral tax treaty containing an exchange of information provision, and which holds at least 10% of the capital of the Belgian resident distributing company.¹³ If a qualifying parent company holds or has held a qualifying participation, all

¹³ The participation percentage for zero-rated dividend distributions has dropped to 10% for dividends distributed on or after 1 January 2009.

additionally acquired shares will also qualify, even though the one-year holding period may not be met with respect to such additional shares.

iii. Denkavit Case

Following the ruling from the E.U. Court of Justice in the *Denkavit* case, Belgium abandoned the condition that the parent must have held a participation of at least 15% uninterrupted during a period of at least one year preceding the distribution of the dividend. Therefore, the parent may hold the 15% participation for one entire year, which may occur partly before and partly after the dividend distribution. If the one-year period has not entirely elapsed at the time the dividend is paid, the Belgian distributing company is allowed to pay out the net dividend only, *i.e.*, the gross dividend minus an amount equal to the dividend withholding tax that would apply if the one-year holding period is not respected. If the latter occurs, the amount of withholding tax that becomes due, increased with interest for late payment, must be paid to the Belgian treasury by the dividend distributing company.

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

iv. Liquidation and Redemption Distributions

As a separate matter, the dividend withholding tax rate is 10% in the case of a liquidation of a Belgian company or a redemption by a Belgian resident company of its shares. Distributions pursuant to liquidations and redemptions are also eligible for rate reductions or exemptions from withholding tax on the basis of the bilateral tax treaties concluded by Belgium, the E.U. Parent/Subsidiary Directive or the unilateral extension of the E.U. Parent/Subsidiary withholding tax exemption discussed above.

C. Withholding Tax on Outbound Interest Payments

Interest paid by any Belgian company is, in principle, subject to interest withholding tax of 15%. This domestic rate can often be reduced by virtue of bilateral tax treaties, several domestic exemptions as well as the E.U. Interest and Royalty Directive as implemented in Belgium.

D. Capital Duty

Pursuant to the Law of June 23, 2005, the rate of the capital tax is set at 0%¹⁴ for all contributions to share capital occurring on or after January 1, 2006.

¹⁴ Technically speaking, the capital tax is not repealed, but its rate is set at 0%.

E. V.A.T.

On the basis of the case law of the European Court of Justice, a distinction is made between so-called “active” and “passive” holding companies.¹⁵ A passive holding company has no economic activity that gives entitlement to credit input V.A.T. Its activities consist exclusively of the collection of dividends as well as the realization of capital gains upon disposition of shares or participations. An active holding company, however, is involved in its subsidiaries’ management. To the extent that its activities are neither exempt nor outside the scope of V.A.T., an active holding company can credit input V.A.T. against output V.A.T.

Based on a recent answer from the Belgian Minister of Finance on a Parliamentary Question,¹⁶ even V.A.T. incurred in connection with the sale of shares may, under appropriate circumstances, be creditable and refundable. This new insight is derived from the ECJ’s ruling of 29 October 2009, Case Nr. C-29/08 *Skatteverket vs. AB SKF*. First, one should determine whether or not there is in principle a direct relationship between a “previous” transaction (for example, an input transaction on which input-VAT is chargeable) and a “subsequent” transaction (for example, an output transaction that is subject to output-VAT). If that is the case, the input-VAT can be credited. Conversely, if there is a direct relationship between an input transaction and an output transaction that is either exempt from VAT, or outside the scope of VAT, the input-VAT is not creditable (as was the situation in ECJ Case No. C-4/94 of 6 April 1995 *BLP Group*). However, if no direct relationship exists between the input transaction and any output transaction, the input-VAT may still be creditable, provided that the cost for the input-services on which input-VAT was due is part of the general expenses of the taxpayer and is included in the price charged by the taxpayer for goods delivered or services rendered. This principle was formulated in the *Skatteverket vs. SKF*-Case of the ECJ of 2009. Where the Belgian tax administration accepted that input-VAT could be creditable in the event of an issuance of new shares or the purchase of shares. Until recently, they follow the same reasoning for VAT incurred in connection with the sale of shares. However, according to the Minister of Finance, no VAT credit is available if the cost of the input-transaction on which VAT was charged is included into the sales price of the shares which is either exempt or out of scope. Only if the cost of the input transaction is included in the price of output-transactions that are subject to VAT (*i.e.*, neither exempt, nor out of scope) will the input-VAT be credited and recovered.

F. Private PRICAF

Private PRICAFs are private (*i.e.*, non-listed), collective investment undertakings, aimed at investing in non-listed companies. In principle, a private PRICAF is not a holding company *per se* and is not allowed to acquire the control of a company (minor derogations are allowed).

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

¹⁵ A.o., C-77/01, 29 April 2004, EDM.

¹⁶ Parl. Question, No. 299 of 12 January 2010 (Brotcorne), Q&A, Chamber 2009-2010, No.52-102, 107.

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

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

Dividends distributed by a Private PRICAF are liable to a 25% or 15% (under certain conditions) withholding tax. However, distributions stemming from capital gains realized on shares by the Private PRICAF are exempt from withholding tax, as well as redemption premiums or liquidation gains. Under conditions, the dividends distributed by the Private PRICAF may benefit from the dividends received deduction regime.

6. THE NETHERLANDS

Over the past few decades, the Netherlands has been a prime location for holding companies. The Netherlands was deemed to be so attractive that a number of countries have copied the Dutch participation exemption system with more and less success. The main benefits of the Dutch holding company remain access to an extensive tax treaty network (almost 80), a large network of bilateral investment treaties (almost 90), the Dutch tax ruling practice and the transparency of its holding regime. The importance of bilateral investment treaties that provide protection for investments by Dutch resident entities becomes apparent when jurisdictions enact defensive measures targeting foreign investors. The benefits of an extensive treaty network have been enhanced the last few years with the popularity of the legal form of the so-called "Cooperative" ("Coöperatie") as a holding vehicle, allowing international holding structures to distribute profits free from Dutch dividend withholding tax.

A. Corporate Income Tax – General

In principle, all income of a holding company will be subject to Dutch corporate income tax at the rate of 25.5% for profits exceeding €200,000. Profits up to €200,000 are taxed at a rate of 20%. However, because of the Dutch participation exemption, a Dutch resident holding company will often have little or no taxable income.

B. Participation Exemption

i. In General

Under the participation exemption as laid down in Article 13 Corporate Income Tax Act ("CITA") dividends (including dividends in kind and "hidden" profit distributions) and capital gains derived from qualifying shareholdings are exempt from Dutch corporate income tax, while capital losses are deductible only under special circumstances (*see* paragraph 6.C.v, below). No minimum holding period is required, although in a short term buy-and-sell transaction, part of the tax exempt capital gain realized may be requalified as a taxable service fee. The

participation exemption only applies if the interest held by the Dutch resident taxpayer qualifies as a participation (“*deelneming*”). A participation exists if the Dutch taxpayer:

- Holds at least 5% of the nominal paid-up capital of a company with a capital divided into shares;
- Holds an interest in an “open” limited partnership which gives entitlement to at least 5% of the profits realised by the open limited partnership;
- Is a member of a cooperative; or
- Holds at least 5% of the voting rights in a company which is resident in an EU member state with which the Netherlands has concluded a tax treaty that provides for a reduction of Netherlands dividend withholding tax on the basis of voting rights.

In addition, under the so-called “drag along rule” a shareholding of less than 5%, a hybrid loan (*see* paragraph 6.B.iv below) or a profit sharing right in a subsidiary will qualify as a participation, if (i) the subsidiary is related to the Dutch taxpayer, or (ii) a related entity (whether resident in the Netherlands or elsewhere) holds a qualifying participation in the subsidiary. Please note that the term “related” is statutorily defined and refers to share ownership of at least one-third.

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

ii. Motive test

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

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

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

iii. Subject to tax test

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

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

iv. Asset test

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

Assets which qualify as free passive assets are:

- Passive assets which are not necessary for the business activities of the entity holding the assets. Interest bearing bank accounts, loan receivables, passive investments such as bonds and shares could, amongst others, qualify as free passive assets. In this respect it should be noted that real estate -including rights over real estate- is not considered to be a free passive asset, unless the real estate is held by a Dutch exempt investment institution, or a Dutch 0%-taxed investment institution.
- Inter-company receivables, unless they are used by an active group finance company or are financed entirely or almost entirely (90% or more) by third party debt.
- Assets leased to a group company, unless they are used by an active group leasing company or are financed entirely or almost entirely (90% or more) by third party debt.

As mentioned above, both direct and indirect assets of the participation must be taken into account. Consequently, assets of companies in which the participation holds an interest of at least 5% must be pro rata allocated to the participation. Interests below 5% are in any event deemed to be passive assets. Furthermore, if less than 30% of the assets held by a company consist out of free passive low taxed assets, all assets -excluding participations- of the company can be allocated to the participation as "good assets".

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

v. Earn-out and balance guarantee arrangements

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

vi. Expiring participation

A participation that qualified for the participation exemption for an uninterrupted period of at least 1 year remains eligible for the participation exemption for an additional period of 3 years if the participation falls below the 5% threshold as a consequence of a sale of shares or an issue of new shares to a third party.

vii. Non-qualifying participations

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

viii. Stock Options/Convertible Bonds

Pursuant to case law, the participation exemption also applies to options that relate to shareholdings qualifying for the exemption. In addition, the Dutch supreme court ruled in 2007 that a conversion gain realized on convertible bonds is covered by the participation exemption, if the conversion leads or could lead to a qualifying shareholding for the participation exemption.

ix. Hybrid Loans/Profit Rights

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

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

If a loan qualifies as a hybrid loan, the loan will be regarded as capital for corporate income tax and dividend withholding tax purposes. Consequently, interest paid on the hybrid loan will not be deductible for corporate income tax purposes and in principle will be subject to 15% dividend

withholding tax. (For a further explanation regarding dividend withholding tax, *see* paragraph 6.E, below.) On the other hand, the interest and principal paid on a hybrid loan will be exempt from Dutch corporate income tax in the hands of a Dutch resident lender if this lender owns a qualifying participation in the borrower or the borrower qualifies as a related entity of the lender. For instance if a Dutch company holds two Dutch subsidiaries and the first subsidiary grants a hybrid loan to the other subsidiary, the interest received by the first subsidiary will be exempt under the participation exemption. Especially in the context of international structures, we note that the exemption for interest received on a hybrid loan by a Dutch lender is not affected by the tax treatment of interest paid by a nonresident borrower. Consequently, even if the foreign borrower is able to deduct the interest in its country of residence the interest received will be exempt from Dutch corporate income tax.

C. Other Aspects

i. Costs/Expenses

Expenses related to the acquisition and expenses related to the sale of a participation are not deductible.

ii. Base Erosion

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

- Profit distributions or repayments of capital to a related entity or related individual;
- The acquisition of, or a capital contribution for, shares, profit shares or similar rights in a related company; or
- The contribution of capital whether direct or indirect, by the company or resident related party to the lending company.

The base erosion provisions contain an exception under which the interest deduction will be granted if the taxpayer can demonstrate that:

Both the loan and the business transactions are based on sound business reasons or

The interest is subject to sufficient taxation in the hands of the recipient, and the recipient is not able to offset the interest income with losses of prior years or anticipated losses in the future. 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 related if:

- The first company holds at least one-third of the capital in the second company,
- The second company holds at least one-third of the capital in the first company, or

- A third party holds at least one-third of the capital in both companies.

iii. Thin Capitalization

Pursuant to the Dutch thin capitalization rules, interest paid on loans from related parties will be deductible if the average debt/equity ratio of the Dutch company as represented in its tax balance sheet does not exceed 3:1 (by more than €500,000) or if the average debt/equity ratio of the Dutch company as represented in its commercial accounts does not exceed the debt/equity ratio of the group to which the Dutch company belongs, as represented in the group consolidated commercial accounts. As a general rule it should be noted that the non-deductible interest will never exceed the amount of interest paid on group loans reduced with the amount of interest received on group loans. Furthermore, if a third party loan is guaranteed by a related party and the loan could not have been obtained by the borrower without such guarantee, the loan will be requalified as a related party loan. A company is considered a “related party” if it meets one of the conditions as described in paragraph 6.C.ii, above.

iv. Innovation Box

In order to stimulate R&D activities by Dutch taxpayers, apart from expensing costs related to R&D activities in the year incurred, self-developed registered patents and certain other assets for which a so-called “research and development statement” has been requested (“R&D Assets”) may be placed in the so-called innovation box. Trademarks are specifically excluded from this beneficial regime. Income generated by way of the R&D Assets will be subject to tax at the statutory rate of 25.5% until the development costs incurred in respect of such patents have been recouped. Any income received exceeding such development costs will be taxed at an effective rate of 5%. Income includes royalty income such as license fees and other income stemming from R&D Assets. The innovation box regime applies to income received from related parties or unrelated parties. A cap on the innovation box of four times the capitalized development costs of the relevant patents was abolished as per 1 January 2010.

v. Capital Losses

As mentioned above, if the participation exemption applies, capital losses are generally not deductible. There is however one exception. Liquidation losses may under certain circumstances be deductible.

D. Tax Rulings

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

E. Dividend Withholding Tax

Distribution of profits in whatever form by Dutch resident entities, including limited liability companies, limited liability partnerships and other entities with a capital divided into shares, are

subject to Dutch dividend withholding tax at a statutory rate of 15%. The rate may be reduced under an applicable tax treaty. Under certain conditions, the dividend withholding tax payable by the distributing Dutch holding company may be reduced by 3% in order to compensate for foreign withholding taxes that cannot be claimed as a credit by the holding company because of the participation exemption. The Netherlands does not levy a withholding tax on royalties and interest, except with regard to interest paid on a hybrid loan (*see* paragraph 6.B.iv, above).

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

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

- The corporate shareholder is a tax resident of a country within the E.U or the E.E.A. (with the exclusion of Liechtenstein);
- The Dutch participation exemption would have been applicable to the shareholding in the Dutch entity distributing the dividends if the recipient of the dividends would have been a resident of the Netherlands;
- The corporate shareholder does not fulfill a similar function as a Dutch exempt investment institution or Dutch 0% taxed investment institutions; and
- The corporate shareholder is the beneficial owner of the dividends.

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

F. Capital Tax

Unlike several other E.U. Member States, the Netherlands does not levy any kind of capital tax.

7. SPAIN

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

In addition to these standard features of a holding company, the E.T.V.E. regime offers a substantial advantage vis-à-vis other attractive European holding company locations, as dividends distributed by the Spanish holding company to non-Spanish resident shareholders are exempt from the Spanish withholding tax on dividends. In addition, capital gains triggered by a nonresident shareholder on the transfer of its interest in a Spanish holding company are not subject to the Spanish 19% capital gains tax to the extent that such capital gains (indirectly) arise from an increase in the value of the foreign holdings of the Spanish holding company.

Finally, the E.T.V.E. may recognize a tax deductible allowance on the difference between the acquisition cost of its participation in the foreign subsidiary and the equity value of such foreign subsidiary. The tax deduction may be used to offset taxable income triggered by the E.T.V.E. through *e.g.*, a trade or business in Spain or financing provided to group companies. However, this tax deductible allowance has been found by the E.U. Commission to represent an illegal state aid that may not be applied to holdings in subsidiaries resident in another E.U. member state purchased after 21 December 2007.

The E.T.V.E. is protected by European Union directives such as the Parent/Subsidiary Directive and the Merger Directive and is regarded as a Spanish resident for tax purposes pursuant to Spain's 77 bilateral tax treaties.¹⁷ Spain's broad tax treaty network with Latin America and the European character of the E.T.V.E. make it an attractive vehicle for channeling capital investments in Latin America as well as a tax efficient exit route for European Union capital investments. In addition, it must be pointed out that the European Council, through the work of the Primarolo Group, has determined that the E.T.V.E. regime is in conformance with the E.U. Code of Conduct and does not represent potentially harmful tax competition.

A. Exemption on Qualified Foreign Source Income

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

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

B. Qualified Foreign Investments

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

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

¹⁷ An updated list of the tax treaties entered into by Spain is available at www.aeat.es.

- The E.T.V.E. directly or indirectly holds the interest in the nonresident subsidiary (and any second level subsidiary) for at least one year;
- The nonresident subsidiary is subject to and not exempt from a tax similar in nature to the Spanish C.I.T. and is not resident in a tax haven country or jurisdiction; and
- Finally, the nonresident subsidiary is engaged in an active trade or business.

i. Minimum participation and Holding Period

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

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

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

ii. Subject to and Not Exempt from Tax

The nonresident subsidiary must be subject to and not exempt from a tax of a nature similar to the C.I.T. Determining the degree of compatibility of foreign tax systems with the Spanish C.I.T. is difficult. A tax of a similar nature will include any foreign tax levied on the income of the nonresident subsidiary, even if levied on a partial basis. For the purposes of this test, it is irrelevant whether the object of the foreign tax is the nonresident subsidiary's income, turnover or any other index-linking element of the nonresident subsidiary. This requirement will be deemed to be met if the nonresident subsidiary resides in a tax treaty country provided that the treaty contains an exchange of information clause. It should be noted that all treaties entered into by Spain contain exchange of information clauses.¹⁸

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:¹⁹

¹⁸ This is a *iuris et de iure* presumption (*i.e.*, the Spanish Tax Authorities will not be able to provide evidence to the contrary).

¹⁹ This would not be applicable to non resident subsidiaries resident for tax purposes in a tax haven country or jurisdiction within the E.U. (such as Gibraltar or Cyprus) provided that the E.T.V.E. can demonstrate to the Spanish Tax Authorities that the incorporation and operation of the foreign subsidiary in the tax haven is

Principality of Andorra	Fiji	Jordan
Emirate of Bahrain	Guernsey and Jersey	Lebanon
Sultanate of Brunei	Falkland Islands	Liberia
Republic of Cyprus	Isle of Man	Liechtenstein
Gibraltar	Mariana Islands	Luxembourg, (until 16 July 2010)
Hong Kong	Mauritius	Macao
Anguilla	Montserrat	Monaco
Antigua and Barbuda	Nauru	Oman
Bahamas Islands	Salomon Islands	Panama
Barbados	St. Vincent and Grenadines	San Marino
Bermuda	St. Lucia	Seychelles
Cayman Islands	Turks and Caicos Islands	Singapore
Cook Islands	Vanuatu	
Dominica	British Virgin Islands	
Grenada	U.S. Virgin Islands	

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

iii. Active Nonresident Subsidiary

The nonresident subsidiary must be actively and primarily engaged in an active trade or business carried out abroad; certain passive income may be generated by the nonresident subsidiary to the extent that it does not exceed 15% of its total turnover. In general, any trade or business is eligible to the extent that the nonresident subsidiary possesses sufficient material and human resources to perform such trade or business activity and provided that its clients are not located in Spain.

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

A nonresident financial subsidiary will be deemed to be active if it is engaged in financial transactions with individuals or entities resident in its jurisdiction of residence or in a foreign

carried out for valid economic reasons and that the foreign subsidiary is engaged in an active trade or business.

country, other than Spain, to the extent that such financial services are rendered through the material and human resources effectively available to the nonresident financial subsidiary.

iv. Qualified Holding Company

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

- The corporate purpose of the Spanish company includes, among others, the holding of participations in operating nonresident entities;
- The Spanish company carries out its activities with the necessary human and material resources;
- The shares or quotas of the E.T.V.E. are in registered form (therefore, Spanish listed companies may not opt for the regime, since their shares are in book-entry form); and
- The Spanish holding company informs the Spanish Tax Authorities that it opts to be subject to the provisions of the Spanish holding company regime.

v. Corporate Purpose

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

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

vi. Material and Human Resources

This requirement is closely related to the previous one.

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

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

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

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

vii. Filing with the Spanish Tax Authorities

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

viii. Deduction of Costs

The value of a participation in the nonresident subsidiaries may be recorded for accounting and tax purposes under the general C.I.T. rules applicable to all Spanish resident companies. Financing expenses connected with a participation are tax deductible within the thin capitalization rules limits. Foreign exchange gains and losses are taxable or deductible.

ix. Deduction of Goodwill On Foreign Subsidiaries

If an E.T.V.E. acquires a participation in a nonresident entity, which meets the requirements of the participation exemption regime, the difference between the acquisition cost of the shares and the underlying book value of the foreign subsidiary is attributed to the assets of the foreign subsidiary in accordance with the Spanish accounting valuation rules governing consolidated financial statements (*i.e.*, limited to the market value of the assets). Any difference not allocated to the step-up of the assets of the target is deductible in 20 years (up to 5% per year) for the E.T.V.E. and may be used to offset taxable profits of the E.T.V.E. (*i.e.*, those profits not linked to its participations in foreign subsidiaries). This means that goodwill is depreciable for income C.I.T. purposes over the 20-year period. Note that, in its rulings, the D.G.T. has stated that only the goodwill attributable to first tier foreign subsidiaries is deductible (the ruling dated October 4, 2002) and that the deduction of the financial goodwill will have to be recaptured and taxed upon the transfer of the participation in the foreign subsidiary (the ruling dated March 16, 2006).

However, as mentioned above, this tax deductible allowance has been found by the E.U. Commission to represent illegal state aid in the context of an investment in a corporation resident in an E.U. member state. The conformity of this tax provision with E.U. law in the context of holdings in subsidiaries not resident in a E.U. member state is being analyzed currently by the E.U. Commission.

C. Liquidation Losses

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

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

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

Otherwise, dividends distributed by the E.T.V.E. will be subject to the standard 19% withholding tax or the reduced bilateral Tax Treaty rate, as applicable. In the context of an E.U. resident shareholder, dividends paid by the E.T.V.E. to its E.U. resident shareholder will not be subject to the dividend withholding tax if the E.U. shareholder:

- Takes one of the forms set out in the Annex to the Parent/Subsidiary Directive;
- is subject to and not exempt from tax as listed in Article 2.c) of the same Directive;
- Owns directly at least 10% of the share capital of the E.T.V.E.; and
- Has held the participation for a period of at least twelve months immediately prior to the dividend payment or is held until the one-year period is completed. In the latter case, the withholding will be levied upon distribution and the E.U. resident shareholder will be entitled to claim a refund once the one year holding period has been completed.

The E.U. Court of Justice, in its ruling dated 3 June 2010 (C-487/08) has found that the Spanish law implementation of the Directive is in breach of article 56.1 of the E.U. Treaty since it requires E.U. resident shareholders to hold a 10% interest in the capital of the Spanish company distributing the dividends, when the minimum shareholding requirement for Spanish resident shareholders is only of 5%.

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

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

The capital gains exemption represents a substantial improvement to the E.T.V.E. tax regime since capital gains are normally subject to a 19% tax. Although in a tax treaty context, a capital gain on the disposition of shares in the E.T.V.E. will generally not be subject to Spanish taxation, some tax treaties entered into by Spain, such as the tax treaty with the U.S., allows Spain the right to tax the capital gain at the general 19% tax rate provided that the foreign shareholder has a substantial interest, usually more than 25% of the capital, in the Spanish entity.

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

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

The liquidation of an E.T.V.E. triggers a capital gain, not subject to withholding tax, taxable as described in paragraph 7.D., above.

F. Other Income Tax Issues

Spanish tax authorities have challenged tax deductions claimed by the E.T.V.E. for interest expense arising from intra-group leveraged investments in companies owned by affiliates. The tax authorities claim that the financing cost is eroding the E.T.V.E.'s tax base on its Spanish trade or business activities. To that extent the intra-group reorganization is abusive..

G. Corporate Income Tax Rate

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

i. Debt-Equity Ratio

The thin capitalization rules apply to financing arranged by a resident entity with related nonresident entities. When the net interest-bearing debt, whether direct or indirect, of a Spanish entity with one or more related individuals or entities not resident in Spain or in other E.U. Member States not classified as a tax haven country or jurisdiction exceeds three times the entity's equity (excluding profit or loss for the year), interest accruing on the excess is deemed to be a dividend distribution. Therefore, interest paid over the maximum allowed ratio will not be considered a deductible item for tax purposes for the E.T.V.E. and will be subject to dividend withholding tax in the same way as an ordinary dividend (and subject as well to the possible dividend withholding tax exemptions).

The E.T.V.E. may submit proposals to the tax authorities to apply a ratio other than the three-to-one debt to equity ratio. The proposals must be based on the financing that the E.T.V.E. would have been able to obtain under normal market conditions from unrelated persons or entities.

ii. Capital Duty

Increases of the capital of a Spanish company generally are subject to a 1% capital duty. The tax is levied on the nominal value of the shares being issued by the incorporated company, including any share premium thereof. Capital Duty is payable by the entity at the time of its incorporation or formation and is an expense regarded as deductible for tax purposes. Furthermore, the movement of the seat of management of a foreign entity to Spain will trigger capital duty on the basis of the foreign entity's net worth, unless the foreign entity was previously established in a European Union Member country.

Certain exceptions exist to the capital duty. In-kind contributions of shares in a foreign entity that are made to the capital of an E.T.V.E. are not subject to capital duty if certain requirements are met. In addition, under the guidelines established by the E.U. Merger Directive, certain types of corporate reorganizations such as mergers, de-mergers, asset contributions and share exchanges will not be subject to the capital duty (and may qualify for a deferral on income tax and indirect taxation, as well). The following may be applicable in the context of the incorporation of an E.T.V.E.:

- De-merger: an entity, as a consequence of its dissolution without liquidation, divides all of its assets and liabilities into two or more parts and transfers the same to two or more existing or new entities in exchange for the pro rata issue to its shareholders of securities representing the capital of the entities acquiring the assets and liabilities, and if applicable, making a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, of an equivalent of the nominal value of such securities calculated from their accounting record;
- Partial De-merger: an entity splits off one or more parts of its assets and liabilities which form a branch of activity and transfers them as a whole to one or more newly-created or existing entities in exchange for securities representing the capital of the latter entities which are allocated to its shareholders in proportion to their respective shareholdings, reducing its capital and reserves accordingly, and if applicable, making a cash payment on the terms set out in the preceding paragraph. After the transfer, the transferor entity will have to keep assets and liabilities forming at least another branch of activity;
- Partial De-merger of a Substantial Holding: an entity, without being dissolved, contributes to a newly created or existing entity a majority interest in the capital of other entities in exchange for securities representing the capital of the latter entities which are allocated to its shareholders in proportion to their respective shareholdings, reducing its capital and reserves accordingly, and if applicable, making a cash payment on the terms set out in the preceding paragraphs. After the transaction, the transferor entity will have to keep (i) assets and liabilities forming at least a branch of activity or (ii) a majority interest in the capital of other entity; or
- In-Kind Contribution of a Business: an entity, without being dissolved, contributes all or some branches of activity to a newly created or existing entity receiving shares in the acquiring entity (this is distinguished from a de-merger in that the shares received in consideration for the contribution of the business are kept by the contributing entity, whereas in a de-merger such shares are allotted to its shareholders).

In order to qualify for the tax neutrality system with respect to income tax triggered on the relevant entities and/or their shareholders, the income generated on the transaction must be one of the following:

- Income arising from transfers by entities resident in Spain of property and rights located therein. Where the transferee entity is resident abroad, only income deriving from a transfer of elements allocated to a permanent establishment located in Spain may be excluded from taxable income;

- Income arising from transfers by entities resident in Spain of permanent establishments located in states that are not member of the E.U. to entities resident in Spain;
- Income arising from transfers by entities, which are not resident in Spain of permanent establishments located within Spain; or
- Income arising from the transfer by entities resident in Spain of permanent establishments located in E.U. Member States to entities resident in said States which take one of the forms set out in the Annex to the Parent/Subsidiary Directive and which are subject to and not exempt from one of the taxes mentioned in article 3° therein.

Furthermore, the income generated by the shareholders as a consequence of the reorganization will not be subject to Spanish taxation provided the said shareholders are resident in Spain or an E.U. Member State or any other State provided that, in the latter case, the shares represent the capital of an entity resident in Spain.

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

iii. Transfer Pricing

According to the Spanish C.I.T. Law, Spanish companies are obliged to assess transactions with related parties (those defined in article 16.3 of the C.I.T. Law) on an arm's length basis. In order to determine the fair market value of the transaction, and following the O.E.C.D. guidelines, the Law sets forth that the parties will use any of the following methods: the comparable uncontrolled price method, the cost plus method, the resale price method, the profit split method or the transactional net margin method, the first three being preferential in use.

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

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

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

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

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

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

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

iv. Controlled Foreign Corporation

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

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

8. IRELAND

A. Introduction

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

To compliment this low rate the Irish Government took the policy decision of making Ireland an attractive holding company location.

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

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

- A low or zero rate of capital gains tax on the disposal of associated companies.
- No withholding tax on payments from the jurisdiction.
- Reduced foreign tax on dividends received from the jurisdiction.

B. Corporate Tax Rate.

The Irish rate of corporate tax on trading income is 12½%. The word “trading” is not defined in the legislation but instead reliance is placed on Irish and UK caselaw. The substantial volume of UK caselaw on the point is not binding on Irish courts but is of persuasive value depending on the seniority of the UK 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 characterised as passive income as it will be dividends, interest, 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. See paragraph 8.C, below). This rate of tax is low compared with other jurisdictions. In addition Ireland’s double taxation treaty network is likely to give a credit for overseas tax. In most cases the credit will exceed the 25% rate of tax applied in Ireland resulting in a nil 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 in many other holding company jurisdictions. Instead, Ireland operates a system of both treaty credit relief and unilateral credit relief whereby credit for foreign tax is available against Irish tax on dividends received by an Irish holding company from certain foreign shareholdings.

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

Foreign dividends are subject to Irish tax at the rate of either 12½% or 25%. The 12½% corporate rate arises in respect of (i) foreign dividends paid out of trading profits by companies which are tax resident in the EU or a treaty partner country, or (ii) foreign companies in which the recipient has a less than 5% shareholding. Tax will arise at the 25% rate in respect of other foreign dividends. By way of exception to this, dividends received from subsidiaries resident outside of Ireland, and not resident in the EU or in tax treaty countries, will be subject to the 12½% corporate rate where the company paying the dividend is quoted on a recognised stock exchange in another EU member state or tax treaty country or is owned directly or indirectly by such a company.

Under Ireland's "tax credit pooling", where a company has different foreign dividends, some carrying a credit in excess of the Irish tax on them and some carrying the credit less than the Irish tax, any excess credit from highly taxed dividends can be "spilled over" to lower tax dividends, to avoid the loss of any tax credits that exceed the Irish tax liability. As most EU member states and tax treaty countries have tax rates in excess of 12½%, in general the Irish tax rate and credit will mean that an Irish holding company should not be subject to Irish tax on dividends from EU or treaty partner country trading subsidiaries. The pooling arrangements apply separately to dividends taxed at the 12.5% and 25% rates. Surplus foreign tax arising on dividends taxable at the 12.5% rate is not available for offset against tax on dividends taxable at the 25% rate.

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 at the rate of 20%, there are a number of exceptions under domestic law which make the withholding tax less problematic in Ireland than in many other European holding company jurisdictions. An Irish holding company which is controlled directly or indirectly by persons resident in an EU member state or in a country with which Ireland has a double tax treaty should typically not suffer any withholding tax on dividend payments.

The Irish legislation implementing the EU parent subsidiary directive allows an Irish company to make distributions free of withholding tax to EU tax resident companies, which comply with the

conditions of the directive (*i.e.*, be a certain type of EU member state company and pay tax in an EU member state) and hold at least 5% of the share capital of the Irish company. No documentary requirements are needed in order to this exemption to apply.

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

- A person, not being a company, who is neither resident nor ordinarily resident in Ireland and who is, by virtue of the law of an EU member state or of a country with which Ireland has a double tax treaty, resident for tax purposes in that country.
- A company which is resident in an EU member state (other than Ireland) or in a country with which Ireland has a double tax treaty, and which is not under the direct or indirect control of a person or persons resident in Ireland.
- A person which is not resident in Ireland which is under the direct or indirect control of a person or persons who is resident in an EU member state (other than Ireland) or in a country with which Ireland has a double tax treaty, provided that controlling person or persons is or are not themselves controlled by a person or persons who is or are not resident in an EU member state (other than Ireland) or a country with which Ireland has a double tax treaty. In other words, a company which is not resident in Ireland and which is under the ultimate control of a person or persons resident in an EU or treaty partner country.

Up until recently certain administrative certificates and declarations were required to obtain the above mentioned exemptions. The Finance Act 2010 has removed the requirement for non resident 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 non resident company provides a declaration and certain information to be dividend paying company or intermediary to claim exemption from dividend withholding tax. The declaration extends of a period of up to six year after which a new declaration must be provided for dividend withholding tax exemption to apply.

E. Exemption from capital gains tax on sale of foreign shares.

An Irish tax resident company will be exempt from Irish corporate tax on its chargeable gains on disposal of shares, or assets related to shares, in certain subsidiaries. The current rate of tax is 25% on the disposal in the event that exemption does not apply. However an exemption from the tax is given where there is a disposal of shares (and assets related to such shares) in foreign companies and

- At the time of the disposal the foreign company is resident for tax purposes in the EU or a treaty country (Ireland has signed double taxation treaties with 56 countries of which 48 are currently in effect);
- The company making the disposal must be beneficially entitled, directly or indirectly to at least 5% of the company's ordinary share capital, at least 5% of the profits available

for distribution to the shareholders of the company and would be beneficially entitled on a winding up to at least 5% of the assets of the company available for distribution to shareholders;

- The disposal must occur during an uninterrupted period of 12 months during which the Irish company, directly or indirectly, holds at least 5% of the ordinary share capital of the company, is beneficially entitled to at least 5% of the profits available for distribution to the shareholders and would be beneficially entitled on a winding up to at least 5% of the assets of the company available for distribution to the shareholders of the subsidiary whose shares are being disposed of or within 24 months of the last such uninterrupted period;
- At the time of disposal of the shares in the investee company (*i.e.*, the foreign subsidiary) either the investee company must carry on a trade or the business of the investor company (*i.e.*, the Irish holding company), its subsidiaries, the investee company and its subsidiaries taken as a whole consist wholly or mainly of trading; and
- The exemption does not apply to the disposal of shares deriving the greater part of their value from Irish land or buildings and certain other Irish assets.

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

Ireland does not have thin capitalisation rules. Therefore an Irish holding company can be financed principally by way of debt. An Irish tax deduction is potentially available for interest on monies borrowed to finance the acquisition of shares. Interest is allowed as a deduction if it is used in acquiring any part of the ordinary share capital of a trading company, a company whose income consist mainly of real estate rental income, or a holding company of such a trading or real estate rental company. A deduction is also allowed for interest on funds used to lend to such companies which is used wholly and exclusively for the purposes of the borrower's trade or business or that of a company connected with it.

Certain conditions must be met in order for the interest deduction to be allowed. When the interest is paid the Irish holding company must beneficially own, or be able to control, directly or indirectly, more than 5% of the company whose shares are being acquired, or to whom the funds are being lent, or a company connected to it. During the period of application of the loan proceeds, until the interest is paid, at least one director of the Irish holding company must be a director of such a company. The Irish holding company must also show that during the application of the loan until the payment of the interest, it has not recovered any capital from such a company, apart from amounts which are used to repay the loan in part or deemed under Irish rules to have been applied toward repaying the loan. Care must also be taken that the anti-avoidance rules in relation to recovery of capital are not breached as such a breach would result in the interest payment not be deductible.

Interest paid by an Irish company to a non Irish resident 75% parent can be recharacterised as a non deductible distribution under Irish law. This recharacterisation does not apply if the parent is tax resident in an EU member state. If the parent is a resident of the US for the purposes of the Ireland/US Double Tax Treaty, a non discrimination article in the treaty should override the Irish

domestic recharacterisation. In addition, an Irish company can elect to have the interest not treated as a distribution provided (i) the company is a trading company, (ii) the payment is a distribution only because it is payable to a non-resident company of which the Irish company is a 75% subsidiary or associate, (iii) it is payable in the ordinary course of the Irish company's trade and (iv) the payment would not otherwise be deductible.

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

H. Treaty Network.

Ireland has signed double taxation agreements with 56 countries of which 48 (listed below) are currently in effect.

Australia	Hungary	Norway
Austria	Iceland	Pakistan
Belgium	India	Poland
Bulgaria	Israel	Portugal
Canada	Italy	Romania
Chile	Japan	Russia
China	Republic of Korea	Slovak Republic
Croatia	Latvia	Slovenia
Cyprus	Lithuania	South Africa
Czech Republic	Luxembourg	Spain
Denmark	Macedonia	Sweden
Estonia	Malaysia	Switzerland

Finland	Malta	United Kingdom
France	Mexico	United States
Germany	Netherlands	Vietnam
Greece	New Zealand	Zambia

Irish resident companies are taxable on their worldwide income. The treaties avoid double taxation by providing for a credit for foreign tax imposed, whether directly or indirectly, on the income received by the Irish company. The credit is allowable only against the Irish tax on the same income. Importantly, Irish domestic law grants a tax treatment more favorable than that given by the treaties (*see* paragraph 8.D, above in connection with tax credits for foreign dividends).

I. Capital Duty

Companies Capital Duty was a charge of 0.5% imposed on the issue of, or increase in a capital company's share capital and on certain other transactions. The duty was abolished by the Finance Act 2006 for transactions effected on or after December 7, 2005. Obviously this is of major relevance to the financing of Irish companies and is a welcome move from the perspective of foreign investment in Ireland.

J. Stamp Duty on Shares

Stamp duty of 1% of the value is imposed on the transfer of shares in an Irish company. This duty is a cost where the Irish holding company is the ultimate company. On the other hand where the Irish company is an intermediate holding company in the group much can be done through exemptions and tax planning to claim relief from or to avoid the duty. The exemptions comprise the associated companies' relief and the reconstruction and amalgamation provisions that apply in group reorganizations.

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

Ireland has no C.F.C. rules. Apart from the recharacterisation rules under which interest may be treated a dividend, Ireland does not have thin capitalization rules.

The Finance Act 2010 has introduced limited transfer pricing legislation. Broadly the legislation is only applicable to trading transactions between associated persons (effectively companies under common control). It utilises the OECD guidelines on the basis of Article 9.1 of the model treaty. It does not apply to small and medium size enterprises. It applies to accounting periods commencing January 2011 in respect of arrangements agreed on or after 1 July 2010.

M. Relevant anti-avoidance provisions.

None

N. Conclusion.

Ireland has considerable tax efficiency as a location for a holding company in an E.U./ treaty country dimension. Generally, the small number of negatives disappear when Ireland is used as an intermediary holding company. The greatest tax benefit can be obtained when head office activity is carried on in the Irish company in addition to its holding company role.

9. UNITED KINGDOM²⁰

A. Introduction

The summary of U.K. law is correct as at 22 June 2010. The United Kingdom has long formed the *de facto* European or international headquarters for many U.S. based multinational companies. The U.K. system of taxing individuals who are resident but not domiciled in the U.K. in respect of their foreign source income and capital gains – those items of income and gains are taxed only to the extent remitted to the U.K. – has made the U.K. an attractive and cost-effective centre for locating foreign executives. While the application of the regime has been restricted since 2008, the remittance basis remains, in principle, an attraction for foreign executives. The new U.K Government has confirmed that it intends to review the taxation of non domiciled individuals and, based on comments made by the Government, it is possible that the rules may be changed in the future. The corporate tax regime continues to offer a number of attractive features:

- No capital gains tax generally on the sale of shares in U.K. companies by nonresidents;
- No withholding tax on dividends paid by U.K. companies to nonresident shareholders (except in the case of R.E.I.T.'s);
- No capital taxes on formation or paid-in capital of companies;
- Exemption from corporation tax for most dividends received from U.K. and foreign resident companies, backed up by a foreign tax credit system where the exemption does not apply, which permits (within limits) pooling of foreign source dividends to maximize foreign tax credit;

²⁰ The section was originally written by Jonathon s. Schwarz and has been updated by Bradley Phillips.

- Exemption from tax on capital gains on the sale of substantial shareholdings involving trading groups;
- Competitive corporation tax rate; and
- One of the largest tax treaty networks in the world.

The U.K. tax authority is called H.M. Revenue and Customs (H.M.R.C.). There was a change of Government in the UK in May 2010 and a Conservative – Liberal Democrat coalition took office.

The U.K. corporate tax system is in a state of flux at present as a combined result of (a) recent Government consultations including into controlled foreign companies (C.F.C.s) / taxation of foreign branches in the U.K and capital gains treatment of corporate groups, (b) wholesale reform of the taxation of foreign profits derived by U.K. companies (which included the introduction of a broad exemption for dividends received by U.K. companies and the introduction of the world wide debt cap) and (c) recent decisions of the European Court of Justice ('E.C.J.') in three seminal cases (which triggered some of the afore mentioned reforms):

- The *Franked Investment Income/Foreign Dividend Group Litigation* (Case C-446/04) (see paragraph 9.C, below);
- The *Cadbury Schweppes plc v. HM.R.C.* (Case C-196/04) (see paragraph 9.O, below); and
- The *Thin Cap Group Litigation* (Case C-524/04).

These three decisions called into question the legality of the system of taxing foreign profits earned in the E.U. and the related foreign tax credit, the C.F.C. regime as it applies to the E.U., C.F.C.'s as well as the U.K thin capitalization and transfer pricing rules within the E.U. (*See H.M. Treasury*; "Taxation of companies' foreign profits; discussion document", June 21, 2007). In response, an exemption system for foreign dividends was introduced in Finance Act 2009 and the C.F.C. rules are to be reviewed. Finance Act 2009 also imposed limitations on the deductibility of intra-group interest expense of corporate groups (referred to as the world wide debt cap).

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

Also of note is the decision of the First Tier Tax Tribunal in *Philips Electronics U.K. Ltd v Revenue and Customs Comrs* [2009] UKFTT 226. The case concerns a claim for consortium relief. H.M.R.C. rejected the claim on the ground that the requirements of the U.K. consortium relief rules were not met. At the time, U.K. legislation required the companies connecting the group claiming the losses to the joint venture to be within the charge to U.K. corporation tax. The Tribunal found that the U.K. rules did breach E.C law. H.M.R.C. has appealed the decision to the Upper Tribunal. Until it reaches the Courts, the case has limited precedential value.

In its 22 June 2010 Budget, the Government confirmed that it would amend the U.K. rules to (a) remove the requirement that the link company be subject to the U.K. corporation tax regime and will open the relief to any qualifying E.E.A company and (b) cap ability to claim the relief by a test based on the level of control / proportion of voting rights held in the loss vehicle.

B. Corporate Tax Rate

The main corporation tax rate in the U.K. is 28% from April 1, 2008. This is levied on the worldwide income and gains of U.K. resident companies. Capital gains are taxed at the same rate as income. However, the base cost of assets is indexed by reference to the U.K. retail price index to eliminate gains based on inflation. The rate of tax of 20% exists for companies whose profits do not exceed £300,000 (although this will be reduced from 21% to 20% from 1 April 2011). Between those rates, marginal rates are applied, so that companies earning in excess of the relevant thresholds have all of their income taxed at the higher applicable rate.

Computation of profits for corporation tax purposes generally follows U.K. GAAP or International Accounting Standards in the case of companies whose shares are listed on an exchange in the E.U. As a result of successive reforms, specific codes apply accounting principles to profits on loan relationships (interest), foreign exchange gains and losses, derivative contracts, and intellectual property rights and other intangibles.

The main rate of corporation tax, payable by companies with profits over £1.5 million, will be reduced from 28% to 27% from 1 April 2011 and then by a further 1% for each subsequent year, until it reaches 24% in 1 April 2014.

C. Dividends Received By U.K. Companies

In principle, corporate profits within groups are taxed only in the company where earned. As a result, dividends paid by a U.K. resident company to a U.K. resident corporate shareholder before July 1, 2009 are not subject to tax. This exemption applies regardless of the size of shareholding. Dividends paid by non-U.K. resident companies to U.K. resident corporate shareholders before that date, however, are subject to corporation tax in the hands of a U.K. corporate shareholder. Relief for foreign tax is provided in the first instance by treaty. Where treaty relief is unavailable, unilateral relief is available under domestic law.

The different treatment of dividends based on the residence of the payer has been challenged in the Courts as contrary to E.U. law. The claimants argued that foreign dividends paid by E.U. resident companies should be exempt from U.K. corporation tax. In the *Franked Investment Income/Foreign Dividend Group Litigation* (Case C-446/04), the European Court of Justice held that in relation to shareholdings of less than 10% in E.U. resident companies, the U.K. must grant an exemption. The credit system for participations of 10% or more was held to be compatible with E.U. law as long as the U.K. does not tax the foreign dividend at a higher rate and the overall rate of creditable tax paid by the foreign affiliate was the same as that in the U.K. other than in exceptional cases. The E.C.J. left the comparison of the two to the U.K. courts. The English High Court has held that the U.K. regime systematically subjects foreign dividends to higher tax and thus contravenes Community law. The Court of Appeal referred the

substantive issues back to the E.C.J. on the grounds that it considered the exercise of construing the words used in the E.C.J.'s original judgment unacceptably difficult.

From July 1, 2009, a unified system for taxing dividends received by U.K. resident companies will apply to both dividends from U.K. resident and non-resident companies. In principle, any dividend or other distribution is charged to corporation tax except if it is exempt. Distributions received by companies other than small companies are exempt if it (a) falls into an exempt class, (b) is not certain kinds of interest deemed to be a distribution, and (c) no deduction is allowed to a resident of any territory outside the U.K. under local law in respect of any amount determined by reference to the distribution.

The exempt classes are

- Distributions from controlled companies. Control for this purpose is similar to the C.F.C. test;
- Distributions in respect of non-redeemable ordinary shares;
- Distributions in respect of portfolio holdings, which are holdings of less than 10 per cent.
- Dividends derived from transactions not designed to reduce tax.
- Dividends in respect of shares accounted for as liabilities under GAAP but which are not treated as debt for tax purposes because they are held for non-business or tax avoidance purposes.

Each has anti-avoidance measures designed to prevent manipulations of the exemptions. In addition, general anti-avoidance rules may disapply the exemptions in cases of schemes in the nature of loan relationships where the return is the economic equivalent of interest, schemes involving payments for distributions or payments not on arm's length terms as well as schemes involving diversion of trade income.

The new dividend exemption does not apply to capital receipts. There has been a difference in opinion between taxpayers and H.M.R.C. about the classification of particular distributions and whether they are income or capital. Legislation will be introduced to provide certainty over the treatment of those distributions and will set out whether or not the distributions fall within the dividend exemption. The Government published draft legislation in early 2010 and it is expected to come into force in late 2010.

D. Foreign Tax Credit

Where the exemption does not apply, or where the U.K. corporate shareholder elects out of the exemption, the general rule is that a credit is granted against U.K. corporation tax for foreign withholding tax levied on dividends. In addition, indirect foreign tax credit (referred to in the U.K. as "underlying credit tax") is granted in respect of dividends paid by nonresident companies where the U.K. company has a substantial interest in the foreign company. The threshold is, in most cases, determined by treaty. The usual requirement is that the recipient company must own shares that represent at least 10% of the voting power in the paying company. Provided that the

dividend payer and the recipient are related, underlying tax in this context includes underlying tax from related companies through an indefinite number of successive levels in the corporate chain. For this purpose, two corporations are related where the shareholder receiving the dividend directly or indirectly controls not less than 10% of the voting power in the paying company. Alternatively, the shareholder may be a subsidiary of a company that controls the dividend-paying company under the foregoing standard.

i. Source of Income

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

ii. Mixer Companies and Pooling

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

The current tax regime eliminates the utility of an offshore mixer, and indeed, provides some disincentives to holding foreign companies through a chain of subsidiaries in respect of dividends paid by other foreign companies from April 1, 2000. Mixing of dividends outside the U.K. is eliminated by capping the credit for foreign tax at a rate equal to the main U.K. rate at each level in the corporate chain.

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

iii. Anti-Avoidance

Broad spectrum anti-avoidance rules aimed specifically at foreign tax credits are found in ss 81-82 T.I.O.P.A. 2010 (previously s 87 Finance Act 2005). The legislation is designed to give effect among other items to an announcement on 10 February 2005 in relation to arrangements where income is acquired for the purpose of securing excessive credit for foreign tax, such as “dividend buying”. This is where extra income is deliberately bought and the credit claimed to be due is more than the U.K. tax due on that income.

The legislation applies where four conditions are satisfied:

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

Schemes or arrangements are prescribed by Sections 83-88 Taxation (International and Other Provisions) Act 2010 (‘T.I.O.P.A. 2010’) (previously Schedule 28AB to ICTA 1988). They are briefly where:

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

Where these criteria are met, H.M.R.C will issue a notice directing the application of the legislation (s. 81(1), (2), 82(2) T.I.O.P.A. 2010, previously s 804ZA(1) ICTA 1988). Taxpayers are then required to form a view on how the legislation should apply and self assess or amend any existing self assessment in the normal way (ss 91-95 TIOPA 2010, previously s. 804ZC ICTA 1988). Disputes on the application of the rules will be resolved through the self assessment enquiry and appeals procedure. Where the legislation is invoked, the credit claim

will be limited so as to cancel the effect of the scheme or arrangement (s 90 T.I.O.P.A. 2010, previously, s 804ZB ICTA 1988).

The rules are elaborated where underlying tax of nonresident companies is involved. In that case, the counteraction will apply where, had the nonresident company that paid the foreign tax been U.K. resident and made a claim for credit for that foreign tax, the regime would have applied to the nonresident company (s. 81 T.I.O.P.A. 2010, previously s.804ZA8(c) ICTA 1988).

Notices may be given as they relate to credit for foreign tax affected by a scheme or arrangement within ss 83-88 T.I.O.P.A. 2010 (previously Schedule 28AB ICTA 1988) from 10 February 2005 and in relation to any further schemes that may be prescribed from 16 March 2005.

The Government confirmed in the June 2010 Budget that it would consider whether it is necessary to introduce a General Anti-Avoidance Rule (GAAR). The Government proposes to consult on these changes and no timeframe for proposed implementation was given.

iv. Hybrid Instruments

Where certain payments may be characterized as a dividend for U.K. tax purposes, but as interest payments in another jurisdiction, the foreign payer would obtain a tax deduction for foreign tax purposes, while a U.K. corporate recipient otherwise meeting the requirements of ss 12-16 T.I.O.P.A. 2010 (previously s 790(6), ICTA 1988), or treaties providing similar treatment such as the U.S.-U.K. Income Tax Treaty obtains credit for underlying tax in respect of the receipt. Credit for underlying tax will not be given if a tax deduction is given in another jurisdiction, calculated by reference to the amount treated as a dividend for U.K. purposes (s. 57(3) TIOPA 2010, previously s 799(2A) ICTA 1988). The denial of credit for foreign tax is automatic and not limited to instruments created or assigned for the purpose of obtaining the benefit of the credit.

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

The U.K. does not impose withholding tax on dividends. Advance Corporation Tax was abolished for dividends paid after April 6, 1999. Withholding tax at the rate of 20% applies to dividends paid by U.K. resident R.E.I.T.'S. This may be reduced by applicable tax treaty. Since a company cannot qualify as a R.E.I.T. if it has shareholders with a 10% or greater participation, only the rate on portfolio holdings will apply. The rate is 15% under the current U.S.-U.K. Income Tax Treaty for qualified U.S. residents.

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

From 1 April 2002, the disposal by U.K. companies of shares in operating companies may qualify for exemption from U.K. tax on the gain, if certain substantial shareholding requirements are met. The main requirements are essentially:

G. Substantial Shareholding

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

H. Trading Company Limitations

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

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

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

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

Any gain or loss that would have arisen under the foreign exchange matching rules, connected with a disposal of a substantial shareholding, will no longer be a chargeable gain or capital loss. This is a logical extension of the exemption in relation to foreign shareholdings where the currency exposure has been hedged.

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

I. Capital Gains on The Disposal by Nonresidents Of Shares In U.K. Companies

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

J. Capital Tax And Stamp Duty

There is no capital tax on the formation of a company or on any capital paid in. No stamp duty is paid on share subscriptions. Transfers of shares of U.K. companies are liable to stamp duty or stamp duty reserve tax at 0.5% of the consideration for the sale. This may be increased to 1.5% where incorporated companies are issued or transferred into a clearing system or a depository receipt facility.

K. Tax Treaty Network

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

L. Debt Financing of U.K. Companies

The U.K. has liberal rules in connection with the deduction of interest expense. Most interest expense and other costs of debt finance are deductible. Deductibility is determined in accordance with an authorized accounting method. Either an accruals or mark-to-market basis may be used. Related party financing must be in accordance with the accruals method. These rules apply in relation to "loan relationships." Loan relationships are broadly defined and exist in respect of a money debt that arose from a transaction for the lending of money. This is the case where a company is either a debtor or a creditor. A money debt for this purpose is one that is satisfied by the payment of money or the transfer of rights under a debt that is itself a money debt. Where a company issues an instrument as security for a money debt, a loan relationship similarly exists.

Anti-avoidance provisions permit the disallowance of interest expense where the interest or loan relationship has tax avoidance as its purpose, or as one of its main purposes. Although the

legislation is widely drawn, it is generally regarded as applying in limited circumstances. In particular, recent discussions relating to interest expense in order to acquire shareholdings that qualify for exemption from corporation tax under the new substantial shareholdings exemption described above will be permitted. Likewise, borrowing which is connected with the purchase of shares in respect of which foreign tax credits eliminate the U.K. tax liability are normally regarded as not contravening these rules. Other anti-avoidance provisions also aimed at denying interest expense deductions have limited application.

The U.K. thin capitalization rules are imposed through the transfer pricing legislation from April 1, 2004. Interest will not be recategorized as a “distribution” or dividend, but a deduction may not be allowed. The U.K. has neither fixed ratios nor safe harbors in this respect. A facts and circumstances approach is adopted based on ordinary transfer pricing principles. However, as an administrative matter, H.M.R.C. do not normally question related party borrowings where there is a debt to equity ratio of one to one and interest is covered by earnings in a ratio of one to three. Higher gearing can be agreed with H.M.R.C. on a case by case basis.

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

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

Most U.K. source interest is subject to withholding tax at the rate of 20%. Exclusions apply for “short” interest that is interest on debt with a term of less than one year. Interest on “quoted Eurobonds” may also be paid without deducting tax at source. A quoted Eurobond is a debt security issued by a company that carries a right to interest and is listed on a recognized Stock Exchange.

M. Anti Arbitrage Legislation

Legislation aimed at countering tax avoidance using arbitrage schemes that involve among others hybrid entities has been enacted in the Finance (No2) Act 2005. Where it applies a deduction for corporation tax purposes will be denied to U.K. companies if, and to the extent that more than one deduction (or an amount otherwise allowed for tax purposes) is available for the same expense whether in the U.K. or elsewhere and the income accruing or arising under the scheme is only taxed once.

The legislation will apply to arrangements involving deductions entered into from 16 March 2005. It will not apply to schemes involving deductions that do not involve connected parties and are in place on or before 16 March 2005 and are terminated by 1 July 2005.

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

The U.K. company is a party to a scheme that involves among others a hybrid entity (a “qualifying scheme”). For these purposes, a hybrid entity is an entity that is recognized as a taxable person under one tax code (*e.g.*, the U.K.), but whose profits or losses are under of the same or another tax code taxable in the hands of one or more persons other than the entity(*e.g.*, the U.S.). This may be because, for example the two countries treat the same entity differently,

one treating it as a company taxable on its own income (the U.K.), and the other seeing it as a partnership with its partners taxable themselves on their shares of its income (*e.g.*, the U.S.). “Scheme” is widely drafted to cover any arrangements or understandings whether or not legally enforceable;

- A deduction is allowed for U.K. corporation tax purposes;
- The main purpose or one of the main purposes in adopting the qualifying scheme was the obtaining of a U.K. “tax advantage.” A U.K. tax advantage includes a relief or increased relief from tax, or a deduction in computing profits or gains. This includes the deduction of the interest expense on the loans;
- The amount of the U.K. tax advantage is not minimal (*i.e.*, if it exceeds £50,000).

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

N. Worldwide Debt Cap

A further restriction of the amount of interest claimed by the U.K. members of a multinational group by reference to the group’s total consolidated external finance costs is introduced by Finance Act 2009 to take effect for accounting periods starting after January 1, 2010. The restriction applies to any worldwide group where the U.K. net debt of the group, exceeds 75% of the worldwide gross debt of the group. For this purpose, U.K. net debt of any company less than £ 3 million is treated as nil.

The total disallowed amount of the worldwide group is the excess of the aggregate relevant financing expense amounts of U.K. resident group companies and permanent establishments of non-U.K. resident members, over equivalent amounts of the worldwide group. In calculating aggregate financing expense, the net financing expense of an company below £500,000 is treated as nil. The disallowed amount may be allocated among relevant companies as determined by the group, but failing proper allocation is apportioned by formula. Where a financing expense disallowance arises, a corresponding exemption applies to financing income of relevant companies. Financing income received may also be exempt if the payer is tax resident of an E.E.A. territory and is denied relief for payment. Exclusions apply to group treasury companies, oil extraction companies, shipping operations within the tonnage tax and to intra-group short term finance. Under proposed changes, qualifying securitisation companies will also be excluded. Various technical changes to the debt cap rules have been proposed by the new Government and will likely come into force is late 2010.

O. Controlled Foreign Companies

The U.K. controlled foreign companies regime seeks to apportion the profits of a controlled foreign company (“C.F.C.”) to its U.K. corporate shareholders. These rules are being challenged

in the Courts as being contrary to E.C. law in respect of C.F.C.'s in E.U. member states. In *Cadbury Schweppes plc v H.M.R.C.* (Case C-196/04), the European Court of Justice held that while C.F.C.-type rules contravene Community law in principle, they may be justified in relation to “wholly artificial arrangements designed to circumvent national tax systems” and that establishing a company in a very low tax jurisdiction within the E.U. does not itself constitute such an arrangement. It is for national Courts to determine if such arrangements exist. This question is now before the U.K. courts. In *Vodafone 2 v H.M.R.C.* (No2) [2008] EWHC 1569, the High Court held that the motive test (*see* paragraph 9.M, above) could not be interpreted as being consistent with the E.C.J. ruling. The only permitted anti-avoidance legislation that would be compatible with Art 43 is that which prohibits artificial arrangements solely to avoid tax and where C.F.C. is not established in a member state conducting bona fide commercial operations there. The Court of Appeal ([2009] EWCA Civ 446) found that the legislation could be read in a way that conforms to the decision of the E.C.J. An application by Vodafone for leave to appeal was refused by the Supreme Court.

The ongoing reform of the C.F.C. rules will continue under the new Coalition Government. Final legislation is expected in Finance Act 2012. However, interim improvements are to be legislated in spring 2011 to make the current rules easier to operate and where possible increase competitiveness.

The review will also extend to the taxation of foreign branches of U.K. companies. The Government intends to move to a more territorial basis for taxing the profits of foreign branches, and will consult in summer 2010 on options for retaining foreign branch loss relief as part of this.

To date, final proposals and draft legislation have not been published.

i. Control

Control for this purpose is widely defined to cover a variety of circumstances in which a party can ensure that the non-U.K. resident company's affairs are conducted in accordance with its wishes. It also applies to certain joint venture companies in which a U.K. shareholder has at least 40% of the non-U.K. resident company and another shareholder has at least 40% but not more than 55% of the joint venture vehicle.

ii. Low Tax

The regime only applies if the C.F.C. is located in a low tax jurisdiction. This is generally where the profits are subject to an effective rate of tax of less than 75% of the U.K. rate on those profits determined in accordance with U.K. rules. In addition, specific rules are aimed at including so-called “designer” corporate tax regimes, which offer facilities such as agreeing the rate of tax, so as to meet the U.K. C.F.C. level of tax. This includes Guernsey and Jersey in the Channel Islands. Further jurisdictions may be designated by regulation. The Treasury has powers to designate jurisdictions in respect of which the normal exemptions from C.F.C. apportionment would apply. No such jurisdictions have been identified and it is believed that this measure was introduced to demonstrate to other O.E.C.D. member countries that the U.K. Government is putting in place measures to retaliate against jurisdictions engaging in harmful tax practices.

iii. Applies to Profits, Not Gains

The C.F.C. regime seeks only to apportion profits liable to be taxed as income, rather than capital gains, to the U.K. corporate shareholders. Capital gains are therefore not within the C.F.C. rules. However, certain items that in general terms might be thought of as giving rise to capital gains may not so qualify. In particular, the introduction of a new tax regime relating to the taxation of intangible property eliminates the distinction between capital gains and ordinary income, taxing all amounts as income. As a result, disposals by C.F.C.'s of a bundle of assets that include intangible assets will result in a potential apportionment of profit to U.K. corporate shareholders. The most common example is likely to be goodwill. The 2007 Finance Act excludes from this apportionment, certain profits attributable to E.U. or E.E.A. resident C.F.C.'s by application to H.M.R.C. in light of the decision in *Cadbury-Schweppes*.

iv. Planning Opportunities

U.K. Corporate shareholders can avoid apportionment of the C.F.C. profits in several circumstances:

- Throughout the relevant period, the C.F.C. is engaged in exempt activities. This generally requires trading activity effectively managed from a business establishment in the country of residence, as well as certain permitted holding company functions. Effective 1 July 2009, this is restricted to local holding companies in the same jurisdiction as companies held by the holding company.
- The chargeable profits for the relevant accounting period do not exceed £50,000.
- The company is resident in a country specified in the Excluded Countries Regulations. This comprises a white list for certain jurisdictions and a list where companies may qualify if they do not participate in certain local tax favored regimes.
- In relation to profits arising before July 1, 2009, the company pursues an "acceptable distribution policy", which broadly involves distributing at least 90% of profits by dividend.
- The main purpose of the company's existence is not avoidance of U.K. tax and a diversion of profit from the U.K. and does not result in a reduction in U.K. tax.

P. Value Added Tax (V.A.T.)

The U.K. imposes V.A.T. on the supplies of most goods and services (with notable exclusions, including, for example, financial services). Currently VAT is charged at 17.5% although some supplies are subject to 0% (referred to as zero rated) and others 5%. From 4 January 2011, this will be increased to 20%. V.A.T. is intended to ultimately fall on the final consumer.

The VAT treatment of supplies made by holding companies came under scrutiny by the E.C.J. in *AB v SKF* and also in a recent First Tier Tribunal decision, *BAA Limited v The Commissioners for Her Majesty's Revenue & Customs*.

The First Tier Tax Tribunal in *BAA* held that VAT incurred on professional fees by a bidder in the context of a takeover offer is recoverable. The VAT was recovered on the basis that it was attributable to the general overheads of the target group. The *BAA* case is being appealed.

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

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

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

The cases confirm that companies contemplating a share acquisition/disposal takeover should be able to recover VAT incurred on fees if they can show an intention to make taxable supplies. The discussion contained in the *BAA* decision suggests that this may be achieved by the bidding company showing an intention to supply taxable services to target post takeover (*e.g.*: management services), but following the decision, the intention to make taxable supplies may also be established where the acquirer is grouped for VAT purposes with target as soon as the takeover completes.

10. AUSTRIA

A. Introduction

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

- International participation exemption for dividends and capital gains received from foreign subsidiaries;
- No thin capitalization legislation;
- A competitive tax rate of 25% ;
- No C.F.C. legislation;
- No withholding tax on interest paid to nonresidents;

- No withholding tax on dividends paid to EC-resident parent companies;
- Extensive network of tax treaties (more than 80 treaties, in particular with all major Austrian trading partners and with Eastern European countries and former member states of the U.S.S.R.), reducing or eliminating the general withholding tax rate of 25% on dividends;
- Possibility to obtain informal advance tax rulings;
- A group taxation system that allows Austrian holding companies to deduct losses incurred by foreign subsidiaries; and
- Full deductibility of interest expenses for loans in connection with the acquisition of subsidiaries.

B. Capitalization of Austrian Companies

i. Equity Contributions

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

ii. Loan Capital

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

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

C. Corporate Taxation

i. In General

A company is resident in Austria for tax purposes if it has its legal seat or its effective place of management in Austria. Resident companies are taxable on their worldwide income, including

capital gains, at a flat tax rate of 25%. Together with the provisions for accounting taxable profit, this tax rate results in an effective corporate income tax burden of approximately 21% (according to Austrian government sources). Independent of the taxable income, a minimum tax of 5% of the statutory minimum share capital is levied, *i.e.*, € 1,750 for limited liability companies and €3,500 for stock companies. The minimum tax payments can be set off against higher tax burdens in the future without limitation.

A nonresident company is taxable on business income derived in Austria if it carries on a business through a permanent establishment in Austria or participates in such a business. Since 2006, income and capital gains from Austrian real estate are also taxable as Austrian business income of the nonresident company even if the real estate is not attributable to an Austrian permanent establishment.

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

ii. **Participation Exemption**

a. **Participation exemption for dividends received from Austrian and EU/EEA corporations**

Pursuant to Section 10/1 of the Austrian Corporate Income Taxation Act (“C.T.A.”) dividends (or similar distributions of profits) received by an Austrian company from another Austrian company or cooperative and from such a corporation resident in the European Union are tax exempt disregarding the extent or period of holding the participation. The exemption also applies to dividends received from a company resident in a European Economic Area country provided that there is a comprehensive mutual administrative and enforcement assistance agreement between Austria and this country; currently this is the case with regard to Norway.

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

Please note that a different set of exemption provisions applies for participations in non-Austrian companies that qualify as international participations! Thus, the participation exemption described here is of relevance only for portfolio-participations.

b. **Participation exemption for qualifying international participations**

1) **Qualifying international participations**

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

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

2) Tax exemptions

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

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

3) Capital gains

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

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

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

This provides for tax planning opportunities. If it is expected that the value of a participation in an Austrian subsidiary will rise in the future it may be advisable to transfer the seat of the subsidiary to a foreign jurisdiction; the difference between the going-concern value at the time of the transfer and the later sales price would then be tax free. Conversely, a foreign subsidiary, for

which no election to tax has been made, could be transferred to Austria if it is expected that its value will decrease in future with the result that a capital loss becomes deductible.

4) Anti-avoidance provisions

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

- The main business of the company consists in, directly or indirectly, deriving interest income, rental income from movable tangible property (*i.e.*, rents from immovable property are not detrimental) or income from royalties or the alienation of participations (passive income). Dividend income derived (directly or indirectly) from operating companies is not considered as passive income.
- The foreign taxation of the company is not comparable to the Austrian system of corporation taxation. According to the International participation ordinance of the Minister of Finance a foreign tax system is comparable to the Austrian system if the average tax rate of the foreign company computed in accordance with the principles of Austrian tax law exceeds 15%. Foreign taxes that are indirectly imposed on the income of the foreign company are taken into account when calculating the foreign average tax rate. If the 15% threshold is missed only because the foreign tax law allows a deduction of depreciations on fixed assets or a deduction of losses carried forward which would not be deductible under Austrian law, the foreign corporate taxation is nevertheless deemed to be comparable to the Austrian taxation.

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

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

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

The participation exemption may also be denied under the general abuse of legal rights concept. Generally speaking, an abuse of a legal right occurs where a specific legal structure can only be explained by tax avoidance related to Austrian taxes. In connection with foreign subsidiaries of Austrian companies, the Austrian Administrative High Court (*Verwaltungsgerichtshof*), the highest tribunal in tax matters, frequently invoked the principle where it came to the conclusion

that the foreign subsidiary had no economic function whatsoever. In cases of an abuse of a legal right, the foreign subsidiary is treated as a transparent vehicle with the result that its profits are directly taxed in the hands of the Austrian taxpayer.

A different anti-avoidance provision applies for the tax exemption provided for portfolio-participations in EU/EEA resident companies: the exemption is not granted if the foreign entity is not subject to a tax system comparable to Austria, the tax rate is less than 15% or the foreign entity is subject to comprehensive tax exemptions. In these cases, the dividends paid are not tax exempt but foreign tax paid is credited against Austrian tax (switch-over).

5) Treaty exemptions

As set out above, the domestic participation exemption regime is in some aspects more favorable than the international participation exemption since there is neither a minimum shareholding required nor a minimum holding period. Under tax treaties that include an equal treatment clause, the Austrian company may enjoy the benefits of the international participation exemption for foreign companies resident in the jurisdiction of the treaty state if the conditions for application of the domestic participation exemption are fulfilled. Such clauses are provided by the double tax treaties with Ireland, Luxembourg, Sweden and Turkey.

c. Interest Deduction

As a general principle, costs relating to tax-exempt income are not tax deductible in Austria. However, interest payments (but not other costs) connected with the financing of (domestic or international) shareholdings are deductible despite the fact that income deriving from such participations is tax exempt.

iii. Group Taxation

Effective January 1, 2005, group taxation concept replaced the former *Organschaft* concept. Under the rules now in effect, it is possible to tax all profits and losses derived by the members of a tax group at the level of the group head.

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

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

To qualify as a group member of a tax group, the group head (or heads in case of joint ventures) or an Austrian group member must hold a direct or indirect participation of over 50% in the Austrian or foreign subsidiaries that shall be part of the tax group. This financial integration requirement must be met during the entire business year of the participating subsidiary. The

Austrian group members must further file a written application with the revenue office, which binds the group members for at least three years.

All profits and losses of the Austrian members of the group are still calculated at the level of the group members, but taxed at the level of the group head. This treatment applies even when a person not being a group member holds a minority stake in one of the participating subsidiaries. For this reason it is necessary that the group members agree on compensation payments. These agreements need not be annexed to the filing; it is sufficient that the group members confirm that such an agreement exists. The compensation payments themselves will be tax neutral in Austria.

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

The deductibility of losses incurred by foreign subsidiaries is more favorable than required by E.C. law since Austrian law allows for an immediate deduction of the foreign loss. The E.C.J. in the case C-44/03, *Marks & Spencer* [2005], on the other hand, held that a provision which prevents the parent company from deducting losses from its taxable profits incurred by a subsidiary in another E.U. member state is justified where there are possibilities for those losses to be taken into account in its state of residence for future periods either by the subsidiary itself or by a third party (in particular where the subsidiary has been sold to that third party). Hence, an immediate deduction of the foreign loss is not required under E.C. law. Moreover, the group taxation regime does not only apply to subsidiaries resident in E.U. Members States, but also to subsidiaries anywhere in the world (although in practice “exotic” accounting rules can make it enormously difficult to integrate a foreign subsidiary into an Austrian tax group).

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

D. Withholding Tax On Outbound Payments

i. Dividend Payments

Generally, dividends paid by an Austrian company to nonresident shareholders are subject to withholding tax at a rate of 25%. Dividends paid by an Austrian company to its E.U.-resident

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

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

Even though Sect 94a I.T.A. was amended in 2009 by expanding its application to payments from cooperatives, the 10% participation requirement and the 1-year holding period requirement have not been abolished. It is questionable whether this restriction complies with EC-law. Even though dividends paid by an Austrian subsidiary to an Austrian parent company are also subject to a 25% withholding tax unless the Austrian parent company has a direct holding in the subsidiary of at least 25%, under the participation exemption regime described above the Austrian holding company is entitled to a refund of such withholding tax regardless of the extent of the shareholding. This difference in treatment between domestic and international holdings should no longer be maintainable in light of the recent E.C.J. decision in the *Denkavit II* case (Case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie* [2006]). The E.C.J. held in *Denkavit II* that national legislation, which imposes a liability to tax on dividends paid to a nonresident parent company whereas resident parent companies are allowed almost full exemption from such tax, constitutes a discriminatory restriction on freedom of establishment. This applies even where a tax convention between the source state in question and the home state of the parent company provides for the tax due in the source state to be set off against the tax charged in the home state if the parent company is unable to set off tax in the home state in the manner provided for by that convention, for instance because the home state of the parent company does not tax dividends paid by foreign subsidiaries.

Hence, where tax is withheld on a dividend payment made by an Austrian company to a foreign company resident in a member state on the ground that the requirements of the legislation implementing the Parent/Subsidiary Directive are not fulfilled, the foreign company (except in a case of illegal tax avoidance) should also be entitled to a refund unless the company is able to set off the Austrian withholding tax, in accordance with an applicable tax convention, against a corporation tax charge in its home state.

ii. Capital Gains

Nonresident shareholders are generally subject to taxation on the disposition of shares in an Austrian company if the shareholder has held 1% or more of the share capital for any time during the preceding five years (if the participation has not exceeded this threshold, capital gains

are not taxable). For corporate shareholders, corporate tax is levied at the regular corporate tax rate of 25% on the realized gains. Gains realized on the liquidation of an Austrian company are subject to corporation tax regardless of the extent of the shareholding.

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

iii. Royalties

Royalties paid by an Austrian company to nonresidents are generally subject to withholding tax at a rate of 20%; expenses are not deductible. However, under most tax treaties the withholding tax is reduced or eliminated altogether (*e.g.*, Germany, Poland, Hungary, and Croatia). If the receiving company is resident in an E.U.-member or E.E.A.-member state, it may deduct expenses directly connected to the royalty income from the withholding tax base, however, the withholding tax will then increase to 25%.

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

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

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

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

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

iv. Interest

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

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

In case of shareholder loans special attention must be given to structuring the loan properly. Under the general anti-avoidance principles the interest accruing on the loan may be subject to withholding tax as a hidden distribution of profits if the terms of the loan do not meet the requirements of an arm's length test.

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

v. Other Income

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

E. Other Tax Issues

i. Wealth Tax

Austria does not impose a wealth tax on Austrian companies.

ii. Anti-Avoidance-Legislation

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

iii. Foreign Tax Credit

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

- The Austrian taxpayer derives income from sources in a country with which Austria has not concluded a tax treaty;

- The foreign state imposes a tax on the income which is comparable to the Austrian income taxation or corporation income taxation; and
- The average foreign tax rate computed in accordance with Austrian tax principles exceeds 15%.

The credit method applies to all foreign source income that is neither exempt from taxation according to foregoing rule nor subject to a tax treaty. The foreign tax credit is capped at an amount corresponding to that part of the Austrian tax that is attributable, as computed before the deduction is given, to the income from sources of the foreign country in question. There are, however, no “basket” rules for the foreign tax credit.

11. FRANCE

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

- It is not a member State of the European Union;
- It is reviewed and monitored by the OCDE global forum on transparency and exchange of information;
- It has not concluded at least 12 tax information and exchange agreements (“TIEA”s) before 1 January 2010 and;
- It has not signed a TIAE with France.

A list of 18 NCCTs was published in February 2010 which includes the following states:

Anguilla, Belize, Brunei, Costa Rica, Dominica, Grenada, Guatemala, Cook Islands, Marshall Islands, Liberia, Montserrat, Nauru, Niue, Panama, the Philippines, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

This list is subject to modifications according to recent developments concerning new tax treaties and the efficiency of exchange of information under the treaties and TIEAs.

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

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

The standard corporate income tax is 33.33%. However, an additional social contribution of 3.3% of the CIT amount may apply on the fraction of the CIT which exceeds € 763,000 (practically speaking where the taxable profits is higher than €2,289,000). The effective tax rate is then 34.43%. Lower rates apply to SMEs.

B. Net Operating Losses (“N.O.L.’s”)

N.O.L.’s can be carried forward with no time limit. In addition, a loss company has the option to carry back the losses of the current taxable year up to the third year preceding that taxable year. Thus, a loss incurred in 2010 can be carried back to 2007. The carry back gives rise to a credit in an amount determined by applying the rate of C.I.T. in effect in the year to which the losses are carried back against the amount of losses actually carried back. This credit can be (i) reimbursed at the end of the five-year period following the year during which the losses were incurred, or (ii) used before that date for the payment of the C.I.T. that may be due during the five years following the election to carry back, or (iii) offered as a guaranty to a credit institution.

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

French corporate shareholders are exempt under the 95% dividends received deduction (“D.R.D.”) or otherwise fully taxed at 33.33% on the amount of the dividends received without deduction or tax credit.²¹

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

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

- The shares are in registered form or deposited with an accredited institution,
- The corporation receiving the dividend holds at least 5% of the capital of the company making the distribution, and
- The corporation must hold the stock giving rise to the tax-free dividend for at least two years

The 5% threshold refers to both financial and voting rights. It is not required that every stock forming the substantial shareholdings carry a voting right. This is favorable for corporate shareholders holding preferred stock with different rights. Consequently, if the shareholdings as a whole reach the 5% threshold, it is irrelevant whether some shares are voting or non-voting or carry restricted voting rights. The 5% test must be met at the time the distribution is actually made. A corporate shareholder holding restricted voting rights must demonstrate that it participates in the most important decisions of the company. The authorities are expected to release new guidelines.

In applying the third test, the exemption applies from the first day of the 5% holding, provided the holding period is ultimately maintained for two years. Failure to keep the shares for two years will result in a claw-back of the exemption. Late payment interest along with the

²¹ For individual shareholders, only 60% of the amount of the distribution received is taxable (40% exclusion). The same exclusion applies to dividends received from either Treaty protected distributing companies with an eligible exchange of information clause in the Tax Treaty or from companies established in the European Union.

applicable C.I.T. must be paid within three months from the date of the disposal of the shares of stock. If a tax-free reorganization such as merger or transfer of a business as a going concern under F.T.C. Sections 210 A and 210 B takes place before the two-year holding period is achieved, it will not result in a claw-back of the exemption. A carryover of holding period exists for D.R.D. purposes.

Dividends from certain entities do not qualify for the D.R.D. The list of excluded stock includes shareholdings in French or foreign R.E.I.T.'S (SIIC in France; SICAFI in Belgium, and BI in the Netherlands). This development is not critical when it comes to U.S. R.E.I.T.'s, as there rarely, if ever, is a 5% shareholder in a U.S. R.E.I.T. In any event, the U.S.-France Income Tax Treaty allows a French investor to credit the 30% or 15% tax levied in the U.S.

The dividend distribution is exempt from C.I.T., with a recapture corresponding to a service charge ("allotment for expenses and costs") equal to 5% of the amount of the dividends distributed. The parent company is currently allowed to cap the service charge to the actual amount of its operating and financial expenses. This limitation may be repealed based on an announcement made in June 2010 by the government.

N.O.L.'s could be used against that taxable profit. The D.R.D. is not applicable to profits²² distributed by venture capital companies or listed real estate companies ("*Société d'investissement immobilier cotée*" or "SIIC", the French equivalent of U.S. R.E.I.T.'S).

Financing costs are deductible subject to the thin capitalization rules (*see* below).

The D.R.D. applies to dividends from foreign subsidiaries with no limitations other than the conditions set forth above. Foreign tax that is withheld in the source country for dividends received from foreign subsidiaries may be used as a credit against any French withholding tax that might be due upon the further distribution of the dividend to a foreign shareholder of the French company.²³ Otherwise, the tax withheld at source is not recoverable.

From the 1st march 2010, dividends distributed by a company established in a NCCT (which is black listed) are not eligible to the D.R.D.

D. Withholding Tax ("WHT") on Dividends

i. Outbound Dividends Within the E.U.

a. E.U. Directive Exemption

Under Section 119 *bis* 2 of the F.T.C., a 25% withholding tax is levied on the outbound dividend payments subject to treaty law or E.U. law. However, dividends could be paid to qualifying E.U. parent companies subject to a 5% ownership test if the E.U. parent cannot recover the French source withholding tax (the "5% E.U. Exemption"); otherwise, the dividend could still be paid free of withholding tax subject to a 15% ownership test ("E.U. Directive Exemption").

²² Profits distributed by venture capital companies or SIIC that have been excluded from corporate income tax.

²³ Doc. Adm. 4 K 1121, December 15, 1989.

This exemption applies if the following tests are met:

- The distributing company is incorporated under the legal form listed in an appendix of the Directive. Eligible entities include “*Société Anonyme*”, “*Société Anonyme Simplifiée*”²⁴, “*Société En Commandite Par Actions*”, “*Société A Responsabilité Limitée*” and the European Company (*Societas Europaea*);
- The shareholder corporation is the beneficial owner of the dividends distributed;
- The distributing corporation is subject to C.I.T. without exemption;
- The shareholder corporation is an E.U. resident defined as having its place of control and management in another Member State and having a legal form listed in the Directive; and
- The shareholder corporation holds directly 10% or more of the capital of the distributing company. The shares must be held for at least two years. However, the E.U. Directive Exemption can be claimed before the expiration of that period.

The dividend can be paid to a permanent establishment in the E.U. of an eligible shareholder corporation.

An anti-abuse provision denies the E.U. Directive Exemption where a non-E.U. corporate shareholder directly or indirectly controls the beneficial owner unless the beneficial owner can demonstrate that taking advantage of the E.U. Directive Exemption was not a principal purpose for the ownership structure (the “purpose test”). According to guidelines released by the tax authorities, the tainted purpose does not exist where the overall withholding tax cost through the ownership chain up to the non-E.U. ultimate controlling shareholder is equal to the withholding tax burden for which the non-E.U. controlling shareholder would have been liable had the dividend been paid directly to the non-E.U. controlling shareholder. The test is also satisfied if the ownership chain was in place before July 23, 1990, *i.e.*, at the time the directive was adopted.

b. 5% E.U. Exemption

This exemption results from the guidelines issued by the French Tax Authorities²⁵ following the E.C.J. *Denkavit* decision

The following requirements must be met:

- The shareholder must enjoy an exemption regime in his own country of residence. This is to say that the recipient shareholder must not be in a position to credit the French withholding tax against its own tax;

²⁴ The scope of the eligible French legal forms was extended to the SAS by administrative regulations 4-J-2-95 dated October 11, 1995.

²⁵ Guidelines 4-C-7-07 dated May 10, 2007

- The shareholder must be a resident of the European Economic Area or the European Union, provided that the recipient shareholder's country of residence has entered into a qualifying tax treaty with France;
- The parties must not have entered into an "artificial arrangement" for tax avoidance;
- The stock must constitute 5% of the capital and voting rights of the distributing company, the stock must be registered shares or be kept by a financial establishment, and the stock must be held for at least two years.

When the above conditions are met, the French withholding tax exemption automatically applies.

In other words, if the qualifying E.U. shareholder is not taxed on the French source dividends, as is generally the case, no withholding tax applies in France for an E.U. shareholder owning a 5% or more interest in the French distributing company. If the dividend is taxed in the jurisdiction of the residence of the E.U. shareholder, the dividend may still be paid gross if the E.U. qualifying corporate shareholder owns 15% (10% in 2009) or more of the French distributing company.

One may rely on tax treaty law as an alternative to the 5% E.U. Exemption. Several tax treaties provide for zero withholding tax on dividends, including those with Spain, Germany, Japan and the U.S.

ii. Outbound Dividends Outside E.U.

Most tax treaties entered into by France provide for a reduced rate of dividend withholding tax ranging generally from 25% to 5%. In addition, some tax treaties provide for a zero withholding tax on dividends (see above). Other income tax treaties have a narrow definition of dividend that restricts the application of the dividend provision to distributions that qualify as dividends under corporate law, only.²⁶ Consequently, distributions that are treated as dividends under tax case law may not be covered by the dividends article. An example is an exceptional distribution of reserves. As a consequence and to the extent that the other operative provision in the tax treaty applies, withholding tax may not be due. This situation may also arise in the tax treaties with the Netherlands and Luxembourg.

iii. Dividends from Foreign Subsidiaries

The D.R.D. may apply even if the subsidiary's profits were not subject to tax unless the distributing company is established in a NCCT..

In addition, when a French company owned by nonresident shareholders receives a dividend from abroad and pays a dividend to its foreign shareholders, French law provides that the French

²⁶ For example, the French Administrative Supreme Court held that deemed distributions do not fall within the scope of the dividend article but rather the other income article, resulting in an exemption from WHT in France (CE October 13, 1999, *SA Banque Francaise de l'Orient*, RJF 12/99 #1587).

company may claim a foreign tax credit against its dividend withholding tax obligation in an amount equal to the foreign withholding tax levied on the inbound dividend.²⁷

E. Capital Gains Tax on Shareholdings– Exemption.

Gains on the sale of stock are treated as ordinary income unless the shareholding qualifies as a substantial shareholding eligible for Capital Gains Tax (“C.G.T.”) relief. Relief is available in the form of an exemption or through a reduced rate of taxation.

C.G.T. on substantial shareholdings include two baskets: one giving rise to a reduced tax of 15.49% tax (the “Tax Basket”) and the other one giving rise to an exemption (the “Exempt Basket”)

Both baskets cover gains on disposition of substantial shareholdings. Substantial shareholdings for both baskets include shares or interests that the shareholder intends to hold as long-term investments, *viz.*, at least two years. They must be sufficient to provide the shareholder with control of, or significant influence over, the company. This condition is deemed met with a holding of at least 5% in the company. Stock in NCCT will not be eligible to the C.G.T. relief as of January 1, 2011.

Regarding the exempt basket, gains on certain substantial shareholdings are exempt subject to a 5% add-back, which brings the effective tax rate to 1.7% of the gain, unless N.O.L.’s are available.²⁸ In addition, the 5% add-back is capped at the actual amount of operating expenditures of the corporation. Shareholdings giving rise to the D.R.D. with a minimum 5% ownership test, or shares acquired in a takeover bid or in a stock tender offer, are treated as substantial shareholdings for C.G.T purposes.

Regarding the Tax Basket, disposition of shares in listed real estate holding companies for who more than 50% of French assets consist of real estate are eligible for the Tax Basket if the substantial shareholding requirements are met. A special C.G.T. rate of 19.62% applies. Disposal of shares of private real estate holding companies are subject standard CIT. Venture capital funds interests in an FCPR or an SCR that are held for more than five years are eligible for the Tax Basket, but only as to the fraction of the gain which is not exempt under special rules.

Gains subject to the Tax Basket must be netted each year against the same basket’s capital losses. Capital losses can be carried forward for 10 years. Ordinary losses can be used against any given year’s Tax Basket gain.

The C.G.T. regime does not prevent the corporation from deducting acquisition expenses. These expenses principally include interest charged on debt-financed acquisition. Like all interest expense, the deduction is subject to the thin capitalization rules.

²⁷ Doc. Adm. 4 K 1121, December 15, 1989.

²⁸ In other words, the gain will be fully exempt and the corporate taxpayer should add back 5% of the gain’s amount to its taxable profits, which brings the effective rate of taxation to 1.7%.

F. Other Tax Items

i. Thin Capitalization

French thin capitalization rules provide for two cumulative tests regarding loans extended by related entities: the interest rate test and the leverage test. The rules also apply to wholly domestic transactions.

Related-party debt within the scope of the limitations include debt extended by the controlling shareholder (either direct or indirect) and sister companies that are under control of the same shareholder (“Affiliates”). A shareholder directly or indirectly holding at least 50% of the capital of the French indebted company, or exercising control over the company decisions, is regarded as controlling the company for purposes of the thin capitalization rules.

Under the interest rate test, the deduction of interest paid to all shareholders is limited to interest whose rate is no higher than the annual average interest rate granted by credit institutions to companies for medium-term loans of two years or more (4,81% for 2009) unless the French borrower can demonstrate that the rate is a market rate (transfer pricing safe harbor). A market rate is a rate that the company could have obtained from independent banks under similar circumstances. The transfer pricing safe harbor rate cannot be claimed by minority shareholders that are not affiliated with a controlling shareholder.

Excess interest paid to affiliates under the interest rate test is treated as a distribution eligible for the D.R.D. within a wholly domestic or which may be subject to withholding tax (subject to the treaty law) with a non-French affiliate lender. Some tax treaties may deny France the right to tax the deemed distribution where the dividend article does not encompass deemed distribution (*see, e.g., Luxembourg and the Netherlands*).

The leverage test applies to affiliates only and not to minority shareholders. It is then applied on the allowed fraction of the interest under the interest rate test to determine if the interest expense is actually deductible.

Deductions claimed for interest expense will be disallowed when the creditor is an Affiliate and the following three tests are met:

- The related-party debt exceeds 1.5 times the amount of the net equity (taking into account related-party debt only);
- 25% of the operating profit before tax, related-party interest expense, depreciation, amortization, and certain specific lease payments is less than the actual related-party interest; and
- The interest paid to related parties exceeds the interest received from related parties.

The disallowed interest is equal to the highest of the above limitations. If it is less than € 150,000 or if the disallowed interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group, the interest is allowed.

The disallowed interest can be carried forward to offset profits of the following years (up to 25% of the profit before tax and after deduction of current allowed related party interest). A reduction of 5% applies each year from the second carryover year.

The rules provide two safe harbors. First, a 1.5-to-1 debt-to-equity ratio safe harbor as seen above.

Second, a worldwide group safe harbor applies. Under the worldwide group safe harbor, the interest expense deduction will not be limited if the French borrower demonstrates that the disqualified interest is attributable to debt that does not represent leverage in excess of the level of third-party indebtedness of the worldwide group. Related-party debt and reciprocal transactions within the worldwide group should be set aside when computing the debt-to-equity ratio of the worldwide group. The worldwide leverage safe harbor does not allow for the split of the leverage test by industry within the worldwide group even though degree of leverage generally differs from one industry to the next.

Interest exceeding the higher of the above limits is not tax deductible, but can be carried forward within certain limits (they are deductible within the limit of 25% of the current income before taxation). Further, the interest deduction is reduced by 5% annually from the second year of the carry-forward period. The excess interest is not regarded as a deemed distribution. No withholding tax should apply, especially where the recipient is treaty protected.

Among companies filing a consolidated tax return, the thin capitalization rules are applied at the level of each member on a stand-alone basis. The aggregate of disallowed interest may be deducted from the consolidated tax profit for an amount that does not exceed the difference between (i) the aggregate of the related party interest paid by companies filing a consolidated tax return to non-consolidated entities and carryovers of pre-consolidation disallowed interest which were deducted during the consolidation and (ii) 25% of the operating profits of member companies before tax.

Banks and certain financial institutions are excluded from the scope of the new thin capitalization rules. In addition, related-party debts within the course of cash-pooling arrangements or asset-financing transactions involving leases or “credit bail” contracts may not be considered for computation purposes for the purpose of those activities only. In addition, third party debt guaranteed by an affiliate is not within the scope of the limitation.

ii. Withholding Tax Exemptions

According to Articles 119 *bis* 1 and 125 A III of the F.T.C., a 25% withholding is levied on interest paid to a nonresident recipient. However, French domestic law provides for several exemptions. We have outlined three of these exemptions for (i) interest on loans (ii) interest on bonds, and (iii) interest paid inside the E.U.

a. Interest on Loans.

Until March 1er, 2010, interest could be paid free of withholding tax where:

- o The initial lender is a nonresident individual or legal entity established outside of France;

- o The loan is documented by an agreement executed before the loan proceeds are transferred to the French company;²⁹
- o 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.

From the 1st march 2010, according to article 125 A III of the F.T.C, no withholding tax should apply to the interest paid by a French company to a nonresident company with no further formalities.

However, in regard of the new NCCT rules, a 50% withholding tax applies to interest payments made on an account held in an NCCT.

b. Interest on Bonds

Under articles 119 *bis* 1 of the F.T.C., interest paid to nonresidents on bonds issued by French issuers is exempt from withholding tax provided the securities were issued after January 1, 1987. Under article 125 A III of the F.T.C., the levy at source is not applicable to interest on bonds (“*obligations*”) issued after October 1, 1984 paid by a debtor domiciled or established in France, if the beneficial owner of the interest demonstrates that he has his fiscal domicile or corporate seat outside the territory of the French Republic, Monaco or a member State of the so-called “*Zone Franc.*” Evidence of the foreign domicile or seat of the beneficial owner must be furnished to the paying agent of the interest. Evidence of the foreign domicile is assumed for bonds converted into Euros on or after January 1, 1999. The exemption applies to tradable securities and units in French securitization vehicles (*fonds commun de créances*).

c. Interest Paid To An E.U. Related-Company

The recipient is an E.U. eligible company that is subject to corporate income tax in its jurisdiction of residence. The “payor” and the “beneficial owner” must be related parties. Parties will be treated as related where (i) the payor or the beneficial owner directly owns at least 25% of the capital of the other party or (ii) a third E.U company directly holds at least 25% of the capital of both the payor and the beneficial owner. The ownership interest must be held for at least two years. Payments made before the expiration of such two-year period can be exempted from withholding tax if the shareholder undertakes to hold the ownership interest for at least two years. An E.U. permanent establishment of an E.U. eligible company can be treated as an eligible party (either payor or beneficial owner) as long as the interest is subject to corporate income tax in the E.U. Member State where the P.E. is constituted. The beneficial owner of the payments must give to the payor all the required evidence that the tests have been fulfilled.

The exemption includes an anti-abuse provision under which the exemption may be denied where the beneficial owner is controlled directly and indirectly by a non-E.U. corporate shareholder and obtaining the tax benefit is a principal reason for the structure (*see* paragraph

²⁹ This requirement is open to question and has given rise to conflicting decisions from French courts.

11.D.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 withholding tax on interest, the anti-abuse provision may be of little practical importance. The U.S. is an example.

In addition, income tax treaties may reduce or eliminate the rate of withholding tax on interest payments by a French company. Thus, each of the income tax treaties between France and Germany, Austria, the U.K., Greece, Ireland and Sweden provides for zero withholding tax on interest.

iii. C.F.C. Legislation

Article 209 B is the French counterpart of “Subpart F” of the U.S. Internal Revenue Code. In 2002, the French high court, the *Conseil d’Etat*, struck down article 209 B as discriminatory under the French-Swiss Tax Treaty.³⁰ The *Conseil* found that article 209 B indeed amounted to a tax on French business profits of the foreign company, which, in the absence of a permanent establishment in France, was precluded by the France-Switzerland Income Tax Treaty applicable at that time. In addition, article 209 B was clearly at odds with the principle of free establishment protected by the E.C. Treaty. The C.F.C. rules were therefore revisited and reformed.

The law changed effective January 1, 2006. The C.F.C. rules apply both to foreign enterprises (namely permanent establishments) and to foreign entities. The foreign entities should be “established or formed” in a foreign country. They include legal entities whether or not distinct from their shareholders (*viz.*, companies, partnerships, associations, etc.). They also include trusts.

The holding threshold increases from 10% to “more than 50%” for the foreign entity to be treated as a C.F.C. under article 209 B. However, that threshold drops to 5% if 50% of the legal entity is held directly or indirectly by other “French enterprises,” even if unrelated under a control test.³¹ In case of related enterprises, the 5% test applies even if the related enterprise is not established in France. The alternative threshold of €2,800,000 has been repealed.

The new provisions do not replace the current anti-abuse provision pursuant to which an interest held by “sister entities” (whether French or foreign), is taken into account in determining the 50% threshold. A sister entity is defined as any entity with the same controlling shareholder in terms of voting rights.

The low tax test is met if the foreign legal entity is subject to C.I.T. at a rate below 16.66 % (50% of the French C.I.T.).

³⁰ CE, June 28, 2002, *Ministre de l’Economie, des Finances et de l’Industrie c/ Sté Schneider Electric*, n°232276, RJF 10/02, n° 1080.

³¹ Control means (i) holding directly or indirectly the majority of the share capital of the “controlled” entity, or (ii) having the majority of voting rights, directly or indirectly, or (iii) having the power of decision. In addition, the control test is met where a company is *de facto* dependent on the other one, due, for example, to commercial ties.

Section 209 B provides an E.U. exclusion. The C.F.C. rules do not apply to legal entities established in an E.U. Member State, unless the foreign company is considered to be a “*wholly artificial arrangement, set up to circumvent France tax legislation.*” This provision follows the case law developed by the European Court of Justice (E.C.J.) and more particularly *Cadbury Schweppes*.³² In this case, the E.C.J. decided that the C.F.C. was not artificially established when it participated in the economic activity of the host country with the required substance (offices, etc.) and that the subjective intent of the establishment (*i.e.*, as tax planning) was not material.

A second exclusion (the “Trade or Business Exclusion”) may apply for C.F.C.’s established in non-E.U. countries.

In case the C.F.C. derives passive income from financial activities or the management of intangibles, the exclusion applies unless the passive income comprises more than 20% of the profits of the C.F.C. or more than 50% of the profits of the C.F.C. is derived from financial activities, the management of intangibles, and services rendered to affiliates. In that case, the French taxpayer must demonstrate that using the foreign entity or enterprise does not primarily result in locating profits in a low tax jurisdiction.

From the 1st of March 2010, where the C.F.C. is established in a NCCT, the trade and business exclusion does not apply unless the taxpayer justify the effectiveness of the business carried out and the compliance with the 20% and 50% rations.

If the C.F.C. does not qualify for either the E.U. or the Trade Or Business Exclusions, the French taxpayer may still justify that the setting up of the C.F.C. does not primarily result in locating profits in low tax jurisdictions in order to avoid the taxation of C.F.C’s profits to France.

In response to the 2002 decision of the *Conseil d’Etat*, the new law provides that profits derived from the legal entity established or formed abroad and attributed to the French company by virtue of article 209 B would be treated as “deemed distributions.” The French Tax Authorities (the “FTA”) contend that under these conditions, the conflict with the tax treaties would be eliminated.

N.O.L.’s of the French company are available to reduce the taxable income arising from the attribution of profits from a C.F.C. Moreover, tax credits of the C.F.C. on the receipt of dividends, royalties, and interest are available to the French company to reduce tax due, provided that an income tax treaty containing an exchange of information provision exists between France and the source country.

iv. Transfer pricing

The arm’s length principle applies to transactions between related parties.. France follows the OECD guidelines.

³² E.C.J., September 12, 2006, *Cadbury Schweppes*, C-196/04 and among others: E.C.J., July 16, 1998, *Imperial Chemical Industries plc*, C-264/96. And guidelines issued by the FTA dated January 16, 2007 (4-H-1-07)

As of January 1st 2010, transfer pricing documentation is mandatory in France for (i) French companies with a gross annual turnover or gross assets equal to or exceeding €400 million; (ii) French subsidiaries of foreign based group when more than 50 % of their capital or voting rights are owned, directly or indirectly, by French or foreign entities meeting the €400 million criteria; (iii) French parent companies that directly or indirectly own at least 50 % of companies meeting the €400 million criteria; or (iv) worldwide consolidated (without any financial threshold) or tax consolidated French companies (with at least one tax consolidated entity meeting the €400 million criteria within the perimeter).

The documentation – corresponding to the E.U. documentation proposed by the Joint Transfer Pricing Forum of the European commission must include (i) general information about the group and its subsidiaries (master file) and (ii) detailed information on the French audited company (description of its activities and transactions, as well as a presentation of the applied transfer pricing method) (country specific file).

If the company fails to provide the documentation, a fine of €10,000, or 5% of the adjusted profits (the actual rate depends on the behaviour of the company), whichever is higher may apply.

For companies not subject to the mandatory TP documentation, Tax authorities may request information regarding transactions with affiliated nonresident companies, information on the transfer pricing method used by the company and details of the activities of the nonresident affiliated companies and the tax regime applicable to them.

In order to avoid uncertainty, taxpayers may want to reach an advance transfer pricing agreement with the French tax authorities. The advance pricing agreement could be unilateral, bilateral or multilateral. The French programme proves to be efficient and pragmatic.

v. NCCT

Article 238-0 A of the F provides for a 50% levy on all types of payments on accounts open in a NCCT from the 1st march of 2010. The criterion is the place where the money is transferred to, regardless of the beneficiary's State of residence. For example, payments made by a French debtor to the benefit of a NCCT resident is not subjected to the 50% withholding tax if the money is wired from France to an account open in a jurisdiction that is not qualified as a NCCT. Conversely, if the payment is made by a French resident to a non NCCT resident via an account open in a NCCT, the 50% withholding tax applies.

For the royalties, this rule applies in case of a payment made to a person domiciled in a NCCT.

12. ITALY

A. Corporate Tax Rate

An Italian resident holding company is subject, as all the other kinds of companies, to corporate income tax (“I.R.E.S.”), as ruled by the Income Tax Code (Presidential Decree dated December 22, 1986, n. 917, (“I.T.C.”)). Income tax is levied on the worldwide income of the company at a 27.5% flat rate.

A regional tax on productive activities (“I.R.A.P.”), as ruled by Legislative Decree dated December 15, 1997, n. 446, also applies to the net value of the production realized in Italy, at rates ranging from 3.9% to 4.9%.

B. Dividend Exemption

i. Domestic Dividends

In general, the I.T.C. provides for a 95% exemption with regard to the receipt of a distribution from a domestic Italian company and no withholding tax is imposed. *See* art. 89 (2), I.T.C. The effective tax rate is thus 1.375% ($0.05 \times 0.275 = 0.01375$). There are no minimum ownership or holding period requirements.

For companies adopting IAS/IFRS accounting, the receipt of profits arising from shares or other financial assets qualified as “held for trading” is fully taxed (*see* art. 89 (2-*bis*), I.T.C.). It is also worth noting that companies adopting IAS/IFRS accounting must determine the positive and negative components of their tax base according to the criteria provided for by the accounting standards, which, in principle, prevail over the ordinary I.T.C. rules.

ii. Foreign Dividends

According to art. 89 (3), I.T.C., the 95% exemption applies also to foreign source dividends, provided that the payment is not deductible by the payer in its country of residence (the non-deductibility must be stated by the foreign company in a declaration or must result from other objective evidence).

If the dividends are directly or indirectly distributed by a company resident in a “black list” country or territory (qualified as privileged tax regime for controlled foreign company purposes), the exemption does not apply and, unless a favorable ruling is obtained from the Italian tax authorities, the entire amount of the dividend is taxed. *See also* paragraph 12.9.

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.

C. Participation exemption for Gains

The I.T.C. provides for a 95% exemption regime for gains derived from the sale of shares of a subsidiary. According to art. 87, I.T.C., the exemption applies to the disposal of participations in both Italian and foreign subsidiaries.

The exemption applies if several conditions are met. First, the shares must be held for an uninterrupted period of twelve months prior to the disposal. In measuring the holding period where shares of stock have been acquired over time, a Last-In First-Out rule applies. Direct tracing is not permitted. Second, the participation must be classified as a financial fixed asset in the first balance sheet of the shareholder covering the start of the holding period for the shares. Third, the tax residence of the subsidiary must be in Italy or in a jurisdiction that is not blacklisted for C.F.C. purposes (*see also* paragraph 12.9). If the company is resident in a blacklisted jurisdiction but was formed to carry out active business operations, the shareholder

may request a ruling from the Italian tax authorities that the purpose of the investment was not to obtain the benefits of a preferential tax regime. Finally, the subsidiary must carry on an active business (unless its shares are traded on a stock exchange).

Several rules apply to the foregoing tests. Under anti-avoidance rule, the company is deemed not to carry on an active business and cannot meet the active business test where real estate is the predominant asset reported in the company's balance sheet. Where the subsidiary is a holding company, the law requires that the final two conditions (residence and business) must be applied at the level of the operating companies owned by the holding company.

Where the participation exemption applies to a gain, only a portion of costs related to the sale is deductible. The percentage that is deductible is equal to the percentage of the gain that is taxable, *viz.*, 5%. See art. 86 (2), I.T.C.

D. Interest Deduction

Finance Act 2008 has completely redefined the regime of interest deduction for companies subject to I.R.E.S.

The new regime (*see* new art. 96, I.T.C.), in general, provides that:

- Interest expense is fully deductible in each tax period for an amount equal to interest income;
- The excess amount of interest expense can be deducted but the deduction is subject to a cap of 30% of an amount substantially corresponding to the EBITDA, as measured in the borrower's profit & loss statement;
- The amount of interest expense exceeding the 30% limit that is not deductible in the tax period incurred may be carried forward indefinitely until absorbed in a year when sufficient EBITDA exists;
- Starting from 2010, the excess EBITDA generated in each fiscal year will be carried forward and used to increase the EBITDA of the following periods.

While banks and insurance companies, together with their holding companies and some other financial institutions, have been excluded, the regime of interest deduction applies to so-called "industrial holding companies", *i.e.*, those companies whose main business consists of holding participations in other businesses rather than being engaged in lending activities or the provision of financial services. See art. 96 (5), I.T.C. These holding companies are likely to be penalized by the new provisions, although if they participate in a domestic consolidation rules (*see* paragraph 12.6.1), excess interest expense of the holding company can be used to reduce the consolidated tax base generated by other consolidated companies. This rule applies also in the case of interest expense carried forward by a company, provided they have been generated during the period of fiscal consolidation. Note that in some circumstances the EBITDA generated by certain nonresident controlled subsidiaries may be taken into account even though foreign subsidiaries are not permitted in an Italian domestic consolidation.

Specific rules are applicable for banks and insurance companies.

E. Minimum Taxable Income for Non-operating Companies

A particular anti-avoidance rule applies to non-operating companies and non-operating permanent establishments in Italy. Under art. 30 of the Law dated December 23, 1994, n. 724, an entity is deemed to be non-operating when the sum of its turnover, increases in inventory, and revenue reported on its profit and loss is lower than a specified base. The base is the sum of the following items: (i) 2% of the total value of participations in resident and non resident companies, bonds and other financial instruments (ii) 4% - 6% of the value of real estate and ships owned or leased by the company, and (iii) 15% of the value of other fixed assets. The calculation is made on the average values of those amounts over a three-year period (*i.e.*, the tax period concerned and the two preceding ones).

When a company is a non-operating company under the foregoing definition, it is taxed on minimum income, calculated by applying a deemed return to the assets mentioned above. The deemed returns are (a) 1.50% of participations and other financial instruments, (b) 4.75% of real estate values (subject to a 3% rate for particular real estate assets), and (c) 12% of other fixed assets.

A non-operating company may demonstrate that specific facts and circumstances prevented it from achieving the minimum turnover. A ruling is required by the Italian tax authorities in order to come within this exception. The law also provides some causes of automatic exclusion from the scope of the application of the general rule. Finance Act 2008 has increased the number of these exclusions and some of the most important are those provided for: (1) companies in the first year of activity; (2) companies whose share are traded on a stock exchange (and their subsidiaries and controlling shareholder); (3) companies which have had at least ten employees in the two preceding fiscal periods; (4) companies whose value of production, as measured in the profit & loss statement, is greater than the total value of assets reported in the balance sheet; (5) companies holding participations in subsidiaries that are considered to be “operating” companies or that have obtained a positive ruling; and (6) companies in insolvency proceedings.

F. Group Consolidation

i. Domestic Consolidation

After the introduction of the participation exemption regime, holding companies cannot reduce income by unrealized losses in participations. However, group consolidation is permitted. See art. 117-129, I.T.C. Two consolidation regimes exist. One is known as the domestic regime and the other is the foreign regime.

For the purposes of the domestic consolidation regime, a group of companies is constituted by a common parent company and its controlled subsidiaries. A subsidiary is deemed to be a controlled subsidiary if two facts exist. First, the common parent must directly or indirectly have the majority of voting rights at the subsidiary’s general shareholders’ meeting. Second, the common parent must directly or indirectly hold more than 50% of the subsidiary’s shares and be entitled to more than 50% of the subsidiary’s profits.

A nonresident company may participate in the domestic consolidation as the common parent of the group, and only in limited circumstances. First, it must be a resident in a country that has a tax treaty in effect with Italy. Second, it must carry on business activity in Italy through a permanent establishment and the participations in the controlled subsidiaries must be recorded in the books of the permanent establishment.

The domestic consolidation tax regime applies only when an election is made by the common parent and the participating controlled subsidiaries. Not all subsidiaries are required to participate in the regime. Once made, the domestic consolidation regime is effective for three tax periods. If the requisite degree of control in a subsidiary is relinquished during this period, that subsidiary no longer participates.

The domestic consolidation tax regime works as follows. Each company determines its taxable income or loss on a separate company basis, according to the ordinary rules, and submits its own tax return (without computing the relative income tax or credit). Then, the common parent aggregates the group's taxable income or loss and computes the consolidated income tax or credit. The entire taxable income or loss of each controlled subsidiary is taken into account regardless of the percentage held by the common parent.

As of 2008, domestic consolidated groups can take advantage of a new rule that allows EBITDA and interest expense to be computed on a consolidated basis. In addition, the EBITDA of certain controlled foreign subsidiaries may be taken into account in computing the consolidated ceiling even though foreign subsidiaries are excluded from the domestic fiscal consolidation.

A separate limitation rule applies to losses incurred in a tax period in which a company did not participate in the consolidation regime. These losses are ring-fenced in that company and cannot be brought forward to reduce group income.

G. Worldwide Consolidation

In addition to the domestic regime, Italian law provides for a worldwide consolidation tax regime when an Italian resident company controls one or more nonresident companies. See art. 130-142, I.T.C. In order for a nonresident company to participate, its financial statements must be audited and an advance approval must be obtained from the Italian tax authorities.

Several differences exist between the domestic consolidation regime and the international regime. First, the international regime is not selective among group members. The option must be exercised by all the nonresident controlled subsidiaries or none. In addition, the consolidation is proportional to the profit entitlement of the common parent in each nonresident controlled subsidiary. It is believed that the option for worldwide consolidation has been exercised only by few Italian groups of companies.

H. C.F.C. Legislation

Italian tax law contains a C.F.C. regime applicable to individuals and companies that control, directly or indirectly, companies or other entities resident in countries or territories characterized by a privileged tax regime. See art. 167, I.T.C. Those countries and territories have been identified according to certain identified factors, most importantly a noticeably lower level of

taxation in comparison to the Italian tax burden and the absence of an adequate procedure for the exchange of information. These jurisdictions are listed in the Ministerial Decree dated November 21, 2001 (the so called “black list”). Finance Act 2008 has planned to substitute the black list with a new “white list” (*see also* next paragraph 12.9)

For purposes of the C.F.C. regime, control is defined according to the Italian Civil Code. See art. 2359 of the Civil Code. A company is deemed to be controlled in one of three circumstances. The first is that the Italian resident holds, directly or indirectly, the majority of the voting rights exercised at the general shareholders’ meeting of the company. The second test is that the Italian resident holds, directly or indirectly, sufficient votes to exert a decisive influence in the shareholders’ meeting of the company. Finally, control may exist where the Italian resident exercises a dominant influence over the company by virtue of contractual relationships.

In order to avoid the application of the C.F.C. regime, an Italian resident company may request a ruling from the tax authorities and must provide evidence (i) that the nonresident company carries out an effective industrial or commercial business activity in the market/territory of the country where it is located or (ii) that the Italian company does not benefit from a diversion of income into a privileged tax regime.

Concerning the first condition, the Law Decree n. 78/2009 introduced the following changes:

- With respect to banking, financial and insurance activities, the condition is deemed to be met when the main portion of the respective sources, investments and proceeds originate in the state or territory where the foreign company is located and
- The condition is never met when more than 50% of the foreign company’s proceeds is derived from (i) the management, holding or investment in securities, shares, receivables or other financial assets; (ii) the transfer or grant of right to use intangible rights on industrial, literary or artistic property; or (iii) the supply of services, including the financial services, within the group. See art. 167 (5 *bis*).

The above mentioned Law Decree n. 78/2009 also broadens the scope of the C.F.C. rules to involve controlled companies located in states or territories different from those included in the black list, if the following conditions are both met:

- The controlled foreign company is subject to an actual taxation that is more than 50% lower than the tax that would have been levied if it were resident in Italy; and
- More than 50% of the proceeds of the controlled foreign company is derived from the management, holding or investment in securities, shares, receivables or other financial assets, from the disposal or licensing of intellectual property rights, or from the performance of intra-group services. See art. 167 (8 *bis*).

A special safeguard clause exists pursuant to which the C.F.C. rules will not be applicable if the resident shareholder can in fact demonstrate in an advance tax ruling that the localization abroad does not constitute an artificial scheme aimed at achieving undue tax advantages. See art. 167 (8 *ter*).

If the C.F.C. rules apply, the profits of the C.F.C. are deemed to be the profits of the Italian resident. These profits are taxed separately at the average tax rate of the Italian resident, which is 27,5% for corporations.

Italian law contains a previously taxed income concept. As a result, when profits that were previously attributed to the resident company are distributed in the form of a dividend, the dividend does not constitute taxable income upon receipt.

I. The New “White-List” of Countries and Territories

Finance Act 2008 has replaced the ‘black list’ of countries and territories characterized by a privileged tax regime (compiled for C.F.C. purposes) with a new list of countries and territories that will be selected by taking into account the presence of an adequate exchange of information between tax authorities and a level of taxation not significantly lower than the level in Italy. This is the so called “White List” regime. The C.F.C. rules and all the other I.T.C. rules relating to the “black list” (including the dividend and participation exemption regimes) have been modified to reflect the change. However, the amendment still has not entered into force, as the new White List will be applicable only from the tax period following its date of publication. As of May 2010, the list has not been published. For this reason, the black list will remain in force during the current fiscal year 2010.

J. Treaty Protection

Italy has concluded Tax Treaties with about 80 jurisdictions, including the more important developed countries and trading partners. In general, the treaties provide for reduced withholding tax rates, in line with the O.E.C.D. Model Treaty. Notable exceptions exist for withholding tax on interest. In the new treaty with the U.S., the withholding tax rate is 10%.

K. 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 27% withholding tax. The rate may be reduced to 12.5% for dividends connected to saving shares and to 11% for dividends paid out to pension funds established in E.U. Member States or E.E.S. Countries (*i.e.*, Iceland, Liechtenstein and Norway) included in the White List. The recipient can claim a refund up to four ninths for the withholding tax suffered if taxes have been paid on the same income in its country of residence. This is provided in art. 27 (3) of Presidential Decree n. 600/1973. If a treaty applies, the favorable provisions of a treaty will reduce the Italian withholding taxes.

For dividends distributed to companies or other entities resident and subject to income tax in E.U. Member States or in the above mentioned E.E.S. Countries included in the White List, a reduced 1.375% withholding tax applies. Thus, the tax on these payments is the same as the tax applicable to distributions to domestic companies. (*See* paragraph 12.2.1.) The 1.375% withholding tax applies to dividends relating to profits accrued from January 1, 2008.

If dividends come from a participation related to a permanent establishment in Italy, no withholding tax applies and dividends are treated as described above (they are subject to a 95% exemption).

a. Parent/Subsidiary Directive

Under the Parent/Subsidiary Directive implemented in the Italian tax system, qualifying parent companies resident in other E.U. Member States may claim a refund of the 27% or 1.375% withholding tax levied on dividends distributed by Italian subsidiaries. After the amendments brought by Directive 2003/123/CE, as implemented in Italy by Legislative Decree dated February 6, 2007, n. 49, the required 25% minimum direct shareholding in the Italian company is reduced to 20%, 15% and 10%, for dividends distributed, respectively, from January 1st, 2005, January 1st, 2007 and January 1st, 2009.

In order for a company to qualify as a parent for the benefit of the Parent/Subsidiary Directive, it must meet certain requirements. First, it must have one of the corporate forms listed in the directive. Second, it must reside for tax purposes in an E.U. Member State. For this purpose, a company that is a dual resident company, and that under an income tax treaty has its residence allocated to a jurisdiction outside the E.U., is not considered to be a resident of an E.U. Member State. Third, it must be subject to one of the income tax regimes listed in the directive without the possibility of opting for favorable regimes or exemptions. Finally, it must have held the participation for an uninterrupted period of at least one year.

To demonstrate compliance with the first three conditions, a certificate issued by a foreign tax authority must be submitted. The last condition is corroborated by a declaration.

Once the conditions have been met, the exemption is mandatory..

b. Interest and Royalties

Italy has implemented the Interest and Royalties Directive on payments made between associated companies of different E.U. Member States. See art. 26-*quater*, Presidential Decree n. 600/1973. Payments of interest and royalties made to associated companies resident in other Member States are exempt from withholding tax. The recipient of the payment must be an associated company resident in another Member State, having one of the corporate forms listed in annex to the directive. Alternatively, it can be a permanent establishment of a Member State if the permanent establishment is located in another Member State.

Two companies are deemed to be associated under either of two tests. The first is that one of the companies holds directly at least 25% of the voting rights at the general shareholders' meeting of the other company. The second is that a third company resident in a Member State and having one of the corporate forms listed in the annex holds directly at least 25% of the voting rights in both companies. The requisite ownership must be held for at least one year.

c. Nonresident Shareholder With a Permanent Establishment

Shareholders with a permanent establishment in Italy are taxed on the income of the permanent establishment. Income of the permanent establishment is determined under the same rules

applicable to income of resident companies. This means that, if the shareholding is qualified, the participation exemption regime applies.

d. Nonresident Shareholder – No Permanent Establishment

Nonresident companies without a permanent establishment in Italy are taxed on their income produced in Italy under the same rules applicable to resident individuals. See art. 151 and art. 152 (2), I.T.C. In particular, they are deemed not to have business income.

Where the foreign corporation sells an interest in an Italian subsidiary, the tax treatment depends on whether the participation is qualified. Once the participation is qualified, according to art. 68 (3), I.T.C., 40% (49.72% for gains realized from 2009) of the capital gain is included in taxable income and is subject to I.R.E.S. tax. If the participation is not qualified and the shares disposed of relate to a participation in a listed company, capital gains are deemed to be produced outside of Italy. See art. 23 (1) (f), I.T.C. If the participation is not qualified and the shares disposed of relate to a participation in a private company capital gains are not taxed if the shareholder is resident in a country with an agreement calling for an adequate exchange of information with Italy. See art. 5 (5) (a), Legislative Decree dated November 21, 1997, n. 461. Finally, if the participation is not qualified and the shares disposed of relate to a participation in a private company, capital gains are subject to a 12.5% substitute tax if the shareholder is resident in a country without an adequate exchange of information agreement with Italy. See art. 5 (2), Legislative Decree n. 461/1997.

A participation in a listed company is deemed to be qualified if the total participation sold during a period of 12 months represents an amount that is greater than 2% of the company's voting rights or 5% of capital of the listed company. If the company is not listed, a participation is qualified if the total participation sold during a period of 12 months represents an amount that is greater than 20% of the company's voting rights or 25% of capital of the company.

These rules are subject to modification under an applicable treaty.

L. Foreign Tax Credit

A foreign tax credit is granted to avoid international double taxation. See art. 165, I.T.C. The tax credit is subject to a foreign tax credit, calculated on a per-country basis. Excess credits may be carried back and carried forward over an eight-year period. See art. 165 (6), I.T.C.

13. CYPRUS

A. General

Over the past 25 years, Cyprus has evolved into an active and well-structured international business center catering to the requirements of international businessmen and business entities.

The key factors contributing to the development of Cyprus as an international business base are:

- It's strategic geographic location.

- A favorable tax package with the lowest corporate tax in Europe.
- A well developed double tax treaty network.
- Legal system and legislation based on English Law.
- The existence of an efficient, high level professional services sector.

The constitution of Cyprus, as well as the international treaties ratified by Cyprus, safeguards basic rights both of legal entities as well as individuals.

Cyprus has two revenue raising measures that must be considered when planning to use Cyprus as a base for a holding company. One is the income tax and the other is the defense levy. Each is discussed in turn.

B. Income Tax

Cyprus modified its corporate tax regime in recent years as part of the process of entering the E.U. The goal was to eliminate the special provisions applicable to offshore companies and to replace it with a system of tax based on a uniformly low rate for all corporations.

i. Tax Rate

One flat rate of 10% tax on annual net profit was introduced, thus eliminating the distinction between international companies and local ones. As a result, the offshore regime has been abolished.

ii. Residence

The concept of residency status for corporations has been adopted so that tax liability in Cyprus is dependant on the status of a company as a resident. This is determined by reference to the exercise of management and control in Cyprus. Although “management and control” is not defined, for a company to be considered a resident of Cyprus:

- The majority of directors must be Cyprus residents;
- All policy decisions and major board meetings must be held in Cyprus; and
- Bank accounts and transactions should be conducted from Cyprus.

The existence of an actual physical location in Cyprus is taken into account, but is not absolutely necessary for residence to exist in Cyprus.

iii. Permanent Establishment

Cyprus has adopted the general concept of the O.E.C.D. Model Treaty, including the “permanent establishment” concept. A permanent establishment is defined to include:

- A place of management,

- A branch,
- An office,
- A factory,
- A workshop,
- A building site or construction activities of more than three months.

iv. Income Subject To Tax

The general rule is that residents are taxed on worldwide income. However, several important exceptions apply to this rule. They may be summarized as follows:

- Profits from the activities of a permanent establishment outside Cyprus are exempt provided that (i) the investment income of the permanent establishment is not greater than 50% or (ii) the foreign tax burden is not substantially lower than that in Cyprus. The term “substantially lower” is not defined within the Law and is therefore left to the discretion of the Income Tax authorities.
- 50% of interest income derived from trading activities is exempt. The balance is subject to the flat 10% tax rate and this is the only tax payable for interest income from ordinary trading activities. Interest income derived from investments attracts the Special Defense Levy, which is discussed below.
- Gains from trading in stocks and shares and securities generally are exempt from income tax for corporations. The definition of securities has recently been substantially expanded so that holding companies in Cyprus dealing in securities have an even broader exemption from Corporate Income Tax. The expanded definition is discussed below. *See* paragraph 13.B.v, below.
- Dividends paid into a Cyprus holding company are exempt from income tax and no withholding tax is payable when dividends are paid by a Cyprus holding company to its nonresident shareholders. The combination of the exemption for share gains and absence of tax on dividend income received and paid by a Cyprus holding company likely accounts for the notable increase in the number of nonresident owned holding companies in Cyprus since its accession to the European Union.
- There is unilateral tax credit afforded in Cyprus for taxes withheld or paid in other countries where there is no bilateral agreement or Double Tax Treaty in force.

v. New Expanded definition of Securities

Pursuant to (ITL Section 8(22)), the following instruments are considered to be securities for purposes of the exempt capital gains rules in Cyprus:

- Short position in titles;

- Rights of claim on bonds and debentures;
- Options on titles;
- Founders shares;
- Units in open-end and closed-end collective schemes;
- Index shares or Index bonds;
- Futures/forwards on titles;
- Preference shares;
- Swaps on titles;
- Repurchase agreements or Repos on titles;
- Depositary receipts on titles;
- Participation in companies; and
- Shares in L.L.C. Companies registered in the U.S.

vi. Tax Losses Group Relief

Tax losses can be carried forward without restriction indefinitely within a group of companies provided these are Cyprus tax resident companies. Group companies can consolidate results so that the losses of one company can be offset against the profits of another.

vii. Reorganization of Companies

The E.U. directive on mergers, acquisitions and spin-offs has been implemented in Cyprus. Consequently, mergers, divisions, transfer of assets, and exchanges of shares can be effected without the imposition of income tax. In addition, the losses of the target company may be transferred to the acquiring company provided that both companies are Cyprus tax residents.

The scope of the exemption is broad. Gains resulting from the exchange of shares in a merger or reorganization will not be subject to tax. When immovable property is included in the reorganization, capital gains on the transfer will not be subject to Capital Gains Tax. No land transfer fees will be payable on the transfer of immovable property.

viii. Specific Income Tax Benefits

Certain types of income are subject to favorable tax treatments. These may be summarized as follows:

- Ship owning companies' income is tax exempt as well as VAT exempt.

- Ship management income is subject to tax at the rate of 4.25%.
- Income derived by a nonresident from the licensing of intellectual property rights in Cyprus is subject to tax at the rate of 5% of the amounts paid. A similar rate of tax is imposed on film rental income derived by a nonresident.
- Royalties granted for the use of intellectual property rights outside Cyprus are not subject to withholding tax.
- Royalties granted for the use of intellectual property rights outside Cyprus to a Cyprus resident company are not subject to withholding tax and corporate income tax is applied only on the profit margin left in the Cyprus company.

ix. Specific Allowances and Deductions

Cyprus income tax law imposes few limitations on the ability of a corporation to deduct allowed expenses arriving at net annual taxable income.

C. The Special Contribution for the Defense of the Republic Law

The second revenue raising measure in Cyprus is the Special Defense Levy. It is a separate income tax imposed on certain dividends and interest.

- The rate for the Special Defense Levy is 15%.
- Nonresident shareholders of Cyprus resident companies are not subject to the Special Defense Levy.
- Dividends paid from one Cyprus resident company to another are exempt. Dividends received by a resident company from a nonresident are also exempt if, either the investment income of the nonresident company is less than 50% of its total income or the foreign tax burden is not substantially lower than the tax burden in Cyprus. This condition is met if either alternative is met.
- Interest received in the ordinary course of business is exempt from the Special Defense Levy. However, investment interest is subject to the Special Defense Levy. In such latter case, the tax rate is 15%.

D. Other Taxes

- Capital Gains Tax is not applicable to profits earned from sale of securities, as seen above.
- Inheritance or Estate Taxes - There are no such taxes on shares held in a Cyprus company.

- Thin cap rules - There are no thin capitalization or transfer pricing rules in Cyprus Tax Law, with the only qualification that transactions should be based in accordance with the “arm’s length principle.”

E. Double Tax Treaties

Cyprus has developed an extensive network of Double Tax Treaties that offer excellent opportunities for international tax planning for a wide range of businesses. Set out below is the table of countries.

Austria	Egypt	Lebanon	Singapore
Belarus	France	Malta	Slovak Republic
Belgium	Germany	Mauritius	South Africa
Bulgaria	Greece	Norway	Sweden
Canada	Hungary	Poland	Syria
China	India	Romania	Thailand
C.I.S. states *	Ireland	Russian Federation	United Kingdom
Czech Republic	Italy	San Marino	United States
Denmark	Kuwait	Serbia/Montenegro	
		Seychelles	

* The Treaty concluded between Cyprus and the former USSR is applicable to the following Republics of the Commonwealth of Independent States: Armenia, Azerbaijan, Kyrgyzstan, Moldova, Tajikistan, Uzbekistan and Ukraine until such time they wish to abrogate the Treaty.

F. Conclusion

For the U.S. company expanding abroad, each of the foreign countries discussed above provides opportunities to reduce overall tax burden through the use of a holding company. Each of the countries provides various forms of tax relief designed to attract investment. However, each country brings with it a unique set of rules and potential tax issues. The choice of country likely will require an in-depth projection of the anticipated levels of investment, dividend income, and potential gains that are anticipated abroad. Meanwhile, the U.S. now appears to be a jurisdiction with an incredibly high effective tax rate for corporations.

14. MALTA

A. General

Malta is distinctive for its blend of civil law principles and U.K. statutory law, resulting in a body of pragmatic law with international application. The Malta company is a vehicle that may be used for any kind of activity without territorial limitation, regardless of whether the Malta Company engages in holding activities, trading activities, or both.

Until December 3, 2006, the Malta company could be classified into two groups: (i) A Malta company owned and controlled by Maltese resident shareholders (a “Local Regime Malta Company”); and (ii) A Malta company owned and controlled by nonresidents of Malta (an “International Regime Malta Company”). The main distinction between the two companies was a prohibition on the International Regime Malta Company from performing trading activities in Malta with Maltese residents. In addition, only a Local Regime Malta Company was allowed to perform both trading and holding activities. The tax regime applicable to the Local Regime Company and the International Regime Company also differed. This distinction was abolished with effect from January 1, 2007, with respect to all companies registered and incorporated on or after that date. Under a grandfather provision, International Regime Companies in existence on December 31, 2006, could retain International Regime Status until the December 31, 2010.

The management of a Malta company is entrusted to a board of directors. Its members need not be residents of Malta. Maltese company law allows corporations to serve as members of a board of directors. The Malta Financial Services Authority (the Maltese financial services regulator) has issued corporate governance guidelines as practical guidance to promote a desired standard of performance. The directors of a Malta company are personally liable for the tax due by the company. Liability for payment of Value Added Tax Act is extended to all the officers of a company, including the company secretary and persons occupying managerial positions within the company. Comparable personal liability is imposed upon the liquidator of a company that is in the process of liquidation.

Malta has adopted the International Accounting Standards of the European Union with effect from January 2009. International Financial and Reporting Standards (“IFRS”) has also been adopted by Malta. However, Maltese generally accepted accounting principles may be adhered to by smaller entities not meeting a designated threshold of assets and income.

B. Taxation of Company Profits

Malta companies are taxed at the flat rate of 35% on all profits after allowing for all deductible expenses wholly and solely incurred in the production of the income. Companies that are in compliance with their tax obligations may be furnished with a Fiscal Residence Certificate issued by the Commissioner of Inland Revenue upon the Company’s request proving the Company’s fiscal good standing in accordance with Maltese fiscal legislation.

C. Taxation of Dividend Distributions

The tax treatment of dividend distributions is dependant upon the tax account from which the company distributes its profits to the shareholders. Profits generated by a company are allocated to the Final Taxed Account, Foreign Income Account, Immovable Property Account, the Maltese Taxed Account and the Untaxed Account, depending on the revenue streams flowing into the company. Several types of refunds are contemplated by the Income Tax Acts and these may be broadly classified as follows:

i. Final Taxed Account

The full imputation system does not apply to the Final Taxed Account. Distributions from the Final Taxed Account are not chargeable to further tax.

ii. Foreign Income Account

The tax paid by the distributing company may be refunded to the shareholders in terms of the refundable tax credit system contemplated by the Income Tax Acts:

a. Full refund

A company may elect to pay tax on its income from a participating holding, but the tax paid by the distributing company may be refunded in full. The application of the full refund is limited by an anti-abuse provision which applies to participating holdings acquired on or after the January 1, 2007, provided certain criteria are met. In the event that the anti-abuse criteria are not met, the five-sevenths refund applies.

b. The two-thirds refund

A nonresident in relation to Malta who receives a dividend paid to him or her from profits allocated to the Foreign Income Account of the distributing company may claim a refund of two thirds of the Malta tax paid by the distributing company.

c. The six-sevenths refund

A person in receipt of a dividend paid by the distributing company registered in Malta from profits allocated to the foreign income account not consisting of passive income or royalties may claim a refund of six-sevenths of the Advanced Company Income Tax paid by the distributing company pertaining to those profits distributed to such shareholder by way of dividend.³³

d. The five-sevenths refund

Distributions of profits classified as having been derived from passive interest or royalties are subject to the five-sevenths refund of the tax paid by the distributing company.

iii. Immovable Property Account

Distributions from the Immovable Property Account are subject to the full imputation system.

iv. Maltese Taxed Account

The six-sevenths and the five-sevenths refunds apply to the Malta Taxed Account.

v. Untaxed Account

Distributions out of the Untaxed Account are subject to 15% withholding tax whenever the recipient is a Malta resident individual. On the other hand, nonresident individuals in relation to Malta and Malta resident companies fall outside the definition of “recipient” and the withholding tax is not applicable.

³³ The six-sevenths refund does not apply to dividends paid out of profits allocated to the foreign income account and in respect of which profits the distributing company has claimed relief for double taxation.

D. Transfer of Shares in a Malta Company

Malta imposes a stamp duty on transfers of shares in a Malta company. However, exemptions exist that benefit foreign investors. Pursuant to the provisions of the Duty on Documents and Transfers Act, the transfer of shares in a company in which more than half the ordinary share capital, voting rights and rights to profits held by persons who are not resident in Malta (or by a trustee of a trust in which all beneficiaries are nonresident in relation to Malta) and not owned or controlled directly or indirectly by persons resident in Malta, are exempt from stamp duty. Likewise, the transfer of shares in a company that are owned by nonresidents are the subject of an exemption from taxation pursuant to the provisions of the Income Tax Acts, and therefore no capital gains tax is due on such a transfer.

E. Double Taxation Relief

Relief from double taxation in terms of the Income tax acts may take one of three forms: (i) treaty relief, (ii) unilateral relief, or (iii) flat rate foreign tax credit

i. Treaty Relief

Treaty Relief may be availed of if the following criteria are satisfied:

- Under the relevant agreement foreign tax paid in the other state must be allowed as a credit against tax payable in respect of that income in Malta;
- The foreign tax is of a similar character to the tax imposed in Malta;
- The person making the claim is a resident in Malta during the year immediately preceding the year of assessment and tax is payable on such income;

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

Malta has concluded Double Taxation Treaties with 55 states:

Albania	Australia	Austria
Barbados	Belgium	Bulgaria
Canada	China	Croatia
Cyprus	Czech Republic	Denmark
Estonia	Egypt	Finland

France	Georgia	Germany
Greece	Hungary	Iceland
India	Ireland	Isle of Man
Italy	Korea (South)	Kuwait
Latvia	Lebanon	Libya
Lithuania	Luxembourg	Malaysia
Montenegro	Morocco	Netherlands
Norway	Pakistan	Poland
Portugal	Qatar	Romania
San Marino	Singapore	Slovakia
Slovenia	South Africa	Spain
Sweden	Switzerland	Syria
Tunisia	United Arab Emirates	United Kingdom
United States of America		

The treaties in effect with Switzerland and with the U.S. relate to ships and aircraft in international traffic. A further seven treaties have been signed but are not yet in force. These treaties are with Jersey, Jordan, Libya (new double taxation treaty), Russia, Serbia, Switzerland, and the United States of America. A further seven treaties are in the process of being negotiated. These treaties under negotiation are with Bahrain, Bosnia and Herzegovina, Oman, Saudi Arabia, Thailand, Turkey, Ukraine.

ii. Unilateral Relief

In order to claim unilateral relief, the following conditions must be met:

- Treaty relief must not be available to the person making the claim;
- The income arises outside Malta and is subject to tax in the state of source;
- The foreign tax is of a similar character to the tax imposed in Malta;

- The person entitled to the income is resident in Malta, or is a company registered in Malta for the year immediately preceding the year of assessment, and tax is payable on such income; and

The person making the claim proves to the satisfaction of the Commissioner of Inland Revenue that the foreign income has borne foreign tax and proves the amount of such tax.

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

iii. Flat Rate Foreign Tax Credit

The Flat Rate Foreign Tax Credit is available if the following conditions are met:

- Treaty relief and unilateral relief must not be available to the person making the claim;
- Income or gains must be received by a company registered in Malta, which includes a Maltese branch of a non-resident company;
- The Company must specifically be empowered to receive such income or gains.³⁴
- Such income or gains must fall to be allocated to the foreign income account;³⁵ and
- Documentary evidence must be available indicating to the satisfaction of the Commissioner of Inland Revenue that the income or gains fall to be allocated to the foreign income account.³⁶

No credit is allowed if a person elects that the credit should not be allowed against income tax chargeable in respect of his income for that year. A claim must be made not later than two years after the end of the year of assessment to which the claim refers, unless a claim is considered excessive or insufficient by reason of any adjustment of the amount of tax payable in Malta or in the other state. In such case the two-year time limit for making the claim starts running from the date of the adjustment.

F. Conclusion

For the U.S. company expanding abroad, each of the foreign countries discussed above provides opportunities to reduce overall tax burden through the use of a holding company. Each of the

³⁴ This condition will only be applicable from 1st January, 2011 in respect of companies resident in Malta prior to the 1st January, 2007, unless a company exercises its option to be treated as a company registered in Malta on or after the 1st January, 2007, in which case such condition applies from the date the option becomes effective.

³⁵ Excluding dividends paid out of the foreign income account of another company.

³⁶ A certificate issued by an auditor is considered to constitute satisfactory documentary evidence.

countries provides various forms of tax relief designed to attract investment. However, each country brings with it a unique set of rules and potential tax issues. The choice of country likely will require an in-depth projection of the anticipated levels of investment, dividend income, and potential gains that are anticipated abroad. Meanwhile, the U.S. now appears to be a jurisdiction with an incredibly high effective tax rate for corporations.