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Many of the jurisdictional tax changes highlighted in the chapters in this volume reflect global tax trends that are likely to continue in 2020 and beyond. Some of these trends merit special mention in this preface.

One such area of material change is the taxation of the digital economy and this edition has a chapter dedicated to this topic. Although OECD attempts to find a consensus-based solution continue, notably with the publication on 9 October 2019 of proposals for a ‘unified approach’, many countries, frustrated by the time it will take to introduce concrete measures, have decided to take unilateral action, pending an international solution. In Europe, laws have been introduced or are pending in Austria, Belgium, the Czech Republic, France, Hungary, Italy, Poland, Slovenia, Spain and the United Kingdom and outside of Europe other countries are also introducing or proposing new laws, including Malaysia, Chile, Uruguay and Colombia. These domestic laws are likely to be a source of political tension with the United States, which sees such taxes as a threat to major US multinationals such as Google, Facebook and Amazon. This tension manifested itself in December 2019 when the United States threatened France with tariffs on key French exports to the United States on items such as champagne and sparkling wine, cheese, make-up, handbags and homeware such as porcelain and bone china, in retaliation for the introduction of the French digital services tax.

Another area where tax reform already introduced in some countries is likely to expand into other jurisdictions in 2020 is in the area of interest limitation rules. The OECD proposed limiting a tax deduction for net interest expense to 30 per cent of taxable EBITDA. This rule has been adopted in Germany, the United Kingdom and the United States and other EU countries are required to implement similar rules by 2022. It is important that groups review their cross-border financing in the light of these changes particularly as, unlike the case with transfer pricing, there is unlikely to be a right to exempt a receipt from tax in the recipient country when a deduction is denied in the paying country.

The effect of the wide-ranging US tax reform continues to impact the approach of US multinational groups to their overseas subsidiaries and one can expect further impact in 2020 as US groups re-evaluate their non-US financing and treasury operations.

It is hoped that this volume will prove to be a useful guide to the tax rules in the jurisdictions where clients conduct their businesses. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions. While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages that lie ahead; this book provides a guide to these.

I should like to thank the contributors to this book for their time and efforts, and above all for their expertise. I would also like to thank the publisher and the team for their support.
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The views expressed in this book are those of the authors and not of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest intelligence.

**Tim Sanders**
London
January 2020
INTRODUCTION TO THE CHALLENGES OF TAXING THE DIGITALISED ECONOMY

Alex Jupp, Joshua Atkinson and Alex Rigby

In October and November 2019, the Organisation for Economic Co-operation and Development (the OECD) released two public consultation documents as part of its work on the taxation of the digital economy (‘digital taxation’). The first outlined the OECD Secretariat’s Proposal for a ‘Unified Approach’ under Pillar One (Reallocation of Profit and Revised Nexus Rules), and the second its Global Anti-Base Erosion Proposal under Pillar Two. These publications are key developments in the international conversation on the tax challenges arising from the digitalisation of the economy; challenges that have received increasing focus from policy-makers, advisers and taxpayers alike.

The consultation documents were released against a background of various unilateral measures and proposals (including digital services taxes (DSTs)) by jurisdictions seeking to ensure that they receive a greater (some would argue, fairer) share of the taxation payable by highly-digitised business models. Some of these unilateral measures have been implemented despite opposition and potential retaliation from the United States.

This chapter will highlight and categorise these unilateral measures, identifying commonalities of approach and exploring what links these ideas to the work of the OECD, outline the most recent proposals by the OECD and discuss key aspects of, and potential issues with, the proposal.

Developments in the sphere of digital taxation occur almost daily. This chapter speaks to the state of affairs as at 10 December 2019.

I THE OECD’S 2015 FINAL REPORT AND THE FIRST WAVE OF DIGITAL TAXES

Before the publication of the OECD’s Action 1: 2015 Final Report (the Final Report), very few jurisdictions had implemented unilateral measures. The Final Report looked at a number of possible short-term solutions to the challenges of digital taxation. The most prominent and influential were: (1) a new nexus based on ‘significant economic presence’; (2) a withholding...
Introduction to the Challenges of Taxing the Digitalised Economy

These solutions were broadly mirrored by the three solutions assessed in the EU Commission’s 2017 Report on Digital Taxation (the 2017 Report): (1) an equalisation levy; (2) a withholding tax on digital transactions; and (3) a levy on revenues generated from the provision of digital services or advertising activity that ‘could be applied to all transactions concluded remotely with in-country customers where a non-resident entity has a significant economic presence’.

While no solution was recommended in either the Final Report or the 2017 Report, both acknowledged the need for action. The Final Report stated that ‘[c]ountries could . . . introduce any of these three options in their domestic laws . . . to account for the time lag between agreement . . . at the international level’ and implementation. The 2017 Report contained a similar acknowledgement. By implying that countries both had the right to tax revenues they could not access under current laws and were justified in adopting such solutions, the OECD and the European Union (EU) opened the doors to, and provided the blueprint for, the implementation of unilateral measures that attempt to address these issues. Unilateral measures can take many forms; the categories adopted for discussion in this chapter are:

- DSTs;
- DSTs based on consideration (Consideration DSTs);
- withholding taxes;
- extended concepts of permanent establishment (PE); and
- indirect taxes (which are predominantly outside of the scope of this chapter).

The equalisation levy, a withholding tax and the reassessment of the concept of PE proposed by the EU and the OECD are digital taxes within the consensus international tax framework. The DST proposed by the EU (its third solution) both attempts to expand the tax base and tax value as yet untaxed. It is this second aim that distinguishes DSTs from other unilateral measures.

II DSTS

DSTs represent a rudimentary and imprecise means of taxing the perceived value targeted by most of the OECD’s proposals. By taxing gross revenues, DSTs seek to tax value created by persons in a jurisdiction currently not covered by conventional taxes.

The first DST was proposed in March 2018 by the EU in its proposal paper setting out long-term and short-term digital taxation solutions (the Policy Paper). This was intended as a short-term stop-gap and was based on the third solution in the 2017 Report: an ‘indirect tax [that] would apply to revenues created from certain digital activities which escape the current

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5 2017 Report, p. 10.
tax framework entirely’. As drafted, the EU DST would apply to revenues of activities or services that derive substantial value from users and that are ‘[hard] to capture with current tax rules’. The EU DST would be charged at 3 per cent on revenues derived from:

- the selling of online advertising space;
- digital intermediary activities allowing users to interact and facilitating the sale of goods and services between them; and
- the selling of data generated from information provided by users.

Only companies with total annual worldwide revenues of €750 million and EU revenues of €50 million would be taxable under the DST. The thresholds embedded in the DST arguably represent a variation on the concept of ‘significant economic presence’ and, by encompassing more than simply services provided for consideration, on the scope of taxable activities and revenues identified as generating untaxed value.

One interesting aspect of the proposed EU DST and the DSTs modelled after it is the challenge of determining what falls within the parameters of taxable revenue. This affects both the where (PE/nexus) and what (taxable value) questions of taxation.

**France**

The French DST offers a much wider approach to both of these questions. France introduced its own DST in July 2019, with retroactive effective from 1 January 2019. This DST is still in force and has inspired many others. The French DST is levied on two types of digital services:

- Intermediary services: which provide a digital interface enabling users to enter into contact and interact. Certain specific services (including some communication and payment services) are excluded.

- Advertising services reliant on user data: which provide services allowing advertisers to place targeted advertising messages on a digital interface based on data collected about users and generated upon the consultation of such interface. This includes the purchase and storage of advertising messages, advertising monitoring, and performance measurement, as well as the management and transmission of user data.

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9 Proposal 2: An interim tax on certain revenue from digital actives, Policy Paper.
12 Article 4, EU DST Legislation.
While the scope of intermediary services is similar to the proposed EU DST, the French DST catches all players involved in the placing of advertising rather than just those placing the final advert or facilitating it.\textsuperscript{16}

The French DST features thresholds similar to that of the proposed EU DST (€750 million of worldwide revenue and €25 million of French revenue (cf. €50 million of EU revenue)).\textsuperscript{17} Unless France accounts for at least 50 per cent of EU revenues, in practice, the French thresholds are higher and therefore appear to target only certain larger multinationals.

The EU and French DSTs have formed the basis of many of the other DSTs that have been proposed or introduced. The DSTs proposed in Israel,\textsuperscript{18} Canada\textsuperscript{19} and the DST recently introduced in Italy\textsuperscript{20} are modelled on the French DST and the DST awaiting approval in Spain\textsuperscript{21} and the DSTs proposed in Belgium\textsuperscript{22} and the Czech Republic\textsuperscript{23} are modelled on the EU DST. Both the Czech DST and the DST recently enacted in Turkey have higher tax rates (7 per cent and 7.5 per cent, respectively) than the 2 to 3 per cent adopted in most other proposals.\textsuperscript{24}

\textbf{ii The UK}

In July 2019, the UK published its own draft DST.\textsuperscript{25} The principal difference between the UK DST and those already discussed is the approach to taxable revenues. The UK DST is targeted at specific business models rather than types of services: the draft legislation charges a 2 per cent tax on UK revenues of internet search engines, social media platforms and online marketplaces\textsuperscript{26} and any associated online advertising undertaken by any such businesses.\textsuperscript{27}

\begin{itemize}
\item \textsuperscript{17} Article 1, French DST Legislation.
\item \textsuperscript{18} https://tax.thomsonreuters.com/blog/israel-preparing-digital-services-tax-modelled-off-pending-french-proposal/.
\item \textsuperscript{19} https://news.bloombergtax.com/daily-tax-report-international/canadas-trudeau-proposes-french-style-digital-services-tax.
\item \textsuperscript{22} https://news.bloombergtax.com/daily-tax-report-international/belgium-mulls-plan-to-tax-digital-companies.
\item \textsuperscript{25} Draft legislation was published in the UK’s Finance Bill 2019 – 2020 (the UK DST Legislation). UK DST was intended to be introduced in 2020 but this may be delayed as a result of the general election. At the time of writing, the UK is still an EU nation, although domestic legislation has been enacted to effect its departure on 31 January 2020.
\item \textsuperscript{26} Clauses 2(2), 4(2) and 8(2), UK DST Legislation.
\item \textsuperscript{27} Clauses 4(6) and (7), UK DST Legislation.
\end{itemize}
UK revenues are defined as those that can be attributed to a user who it is reasonable to assume is either an individual normally resident in the UK or a business established in the UK.\(^{28}\)

While the UK DST has thresholds akin to those in other DSTs and a similar UK specific threshold of £25 million, its global revenue threshold of £500 million is much lower than the €750 million in the EU and French DSTs.\(^{29}\) The UK DST excludes the first £25 million of taxable revenues and contains a safe harbour provision for businesses with low profit margins or those that record a net loss, allowing a group to divide its various chargeable activities to exempt the loss-making taxable activities from the DST and to subject the activities with a slim profit margin to a lower charge.\(^{30}\)

### iii The influence on other DSTs

While tax authorities disagree over the introduction of DSTs and to which revenues and services these new taxes should apply, political impetus for DSTs (in particular those based on the French or EU model) seems to be growing. Common among the DSTs surveyed is the idea that, within the profits of a company or group, an amount derived from user value and that value should be taxed in a market jurisdiction.

### III CONSIDERATION-BASED TAXES

Most other unilateral measures do not look to tax untaxed value but rather seek to bring into a charge to tax or increase the tax on certain services provided for consideration. Consideration DSTs, equalisation levies and withholding taxes all contain these features.

#### i Consideration DSTs

In April 2019, Austria published draft legislation for a DST that would, from 1 January 2020, tax online advertising services provided for consideration by companies with worldwide advertising revenues of at least €750 million and Austrian revenues of €25 million at a rate of 5 per cent.\(^{31}\)

Similarly, after its initial tiered advertising tax was declared to be in violation of EU law by the European Commission (the Commission),\(^{32}\) effective as of 1 July 2017, Hungary introduced a 7.5 per cent tax on revenues from advertisements that are published in the Hungarian language, or where an advertisement is not published in the Hungarian language but is available on a website that is mainly displayed in the Hungarian language. The first 100 million forints of revenue is taxed at zero per cent.\(^{33}\)

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28 Clause 5, UK DST Legislation.
29 The Italian DST also has this same threshold. See, R-A Papotti and M Caziero, ‘Italian DST in Taxing the Digital Economy’.
30 This is expected to be beneficial to businesses that have a taxable business model with a profit margin under 2.5 per cent (see, H. Buchanan and other, ‘The UK’s proposed digital services tax’, Tax Journal, Nov 2018).
Rather than tax digital services as a whole (or a large proportion thereof), consideration DSTs specifically target one form of digital service: advertising services provided for consideration. With this explicit focus, they equalise the treatment of online and conventional businesses and more easily tax a specific metric of value; the consideration paid for the service. In so doing, jurisdictions may be attempting to make their tax systems horizontally equitable (so that similar business models are taxed in similar ways) rather than tap into an as yet domestically untaxed revenue stream.

ii Equalisation levy

Equalisation levies also function to equalise the tax treatment of the digital and conventional economies. 34 In 2016, India became the first, and only to date, jurisdiction to introduce a pure digital ‘equalisation levy’. 35 India specifically mentioned the suggestion by the OECD when introducing the levy.36

Like the two consideration DSTs discussed above, the ‘equalisation levy’ taxes revenues derived from online advertising, specifically ‘online advertisement, any provision for digital advertising space or any other facility or service for the purpose of online advertisement’ at a rate of 6 per cent. To ‘equalise’ treatment, the levy only applies to taxable services provided by a non-resident (other than a non-resident with an Indian permanent establishment) that are received or receivable by an Indian resident conducting a business or profession or a non-resident’s Indian permanent establishment. 37 Thus, the Indian equalisation levy seeks to establish equality between Indian businesses and non-Indian businesses providing services into India (rather than digital services as a whole irrespective of by whom they are provided). Similar to DSTs and consideration DSTs, equalisation levies include an economic nexus in the form of a threshold requirement of aggregate consideration between the parties of at least 100,000 rupees.38

iii Withholding

On 16 March 2018, the Malaysian Inland Revenue Board published a practice note stating that income from the provision of digital advertising services earned by non-residents without a Malaysian PE would be subject to withholding at a rate of 10 per cent (unless reduced by a treaty) as either royalty or service income. This provides an example of recharacterising income to bring it into a charge to tax under the current international framework.

Turkey introduced a similar withholding provision into its tax law, effective 1 January 2019, placing a 15 per cent withholding on payments for online advertising services when they are provided by non-resident persons. Pakistan has introduced withholding at 5 per cent on consideration provided for an even wider array of digital services.

Withholding taxes are comparatively easy to introduce and are usually levied at higher rates than other unilateral measures discussed in this chapter (compare the UK DST rate of 2 per cent and the Turkish withholding at 15 per cent). However, notwithstanding their simplicity, withholding taxes have not proved to be a universally popular form of digital taxation and relatively few are in play at present.

35 Chapter VIII, Finance Act 2016 (FA).
37 Section 165(1), FA.
38 Sections 165(2) and 166, FA.
iv Extending the definition of PE

All of the unilateral measures discussed above (other than withholding) seek, to some extent, to tax persons with an economic presence in the jurisdiction that does not amount to a PE in the traditional sense. Certain jurisdictions, however, have further sought to amend the definition of PE within their domestic tax legislation.

Following the Final Report, the Israel Tax Authority (ITA) announced in April 2016 that it would tax income of digital businesses that had ‘significant economic presence’ in Israel. Indicators of such a presence included a substantial number of online transactions with Israeli residents, the provision of online services, the use of services provided by non-residents being used by a large number of Israelis and a correlation between consideration and the user base in Israel. This approach, however, has proven unsuccessful and the DST mentioned above is intended to replace it.39

The EU’s longer term proposal in the Policy Paper was to introduce the concept of a virtual PE and ‘enable Member States to tax profits that are generated in their territory, even if a company does not have a physical presence there’.40 A digital platform would be taxable if it had a ‘digital presence’ or virtual permanent establishment in a Member State as a result of its annual revenues, number of users or number of business contracts entered into in, or with residents of, a Member State. The Commission was so committed to this idea that it advised Member States to renegotiate their tax treaties to include ‘significant economic presence’ within the concept of permanent establishment.41 Romania, for example, stated that it would seek to renegotiate its treaties on this basis42 and Belgium, alongside publishing a draft DST, published a draft bill to include ‘significant economic presence’ within its concept of a ‘Belgian institution’ for the purposes of establishing a PE.43 Similar measures have been considered in other jurisdictions, such as South Korea.44

v A US hybrid – example of indirect taxes

While indirect taxes predominantly fall outside the scope of the chapter (as they are not derived from the OECD’s work leading to Unified Approach), their introduction should be noted. Although many developments in digital taxation have faced opposition from the US federal government, US states have been active in implementing their own digital taxes in the form of indirect sales taxes on consumers. These taxes are an attempt to equalise the treatment of brick-and-mortar retailers physically present in the relevant state and larger online distributors with no such presence. These taxes share many similarities with consideration DSTs and equalisation levies.

Some states have specifically targeted the sale of certain digital services, such as streaming services. In 2015, Chicago expanded its 9 per cent amusement tax, enacted to tax sporting or concert tickets, to cover streaming services.45 In 2016, Pennsylvania expanded

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40 Proposal 1: A common reform of the EU’s corporate tax rules for digital services, Policy Paper.
45 Amusement Tax Ruling #5, Electronically Delivered Amusements, Chicago Dept of Fin. (9 June 2015).
its 6 per cent sales tax to cover both streaming services and other downloadable services. Other states, including Alabama, Illinois, Louisiana, Maine and West Virginia have considered similar taxes.

More recently, general digital sales taxes have increased after the US Supreme Court decision of South Dakota v. Wayfair. This case overturned previous case law and held that states may collect taxes on internet sales even when the purchaser does not have a physical presence in the state. Essentially, this judgment accepted that entities could be taxable if they had a sufficient economic nexus in a state. Subsequently, over 40 states have amended their tax laws to account for this change in law.

While these indirect taxes are levied on the consumer, they embody many of the concepts seen in other forms of digital taxation: in particular they seek to equalise tax treatment across business and to expand the concept of a PE. However, what these taxes do not address and what DSTs are trying to accomplish is to locate as yet untaxed user value not covered by ‘standard’ forms of taxation.

IV OECD PROPOSALS

Since the call for further reports and work on Action 1 within the Final Report, the OECD has released a number of key publications and held consultation meetings regarding digital taxation. Most recently, the OECD Secretariat has released its consultation documents on its (1) Proposal for a ‘Unified Approach’ under Pillar One (the Unified Approach); and (2) Global Anti-Base Erosion Proposal under Pillar Two (the GloBE Proposal), as well as holding a consultation meeting on Pillar One. The GloBE Proposal envisages, inter alia, an income inclusion rule and tax on base-eroding payments, together designed to define a global minimum tax and strengthen anti-abuse provisions in a post-BEPS world. While the GloBE Proposal is likely to play an important role in any international digital taxation regime adopted, we will focus on the Unified Approach and the interactions between, and cross-influences seen in, the proposal and DSTs.

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46 Pennsylvania’s Act 84 of 2016.
48 Illinois’ House Bill 3359.
49 Louisiana’s House Bill 655.
52 138 S.Ct. 2080.
54 Final Report, para. 361.
55 For further details, see Unified Approach to Pillar One, paras 1–6.
56 At time of writing.
57 GloBE Proposal, para. 5.
58 And could be seen as the more effective first step, see Moises Dorey, A Road Map for Reaching Global Consensus on How to Tax the Digitalized Economy, International Transfer Pricing Journal, 2019 (Volume 26), No. 5, Section 3.
i Unified Approach

The Unified Approach states an aim to reallocate existing taxing rights to market jurisdictions while maintaining administrability. The OECD identified reallocation as motivating all three proposals in its Programme of Work that defines the scope of Pillar One, namely ‘user participation’, ‘marketing intangibles’ and ‘significant economic presence’ proposals. In short, each of these proposals suggests:

a User Participation, where an amount of profit is allocated to jurisdictions to reflect value generated by active and participatory user bases, irrespective of physical presence.

b Marketing Intangibles, created in market jurisdictions through the active and (remote) participation of a multinational enterprise (MNE). As a result, a portion of the MNE’s residual income should be allocated to the market jurisdiction (either using the arm’s-length principle (the ALP) or a revised profit split).

c Significant Economic Presence, where taxable presence arises if sufficient factors show interaction with a jurisdiction through digital technology.

The OECD developed the Unified Approach based on identified commonalities within the three proposals (such as a new nexus rule independent of physical presence). The Unified Approach proposes a three-tier mechanism including:

a Amount A – the ‘New Taxing Right’ under the OECD’s proposal, this amount is a jurisdiction’s fractional entitlement to deemed non-routine profits, calculated by:

• identifying standardised MNE profit (possibly on a business-segment basis);

• apportioning part of this profit between routine returns to activities in jurisdictions where the MNE is resident (as traditionally understood). Routine returns may be proxied by a percentage of return on sales;

• further dividing the remaining non-routine profits, a proportion being attributable to certain non-routine activities (such as trade intangibles and synergies) with the remainder allocable to market jurisdictions; and

• apportioning this amount to each market jurisdiction using (as it appears) local revenues (which, in the case of business operated via a remote presence, would likely be tied to user or consumer location) to generate Amount A.

b Amount B – the tax due on the routine distribution and marketing operations in each market jurisdiction. This amount may, for simplification purposes, use a fixed percentage return to estimate the profits of such baseline activities.

c Amount C – an additional amount above Amount B that may be allocated to a jurisdiction using the ALP where an MNE’s activities there exceed the routine activities

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61 Unified Approach, para. 4.
62 OECD February Consultation, paras 17–28.
63 OECD February Consultation, paras 29–49.
64 OECD February Consultation, paras 50-54.
that are compensated through Amount B. This amount may include both routine returns for activities other than distribution and marketing as well as non-routine returns determined by application of the ALP.

This system, as currently outlined, will apply to consumer-facing businesses (rather than just highly-digitised business models), creates a new nexus independent of physical presence, and includes a new profit allocation rule that moves beyond the ALP. 67

V COMBINATION OF PROPOSALS WITHIN THE PROGRAMME OF WORK

Although the OECD has continued its work to meet the tight 2020 deadline, the complexity of the issue, and the conflicts of interest between the various (and often overlapping) groups of stakeholders mean that achieving balance between the interests of countries involved in the OECD project is not straightforward. The stakeholders could be grouped into:

a Headquarter jurisdictions – Where the intangibles that are attributed profits under the ALP are largely located, leading to a large allocation of residual profits. However, these jurisdictions also deal with reductions in their tax base because of credits given for unsuccessful investments.

b Market jurisdictions – Contain a large number of digital consumers despite digital MNEs having limited or no physical presence. Under traditional tax principles, the operations of MNEs in these countries will not amount to a permanent establishment, nor will significant profits be allocated under the ALP.

c Developing jurisdictions – Similar concerns to market jurisdictions, but the tax authorities of these countries are in favour of a simple, administrable regime, given limitations in tax authority function. 69

Indications of these differing attitudes can be seen in their reactions to the introduction of DSTs. Market jurisdictions have generally instigated the measures, headquarter jurisdictions have generally met implementation of DSTs with hostility and are resistant to giving credit for DST payments, 70 and developing jurisdictions have adopted a variety of different measures, some of which are conceptually similar to a DST (i.e., all are akin to an excise tax), 71 but others which are organised around more easily measurable metrics than revenue, such as levies on access to social media. 72

66 Unified Approach, para. 30.
67 Unified Approach, para. 15.
68 Factors described as ‘insurmountable’ by certain commentators, see Dorey, supra n.58, at section 1.
The melding of all three proposals under Pillar One within the Unified Approach could be seen as an attempt to provide a ‘pragmatic fudge’, with Pascal St Amans, the Director of the Centre of Tax Policy and Administration at the OECD, stating in October 2019 that unanimity is not required for new digital taxation to move forward. Hints of a compromise can be seen in the combination of: (1) the provision for an allocation (outside the ALP) of residual profits to market jurisdictions through Amount A, recognising the right to tax value asserted by DST-supporting jurisdictions; with (2) the utilisation of the ALP in determining Amount C, showing a desire to retain some utilisation of existing transfer pricing principles.

Considering the increasing number of DSTs and other unilateral measures discussed above, and given the pressure from the G20 for a solution, political compromise appears to be necessary. The OECD is trying to lead a unified solution, while satisfying (or at least placating) all interested parties. Desire to lead the way may arise from concern that a continuing lack of consensus could perpetuate ‘interim’ DSTs, much like UK income tax ended up surviving the Napoleonic Wars.

VI DEPARTURE FROM THE ALP

One of the most radical aspects of the Unified Approach is its proposal of a departure from the ALP. St Amans acknowledged in August 2019 that ‘it was something of a shock . . . that the OECD – the organisation that wrote the bible on arm’s length – would have doubts about the ALP’. However, doubts about the suitableness of the ALP as the primary tool of the international tax regime are not new. For example, following the release of the new OECD Model Treaty in 2010, countries including India reserved the right to incorporate the 2008 version of Article 7 into their double tax treaties, believing that the reference to the fractional apportionment in the earlier version provided more suitable tools to carry out an apportionment of profits based on where value is created.

Also arguable is whether fractional apportionment has appeared previously in OECD guidance. Some argue that the DEMPE functions introduced as part of the Final Report on Action 8-10 of the BEPS project reveal that the OECD was willing to adopt formulary apportionment at that time, even if it wasn’t willing to label it such.

73 The Final Report on Actions 8-10 in 2015 was similarly described by Andrew Hickman, former head of the OECD transfer pricing unit, see R. Finley, ‘OECD Took a Pragmatic Approach to Arm’s-Length Principle, Hickman Says’, 22 July 2016, Tax Analysts.


75 These are exerting ‘heavy pressure’, see Liu, footnote 69, at sections 1 and 2.

76 Communiqué, G20 Finance Ministers and Central bank Governors Meeting, Fukuoka (8–9 June 2019), para.11.


VII UNCERTAINTIES

Many uncertainties surround whether, when, how, and by whom the Unified Approach will be adopted, as reflected in the questions asked at the end of the consultation paper. All are of critical importance to businesses facing unprecedented uncertainties in planning their future models. However, none of the questions specifically address the merits of the proposal, so this ‘pragmatic fudge’ is likely to be the basis for the OECD’s proposal in 2020.

Key questions that remain unanswered include the response of the US and other headquarter jurisdictions, particularly regarding whether they will participate in the new system, and whether they will allow foreign tax credit for any amounts payable under Amount A (or the Unified Approach more widely). The US Treasury Secretary stated in a letter to the OECD in December 2019 that the US has ‘serious concerns’ about aspects of the OECD’s work under Pillar One.

Further, the ways in which the OECD envisions the multilateral dispute mechanism required under the Unified Approach operating are not yet clear. An effective dispute mechanism is crucial to avoiding double taxation if the Unified Approach is adopted, and must be a focus of: (1) the OECD in its work moving forward; and (2) those countries that choose to implement the Unified Approach in due course.

VIII CONCLUSION

It remains to be seen what, if any, unanimity among the various stakeholders can be forged around the Unified Approach. The authors take no position on whether the aim of reallocating existing taxing rights to market jurisdictions (howsoever implemented) is a desirable one or not, but strongly believe that any proposals to be adopted must be administrable, must not lead to double taxation, and must provide for strong and sensible dispute resolution. What is clear is that the concepts behind the short-term solutions and the three approaches considered by the EU remain influential on DSTs and the OECD’s thinking. Both involved the creation of a new nexus independent of physical presence and both seek to tax value that is, as yet, domestically untaxed. The DSTs apply to specifically defined digital services or business models, whereas the Unified Approach now looks beyond the digital economy. The DSTs are predicated on the vague idea that a ‘value’ exists that should be taxed and rather than precisely isolating this value, the DSTs hope that the value (or part of the value) is then captured and taxed appropriately by the new regime. The Unified Approach attempts to achieve agreement on how to locate value and re-allocate profits accordingly in an (arguably) more scientific manner. That task is, however, much more difficult and much more politicised and it remains to be seen whether a consensus can be reached.

81 Unified Approach, pp. 17 & 18.
82 Secretary Mnuchin Letter to OECD Secretary-General, 3 December 2019.
83 The consultation document asks for comments on the appropriate mechanism, Unified Approach, p. 18.
Chapter 2

AUSTRIA

Niklas JRM Schmidt and Eva Stadler

I INTRODUCTION

Austria, one of the wealthiest countries in the world and a European Union (EU) Member State, continues to attract investors owing to its stable political and social situation and its geographical position in the centre of Europe. Apart from proximity, historical ties to the countries of Central and Eastern Europe (CEE) have made Austria a very attractive location for multinationals to choose as their base of operations regarding CEE.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

The most commonly used form of Austrian business organisation for inbound investments is the limited liability company (GmbH). Owing to its less burdensome corporate governance requirements, it is generally preferred by investors to the more complex stock corporation (AG), a corporate form that has to be used if a listing on a stock exchange is being considered.

Both entities are subject to Austrian corporate income tax on their income. Shareholders are taxed separately on dividends received from these corporations.

ii Non-corporate

Partnerships, such as the general partnership (OG) or the limited partnership (KG), are of lesser relevance for inward investments into Austria. In a general partnership, all partners are subject to unlimited liability for the partnership’s debts and obligations, while in a limited partnership, only one partner must have unlimited liability. A structure commonly seen is the GmbH & Co KG; this is a limited partnership with the general partner being a limited liability company.

Partnerships are treated as transparent for Austrian tax purposes. Thus, the income of a partnership is not taxed at the level of the partnership, but rather attributed to its partners and subject to (corporate) income tax at the level of the partners.

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1 Niklas JRM Schmidt is a partner and Eva Stadler is a counsel at Wolf Theiss.
III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Austrian tax-resident corporations are taxed on their worldwide income. The tax base for income from an active trade or business is generally the profit as shown in the financial statements. Adjustments have to be made where mandatory tax provisions deviate from financial accounting rules. Profits are generally taxed on an accruals basis.

As a general rule, expenses incurred in acquiring, securing and maintaining taxable income are tax deductible. The following types of expenses are, however, partly or fully non-deductible: restaurant expenses, penalties and fines, income taxes, remunerations paid to supervisory board members, remunerations paid to employees and managers exceeding €500,000 per person per year, and expenses in connection with earning tax-exempt income. As explained below in further detail, certain interest and royalty expenses may also be non-deductible.

Assets subject to wear and tear are in general depreciated on a straight-line basis over their ordinary useful life. If in the tax year of purchase or construction an asset is used for more than six months, the yearly depreciation amount applies; otherwise, only half of the yearly depreciation amount may be deducted from the tax base. Depreciation for extraordinary technical or economic loss in value is possible. For certain assets, the statute mentions the depreciation rates to be used, namely buildings (generally 2.5 per cent), goodwill (6.67 per cent) and cars (12.5 per cent). Assets having an acquisition cost of not more than €800 can be fully depreciated in the year of purchase.

Only the following provisions are deductible for tax purposes: provisions for severance payments, provisions for pension payments, provisions for other contingent liabilities and provisions for anticipated losses from pending transactions.

Capital and income

Regarding Austrian tax-resident corporations, there is no distinction between the taxation of capital gains and the taxation of ordinary income in Austria. As regards personal income taxation, flat tax rates are applicable to specific types of income, including capital gains from the sale of financial assets and real estate (see below).

Losses

Under Austrian law, tax losses carried forward from past years reduce the corporate income tax base. The utilisation of such losses carried forward is limited to 75 per cent of the income of the respective year in the case of corporations (no time limit applies). A carry-back of losses is not permitted.

A corporation’s tax loss carry-forwards are forfeited upon an ownership change if there is a material change in its organisational (e.g., replacement of all directors of the corporation), economic (e.g., a new area of business is pursued by the corporation) and shareholder structure (e.g., the majority of shareholders of the corporation are replaced).

Rates

Corporate income tax is levied at a rate of 25 per cent. In the event that a corporation has not made a profit, a minimum corporate income tax in an amount of 5 per cent of the statutory minimum stated capital of a corporation is due. For example, in the case of a limited liability
company this minimum corporate income tax generally amounts to €1,750 per year, and in the case of a stock corporation it amounts to €3,500 per year, with lower rates applying to limited liability companies for the first 10 years. Minimum corporate income tax is creditable against the final amount of corporate income tax assessed for that and the following tax years. Apart from corporate income tax, no other taxes or surcharges are levied on a corporation’s income.

**Administration**

The tax year is generally the calendar year. Corporations may, however, apply to the tax authorities for permission to use a different tax year, if reasons other than tax considerations exist for such application.

Corporate income tax returns must be filed electronically by 30 June of the year following the tax year (in the case of paper-based filings, the deadline is 30 April). Taxpayers making use of tax advisers benefit from longer deadlines. An extension of the filing date is possible in justified cases. Failure to file generally triggers a penalty.

Quarterly prepayments of corporate income tax are due on 15 February, 15 May, 15 August and 15 November. Such prepayments are creditable against the final amount of tax assessed. Any balance is payable within one month after receipt of the tax assessment notice.

Assessment notices of the competent tax office can be challenged before the Austrian Federal Tax Court.

**Tax grouping**

Austria has a group taxation regime for affiliated companies. Affiliated companies are those that are connected through a direct or indirect participation of more than 50 per cent of the nominal capital and voting power. Such participation must exist throughout the entire fiscal year of the member of the tax group (and in total for at least three years).

The formation of a tax group results in 100 per cent of the taxable income of each resident member of the group being attributed to the top-tier company in the tax group. In the case of non-resident companies that are members of a tax group, only negative income of such companies is attributed to the top-tier company, and only on a pro rata basis (this makes the utilisation of foreign losses possible; this is only of a temporary nature, with a claw-back provision applying). In the case of losses of non-resident companies there is a limitation insofar as only losses amounting to 75 per cent of the sum of the income of the top-tier company in a tax group and the Austrian-resident members of the tax group may be offset immediately.

**ii Other relevant taxes**

**Value added tax**

Austria levies value added tax in line with the pertinent EU directives at a standard rate of 20 per cent. Reduced rates of 10 and 13 per cent apply to certain supplies. There are a number of exemptions applicable (e.g., for financial services and health services).
Real estate transfer tax

The transfer of Austrian real estate triggers real estate transfer tax. In the case of a sale of Austrian real estate, the tax base is generally the purchase price, and the tax rate amounts to 3.5 per cent. In addition, a 1.1 per cent court registration fee based on the fair market value of the property transferred falls due.

Further, real estate transfer tax at a rate of 0.5 per cent of the fair market value of the real estate is triggered if Austrian real estate is part of the assets of a corporation or a partnership, and at least 95 per cent of the shares in such corporation or interests in such partnership are pooled in the hand of a single buyer or in the hand of a tax group. The same applies in the case of a partnership holding Austrian real estate if at least 95 per cent of the interests in such partnership are transferred to new partners within a period of five years.

Stamp duty

Austria levies stamp duties on a wide range of legal transactions, including, inter alia, assignment agreements, lease agreements and surety agreements, if a written deed evidencing such stamp-dutiable transaction is signed and a certain Austrian nexus exists. However, these stamp duties can in many cases be avoided by way of careful structuring.

Bank tax

Austria levies a bank tax on the adjusted balance sheet total of credit institutions licensed pursuant to the Austrian Banking Act and foreign credit institutions authorised under the Austrian Banking Act to carry out banking business in Austria by way of a branch (in the case of the latter, only the balance sheet total attributable to the Austrian operations is taken into account).

Wage tax

While income tax is levied by way of assessment, income tax on employment income is in general levied by way of withholding by the employer. Such wage tax is a prepayment of the employee's final income tax and is credited against the employee's assessed income tax liability if the taxpayer files (voluntarily or in certain cases on an obligatory basis) an annual tax return.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Corporations having their legal seat, their place of effective management, or both, in Austria are deemed to be tax residents of Austria, and are thus subject to unlimited corporate income tax in Austria on their worldwide income. The legal seat of a corporation is the place defined as such by law, by contractual agreement, in its articles of association, etc. The place of effective management of a corporation is the place where all the measures are taken that are required and essential for the management of the corporation.

ii Branch or permanent establishment

Corporations having neither their legal seat nor their place of effective management in Austria are taxable only on specific types of income with an Austrian nexus, which are exhaustively enumerated in the statute. This, inter alia, includes income from an Austrian permanent
establishment, which is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried out. A permanent establishment for Austrian domestic tax purposes is quite similar to the Organisation for Economic Co-operation and Development (OECD) concept.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

Under the national participation exemption, dividends received by an Austrian corporation from its Austrian subsidiary are exempt from corporate income tax regardless of the extent of the participation or the holding period.

Under the international qualified participation exemption, an Austrian corporation is exempt from corporate income tax on dividends received from a foreign subsidiary or capital gains realised on the alienation of shares in that foreign subsidiary if the parent demonstrably holds a participation of at least 10 per cent of the stated share capital of the foreign subsidiary for a minimum duration of one year, and if the foreign subsidiary qualifies as a company of a Member State pursuant to Article 2 of the EU Parent–Subsidiary Directive or is legally comparable to an Austrian corporation.

Under the international portfolio participation exemption, an Austrian corporation is exempt from corporate income tax on dividends received from a foreign subsidiary, regardless of the participation or the holding period, if the Austrian international qualified participation exemption outlined above is not applicable, and if the foreign subsidiary qualifies as a company of a Member State pursuant to Article 2 of the EU Parent–Subsidiary Directive or is legally comparable to an Austrian corporation and has its legal seat in a state with which Austria has agreed to the comprehensive exchange of information. This exemption does not cover capital gains.

These participation exemptions are subject to special anti-abuse provisions outlined below. Further, they do not apply to payments received from foreign subsidiaries under hybrid instruments if such payments are tax deductible at the level of the foreign subsidiary.

ii IP regimes

Austrian tax law provides that companies conducting qualified research and development activities may claim a credit (over and above the full deduction of the expense) equal to 14 per cent of eligible expenses.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Dividends distributed by Austrian corporations to their (resident or non-resident) shareholders are subject to Austrian withholding tax at a rate of generally 27.5 per cent.

Royalties paid to non-residents are subject to Austrian withholding tax at a rate of 20 per cent.

Interest on loans (not in the form of bonds) is not subject to Austrian withholding tax.
Certain services rendered by non-residents are subject to Austrian withholding tax at a rate of 20 per cent. This category includes:

- remunerations in connection with an occupation as an author, lecturer, artist, architect, sportsperson or performer in Austria;
- payment for a right of use regarding works protected by copyrights or industrial property rights;
- supervisory board remunerations; and
- payment for commercial or technical consulting work.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

As an EU Member State, Austria applies the EU Parent–Subsidiary Directive and the EU Interest and Royalties Directive.

Pursuant to the Austrian provisions implementing the EU Parent–Subsidiary Directive, the distribution of dividends is fully exempt from Austrian withholding tax if the recipient of the dividends is a company of a Member State pursuant to Article 2 of the EU Parent–Subsidiary Directive that has held at least 10 per cent of the capital in the paying company for an uninterrupted period of at least one year and meets certain substance requirements.

Similarly, pursuant to the Austrian provisions implementing the EU Interest and Royalties Directive, the payment of royalties is fully exempt from Austrian withholding tax if the recipient of the royalties is an associated company of another Member State. A company is an associated company of a second company if, at least, the first company has a direct minimum holding of 25 per cent in the capital of the second company or the second company has a direct minimum holding of 25 per cent in the capital of the first company, or a third company has a direct minimum holding of 25 per cent both in the capital of the first company and in the capital of the second company. Such holdings must apply for an uninterrupted period of at least one year.

iii Double tax treaties

There are currently 89 treaties in force in Austria. Austria generally follows the OECD Model Convention and the commentary thereto in respect of its treaty policy and interpretation. Because, under Austrian rules of interpretation, the more specific provision takes precedence over the more general provision, double tax treaties generally take priority over domestic law.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

There are no statutory thin capitalisation rules in Austria. However, the Austrian Supreme Administrative Court has established certain broad guidelines that are used to determine whether the equity funding at hand is adequate for the purposes of taxation. If the equity is inadequate, a portion of the indebtedness to shareholders may be regarded as the equivalent of shareholders’ equity. Interest paid on such debt may not be deducted from the taxable income and may be subject to withholding. In practice, debt-to-equity ratios of 4:1 are not uncommon.
Austria

ii  Deduction of finance costs
In general, interest (including interest incurred in connection with the acquisition of an Austrian or non-Austrian participation) may be fully deducted from a corporation’s tax base. Two restrictions regarding deductibility apply.

Firstly, financing costs incurred in connection with the acquisition of shares that were directly or indirectly purchased from a group company or from a controlling shareholder are not deductible.

Second, no deduction is possible for interest paid to a corporation if the payer and recipient are, directly or indirectly, part of the same group, or have, directly or indirectly, the same controlling shareholder; and the interest paid at the level of the recipient (or the beneficial owner, if different) is:

a. not subject to corporate income tax owing to a comprehensive personal or material tax exemption;
b. subject to corporate income tax at a rate of less than 10 per cent;
c. subject to an effective tax rate of less than 10 per cent owing to an applicable reduction; or
d. subject to a tax rate of less than 10 per cent owing to a tax refund (here, tax refunds to the shareholder are also relevant).

The latter provision also applies to royalties.

iii  Restrictions on payments
Under Austrian corporate law, Austrian corporations may only pay out dividends to their shareholders to the extent they have sufficient balance sheet profits.

iv  Return of capital
As mentioned above, dividends paid out by Austrian corporations to shareholders trigger a withholding tax of generally 27.5 per cent. However, the repayment of capital – whether resulting from a formal capital reduction or from the distribution of capital reserves – does not trigger withholding tax under Austrian domestic law. Such repayment of capital reduces the tax basis of the shares (which might be relevant in the case of a later sale: if the repayment of capital exceeds the tax basis, the excess is considered a capital gain, which is generally taxable). Austrian companies must keep a capital account for tax purposes to document the amount distributable as a repayment of capital.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES
i  Acquisition
Austrian businesses are typically acquired by way of a share deal (rather than by way of an asset deal), with the shares in the Austrian company being purchased by a special purpose vehicle in a country with a favourable participation exemption.

ii  Reorganisation
Under Austrian corporate law, many types of reorganisations are possible, including mergers, demergers, conversions of partnerships into corporations and vice versa, and share-for-share exchanges.
While such transactions would under the general tax law rules normally constitute a taxable event (making them prohibitively expensive), the Austrian Reorganisation Tax Act allows such restructurings to be carried out in a tax-free manner if certain prerequisites are met.

iii Exit

If, owing to the relocation of a business abroad, Austria loses its right to tax hidden reserves contained in these assets, then corporate income tax is generally triggered on the hidden reserves at the time of exit. Relief might be possible if Austria’s right to tax is lost as regards an EU Member State or a state that is a party to the Agreement on the European Economic Area.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Under Austrian tax law, there is the principle that taxpayers are free to arrange their economic affairs in the manner they deem most beneficial to themselves, which includes choosing those structures and approaches that incur the least tax costs. Nevertheless, Austrian law contains a general anti-abuse provision pursuant to which one’s tax liability cannot be avoided by abusing the legal forms or methods available under civil law. If such an abuse has been established, the tax authorities may compute the tax as it would have been had a genuine legal arrangement been carried out. Additionally, an action not seriously intended by the parties (i.e., a sham transaction) but performed only to cover up facts that are relevant for tax purposes will be disregarded and taxation will be based on the facts the taxpayer sought to conceal. In addition, various specific anti-abuse provisions exist; for example, a switchover clause in connection with the international participation exemptions discussed immediately below.

ii Controlled foreign corporations (CFCs)

To transpose the EU Anti-Tax Avoidance Directive, Austria, inter alia, introduced CFC legislation. Pursuant thereto, non-distributed passive income of a low-taxed CFC (wherever resident) shall be included in the tax base of the controlling corporation if the following prerequisites are fulfilled:

a the passive income of the CFC exceeds one-third of its total income (the income is to be calculated in line with Austrian tax provisions, whereby tax-exempt dividends and capital gains are also taken into account when calculating the total income);

b the controlling corporation – alone or together with its associated enterprises – holds a direct or indirect participation of more than 50 per cent of the voting rights or owns, directly or indirectly, more than 50 per cent of the capital or is entitled to receive more than 50 per cent of the profits of the CFC;

c the CFC does not carry out a substantive economic activity supported by staff, equipment, assets and premises (in case a substantive economic activity exists, the controlling corporation has to furnish proof thereof); and

d the CFC is low-taxed, meaning that its effective foreign tax rate is not more than 12.5 per cent (to determine the effective foreign tax rate, the foreign company’s income is to be calculated in line with Austrian tax provisions and compared to the foreign tax actually paid).
In the event the CFC provision kicks in, the amount of the CFC’s passive income to be included in the tax base of the controlling corporation is calculated in proportion to the (direct or indirect) participation in the nominal capital of the CFC; if the profit entitlement deviates from the participation in the nominal capital, then the profit entitlement ratio is decisive. The passive income of the CFC is included in that financial year of the controlling corporation in which the CFC’s financial year ends. Losses of the CFC, if any, are not to be included.

The CFC rules also apply to Austrian corporations being tax resident outside of Austria under an applicable double tax treaty and to foreign permanent establishments (even if an applicable double tax treaty provides for a tax exemption in Austria).

Further, dividends and capital gains from the following types of subsidiaries do not benefit from the international participation exemptions outlined above, but are taxable (and a credit is given for underlying taxes in the case of dividends), if they are low-taxed and have a predominant focus on earning passive income:

a shareholdings of at least 10 per cent held for a minimum duration of one year in a foreign subsidiary qualifying under the EU Parent Subsidiary Directive or being legally comparable to an Austrian corporation; and

b shareholdings of at least 5 per cent in a foreign subsidiary qualifying under the EU Parent Subsidiary Directive or in a foreign subsidiary being legally comparable to an Austrian corporation and having its legal seat in a state with which Austria has agreed to the comprehensive exchange of information.

This switchover provision does not apply if passive income has demonstrably been taken into account under the CFC provision mentioned above.

Both the CFC rules and the switchover provision are not applicable to foreign financial institutions if not more than one-third of the passive income stems from transactions with the Austrian controlling corporation or its associated enterprises.

### iii Transfer pricing

Pursuant to the case law of the Austrian Supreme Administrative Court, agreements between related parties (e.g., between the shareholder and its company) are only recognised for tax purposes if they have been concluded in writing, if their content is unambiguous and if they have been concluded in accordance with the arm’s-length principle (i.e., on terms that unrelated parties would have agreed upon). The Austrian tax authorities in practice follow the OECD Transfer Pricing Guidelines in this respect. Pursuant to the Austrian Transfer Pricing Documentation Act, multinational groups with consolidated group revenues of at least €750 million in the preceding fiscal year are required to prepare a country-by-country report, which Austria will automatically exchange with other countries. Additionally, the Act obliges a separate business unit (that is tax-resident in Austria and that has had revenues of at least €50 million in the two preceding fiscal years) of a multinational group to prepare transfer pricing documentation in the form of a master file and a local file.

### iv Tax clearances and rulings

A legally binding formal tax ruling procedure exists in connection with questions concerning restructurings, tax groups, international tax law, value added taxation and the existence of abuse of law. If certain formal prerequisites are met, the competent tax office must issue a tax ruling, generally within a period of two months from application. This ruling has to contain
the facts and statutory provisions on which it is based, a legal assessment of the facts and the
time frame during which it is valid. In addition, the applicant may be required to report on
whether the facts of the case have been implemented and also on whether the implemented
facts are different from those outlined in the request. A fee of between €1,500 and €20,000,
depending on the applicant’s annual turnover, is due in conjunction with any such request.

X  YEAR IN REVIEW

The Austrian legislator was not very active in 2019 of its own accord. Most of the tax laws
passed in that year were the result of EU developments or developments at an international
level (in particular in relation to the Anti-Tax Avoidance Directive).

XI  OUTLOOK AND CONCLUSIONS

Austria, as a wealthy and sophisticated jurisdiction with a stable political system in the centre
of the EU, will remain a strong candidate for inward investment for years to come.
I INTRODUCTION

Belgium offers a wide range of tax-planning opportunities for companies (and Belgian branches). At first glance, the rather high corporate income tax rate (29.58 per cent; 25 per cent as of 2020) ought to restrain foreign investors from making an investment in Belgium; however, Belgium plays an important role in the international tax arena as a result of some advantageous features of the tax system resulting in planning opportunities for companies.

These advantageous features, further discussed in this chapter, include:

- **a** the participation exemption, which virtually exempts income from qualifying subsidiary companies (i.e., dividends received and capital gains on shares);
- **b** the notional interest deduction regime, which reduces the effective corporate income tax rate;
- **c** the extensive and beneficial tax treaty network;
- **d** the deductibility of finance costs;
- **e** the application of the EU Parent-Subsidiary Directive to all tax treaty countries;
- **f** the ruling practice, allowing companies to obtain a legally binding advance opinion from the Belgian tax authorities on various tax issues;
- **g** the absence of capital tax and of a net wealth tax; and
- **h** the innovation income deduction (IID).

An important modification of the corporate income tax system was enacted at the end of 2017 and mid-2018, including a decrease of the nominal corporate income tax rate to 25 per cent as from 2020.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

A new Companies Code has been approved by the Belgian Parliament on 23 March 2019. The new Companies Code entered into effect for new companies on 1 May 2019 and will enter into effect for existing companies on 1 January 2020. The new Companies Code intends to make Belgian corporate law more flexible and more competitive. The section below is based on the new Companies Code.
i Corporate

In Belgium, businesses generally conduct their activities through a subsidiary that adopts a corporate form. Several legal forms exist under Belgian law, but the most commonly used are:

- the public limited liability company (NV or SA); and
- the limited liability company (BV or SRL).

Originally, the NV/SA was mainly seen as a vehicle for medium-sized or large undertakings, whereas the private limited liability company (BVBA/SPRL), which has been replaced in the new Companies Code by the BV/SRL, was intended to be used for small businesses where management and ownership often coincide. To this day, the BV(BA)/S(P)RL is used most often for smaller (privately owned) businesses but in light of the added flexibility offered in the new Companies Code to the BV/SRL in terms of governance, funding and distribution of proceeds, this may change in the future. Large multinational groups most often incorporate their Belgian subsidiaries under the form of a NV/SA (although some may opt for the BV/SRL for foreign tax transparency reasons).

From a Belgian tax perspective, an NV/SA and a BV/SRL are subject to the same corporate tax rules.

<table>
<thead>
<tr>
<th>NV/SA</th>
<th>BV/SRL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Registered or dematerialised shares</td>
<td>Registered shares only but a listed BV/SRL can issue dematerialised shares</td>
</tr>
<tr>
<td>Shares are freely transferable (limitations on transferability possible but subject to statutory restrictions)</td>
<td>Shares are freely transferable if determined in the articles of association</td>
</tr>
<tr>
<td>Issue of profit shares, warrants and convertible bonds possible</td>
<td>Issue of profit shares, warrants or convertible bonds possible</td>
</tr>
<tr>
<td>One-tier board of directors or sole director or two-tier board of directors, with possibility to delegate daily management power</td>
<td>Board of directors with possibility to delegate daily management power</td>
</tr>
<tr>
<td>Minimum capital: €61,500</td>
<td>No (minimum) share capital</td>
</tr>
<tr>
<td>Possibility to solicit public funds and obtain quotation on the stock exchange</td>
<td>Possibility to solicit public funds and obtain quotation on the stock exchange</td>
</tr>
</tbody>
</table>

In addition, several forms of real estate investment companies with fixed capital for investment in real estate exist; for example, the specialised real estate investment fund (SREIF).

The SREIF is dedicated to institutional investors. Its shares may be held by institutional and professional investors. It is not listed on any stock exchange, but must be registered in a special list by the Federal Public Service Finance (i.e., the Ministry of Finance).

Important legal requirements for the new vehicle include the following:

- it must have an investment policy;
- it must be established for a minimum period of 10 years, which may be renewed by periods of five years each;
- its accounting records must be kept in accordance with international financial reporting standards (IFRS); and
- at least 80 per cent of its net profits must be distributed.

SREIFs are taxed in the same manner as regulated real estate companies. This means that they are subject to corporate income tax. However, the taxable base only includes exceptional or gratuitous benefits received and costs and expenditure not deductible as professional costs.

This means, inter alia, that dividends, interest, capital gains on real estate assets and rental income are exempt.
Dividends distributed by SREIFs to Belgian corporate shareholders arising from foreign-taxed income benefit from the participation exemption regime. Such income includes income from foreign real estate and foreign dividends.

Dividends distributed by SREIFs arising from foreign income that has been taxed in the foreign country are exempt from dividend withholding tax.

An ‘exit tax’ is levied on Belgian real estate attributed to a SREIF through conversion of an existing company, a (de)merger or a contribution. The tax is due on unrealised capital gains at a favourable tax rate of 12.75 per cent (increased to 15 per cent as of 2020). This tax also applies if Belgian real estate assets are contributed to a SREIF.

Management services rendered for the benefit of a SREIF will be exempt from VAT to the extent that these services are specific to and essential for managing the SREIF. The SREIF is subject to the annual tax on collective investment institutions. This tax is levied at a rate of 0.01 per cent of its total net assets.

ii Non-corporate
In Belgium, the use of non-corporate entities remains relatively limited. The most commonly used forms are: the limited partnership, the general partnership and the partnership.

The former partnership limited by shares, which was often used in structuring succession planning, has been abolished in the new Companies Code with the public limited liability company with a sole director as its replacement. The temporary commercial company that was used in the framework of structuring certain (development) projects, such as large construction works, has also been abolished in the new Companies Code but it is possible to tailor the partnership to achieve similar results. The same is true for the undisclosed company that was sometimes used to structure joint ventures.

The limited partnership and the general partnership have a separate legal personality, and are therefore treated as non-transparent entities. Consequently, they are subject to corporate income tax at the level of the partnership.

The partnership has no separate legal personality, and is treated as a transparent entity for tax purposes. Tax is, therefore, not levied at the level of the partnership, but in the hands of the different partners. Each partner will be apportioned his or her share of the profits and the losses of the partnership in accordance with the relevant provisions of the partnership agreement.

The existence of some entities that have a separate legal personality but that are nevertheless treated as tax-transparent entities should be noted.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit
Companies are subject to Belgian corporate income tax if they meet all three of the following conditions:

a they have a separate legal personality under Belgian or foreign corporate law or, if the governing foreign corporate law does not confer legal personality, they have a legal form that is comparable to a legal form that has legal personality under Belgian corporate law;

b they carry out a business or are engaged in profit-making activities; and
c they have their main establishment or place of management in Belgium.
Corporate income tax is levied on the total worldwide profit realised by a company, including distributed dividends. The profits are taxed on an accruals and not a receipts basis.

Contrary to, for example, the Netherlands, Belgium does not recognise the concept of a separate fiscal balance sheet. The taxable income of resident companies is, therefore, determined on the basis of the financial accounts and the accounting rules, unless the tax laws provide otherwise (such as for transfer pricing adjustments).

In general, all business expenses are tax-deductible to the extent that they are borne to obtain or preserve taxable income; however, special tax provisions limit the tax deductibility of certain items, such as fines, certain social benefits granted to employees, 31 per cent of restaurant expenses, some regional taxes, up to 50 per cent of car expenses (depending on the carbon dioxide emission factor of the car), a 40 per cent portion of the fringe benefit related to company cars (including fuel cards), granted non-arm’s-length benefits, clothing costs, capital losses on shares and write-downs on shares. In addition, the corporate income tax paid constitutes a non-deductible item. The (formula that determines the) percentage of tax deductibility for car expenses will be amended as of 2020 (i.e., tax assessment year 2021 relating to the taxable period starting at the earliest on 1 January 2020).

The depreciation of establishment costs, tangible assets and intangible assets constitutes a tax-deductible item to the extent that it is necessary and corresponds to a decline in value that actually occurred during the taxable period. Belgian tax law currently allows the use of both straight-line depreciation and declining-balance depreciation. However, the latter method can only be used for certain assets and cannot be applied to intangible assets, for example. The double declining depreciation method is abolished as of 1 January 2020. Goodwill acquired from third parties may be depreciated (as a rule, over five years).

**Minimum taxable basis**

A minimum taxable basis has been introduced as of 1 January 2018. The deduction of certain tax attributes is limited to 70 per cent of the remaining taxable result exceeding €1 million. In other words, a minimum taxable basis equal to 30 per cent of the remaining taxable result that exceeds this amount is introduced.

The minimum taxable basis is calculated as follows: first, the result of the taxable period is determined under the normal rules. Then, in the following order, dividends received deduction of the year, patent income deduction, innovation income deduction, investment deduction and (as of 2019) the group contribution pursuant to the tax consolidation regime are deducted (i.e., ‘fully deductible tax attributes’). If after the above-mentioned deductions the remaining taxable basis exceeds €1 million, the following deductions can only be applied to 70 per cent of the taxable basis exceeding €1 million, again in the following order: the current year notional interest deduction, carry-forward dividends received deduction, carry-forward innovation income deduction, carry-forward tax losses, and finally, carry-forward notional interest deduction. The excess can be carried forward to the following years. An exception to the minimal taxable basis exists for carry-forward tax losses incurred by start-up companies that qualify as small or medium-sized enterprises (SMEs) during the first four taxable periods.

**Capital and income**

In Belgium, there is no separate capital gains tax. Capital gains are, therefore, taxed as ordinary profits.
Unrealised capital gains that are recorded on certain assets remain untaxed if they are booked in a special blocked reserve account on the liabilities side of the balance sheet. Note, however, that unrealised capital gains on stocks and orders are taxable.

Capital gains realised by a company upon the sale of any asset are, in principle, included in the taxable basis of the company. Two exceptions must be mentioned in this respect.

First, capital gains realised on shares qualifying for the participation exemption regime (see below) are fully exempt from corporate income tax.

Second, it is possible to apply a deferred taxation regime on capital gains realised on fixed tangible and intangible assets that, at the time of the disposal, have been owned by the company for at least five years already. Intangible assets qualify only under the deferred taxation regime if they have been depreciated. Consequently, capital gains realised on, for example, a self-established client base cannot benefit from the deferred taxation.

The capital gains realised on the qualifying assets will only benefit from the deferred taxation if the entire selling price (thus, not only the capital gain realised) is reinvested in intangible or fixed tangible assets that are used in the European Economic Area (EEA) and that can be depreciated (thus, for example, not in land).

The total reinvestment must, in principle, be implemented before the end of the third year following 1 January of the year during which the assets were sold. The term for reinvestment is increased to five years in the case of reinvestment in real estate (other than land), planes or ships.

If the reinvestment is made in qualifying assets and in due time, the capital gain realised is only taxable in proportion to the annual depreciation on the fixed assets in which the reinvestment is made. If the total selling price is not reinvested within the aforementioned terms, the capital gain realised will be taxable in the tax year during which the reinvestment period has expired. In this respect, an anti-abuse provision is introduced to avoid that a tax-free reserve for spread taxation of capital gains is recorded to benefit from the new lower tax rates (that are introduced as of 2018 – see rates below) upon reversal at a later stage: a reversal of such reserve that is recorded during a taxable period that starts at the earliest on 1 January 2017 and ends at the latest on 30 December 2020 will be taxed at the tax rate that was applicable when the reserve was recorded if (1) the capital gain becomes taxable prior to the expiry of the reinvestment period without the required reinvestments being made, or (2) the capital gain becomes taxable because the company did not reinvest in a timely manner. Furthermore, interest for late payment will be due.

**Losses**

Losses incurred by a Belgian company can be carried forward without limitation. They cannot, however, be carried back.

Losses carried forward may be proportionally reduced (or even cancelled) if the company is involved in a tax-neutral restructuring (merger, spin-off, etc.).

The losses carried forward will, moreover, be cancelled upon a change in control over the company that does not correspond to legitimate financial or economic needs. For these purposes, ‘control over a company’ is defined as the ability to exercise a decisive influence on the appointment of the majority of the directors or on the orientation of the company’s policy.

Even if there is a change in control, the losses carried forward will not be cancelled if it can be established that the change in control corresponds to legitimate financial or economic needs. With respect to the presence of the latter, one can request an advance ruling from the
Belgium tax administration. From a number of published advance rulings, one can deduct that legitimate financial or economic needs will be deemed present if the following conditions are (cumulatively) met:

a. the change in control forms part of an (international) reorganisation of the group that has the objective of rationalising or simplifying the group structure in view of the development of new activities or the strengthening of the market position; and

b. the transactions envisaged (causing the change in control) are aimed at ensuring the continued existence of the company, maintaining the present employment, and continuing or even expanding the present activities of the company.

The crucial criterion in this discussion seems to be the maintaining of the activities and the employment after the change of control.

Tax losses incurred by a permanent establishment (PE) of a Belgian company or with respect to assets of such a company located abroad and of which the income is exempt in Belgium by virtue of a double tax treaty can no longer be deducted from the Belgian taxable basis as of tax assessment year 2021 (relating to the taxable period starting at the earliest on 1 January 2020). The tax treatment of these losses in the foreign state is irrelevant. An exception is made for definitive losses within the EEA. Definitive losses are losses that exist in a certain Member State upon the final termination of the activity or possession of the asset if these losses have not been deducted in that state and cannot be deducted by another tax subject in that state. If an activity is restarted within three years after the termination, there is a recapture of the losses deducted from the Belgian taxable basis.

**Capital losses**

Losses originating from the transfer of assets are first set off against other positive income. If these losses exceed the positive income, they are treated as ordinary losses.

Capital losses on shares are, in principle, not tax-deductible. The only exception to this rule is that the loss incurred on the liquidation of a company in which shares are held remains deductible up to the loss realised on the fiscal paid-up share capital represented by those shares. The scope of application of this tax non-deductibility is limited to capital losses realised on shares. Capital losses realised on other securities (e.g., bonds) or derivatives (e.g., options) are fully tax-deductible.

**Rates**

The standard corporate income tax rate is 29.58 per cent and will be reduced to 25 per cent in 2020. SMEs benefit from a reduced rate of 20.4 per cent on the first tranche of €100,000 taxable income as of 2018 (further decreased to 20 per cent by 2020). The definition of ‘SME’ for the purpose of the reduced rate refers to companies that fulfil all of the following conditions:

a. in accordance with Article 1:24, Sections 1–6 of the new Belgian Companies Code, the company may not exceed more than one of the following criteria: (1) annual average number of 50 employees; (2) annual turnover of €9 million (excluding VAT); and (3) a total balance sheet of €4.5 million (if applicable to be determined on a consolidated basis);
the company pays a minimum annual remuneration of €45,000 (or, if lower, at least the amount of the taxable income of the company) from the 5th taxable period following the establishment of the company, to at least one company manager that is a natural person;
c. more than 50 per cent of the company’s shares are held by natural persons;
d. the company is not an investment company; and
e. the company does not hold participations for an acquisition value that exceeds 50 per cent of either the revalued paid-up capital or the paid-up capital, taxed reserves and recorded capital gains (participations of at least 75 per cent being excluded for the calculation).

Administration

Federal taxes, such as corporate income tax, are handled by the Federal Public Service Finance. Companies must file their corporate income tax return with the tax office responsible for the area in which they are established. In principle, tax returns must be filed by the date mentioned on the official return forms that are sent to each company. The filing period may not be shorter than one month following the approval of the accounts, nor longer than six months following the end of the financial year. However, the tax administration may deviate from these time limits. In practice, the date mentioned on the forms is often nine months after the closing of the financial year. Corporate income tax returns must be filed using an online application, BizTax. Paper returns are no longer allowed.

Companies must, in principle, estimate their corporate income tax liability during the financial year and must pay the tax in advance. If insufficient tax is paid in advance, a tax increase is applied.

The statute of limitations is three years. In the event of (alleged) fraud, it is extended to seven years. Even longer audit and assessment periods are possible; for instance, in case the tax authorities spontaneously receive information from foreign tax authorities. Tax audits may take place within these terms, but there is no regular routine audit cycle. A tax audit is in most cases preceded by a request for information. The taxpayer must, in principle, reply within one month to this request for information, but extensions are often granted.

If the tax administration wants to change the filed tax return upon a tax audit, it must send a notice of change of tax return. The taxpayer can reply to this notice within one month. If the tax administration does not agree with the position taken by the taxpayer and intends to assess the company on a modified tax return, it must send another notification by registered mail to the taxpayer.

If a taxpayer disagrees with an assessment imposed after a tax audit, it may file a notice of objection. This notice, which must include specific grounds for the objection, must be filed within six months following the date on which the assessment was sent. If the tax administration fails to take a decision within six months, the taxpayer may challenge the assessment before court. If the taxpayer waits for the decision, or if the tax administration takes a negative decision within the time frame mentioned above, the taxpayer can still challenge this decision before court within three months after notice of the director’s decision was given to the taxpayer.

To stimulate taxpayers to fulfil their duties in the field of corporate income tax compliance, no deduction of current year losses and deferred tax assets (e.g., carried forward tax losses) is allowed against a taxable basis determined as a result of a tax audit. An exception is made for the participation exemption for dividends received during the same taxable
period. This rule does not apply for infractions committed negligently and for which no tax increases are applied. In an M&A environment, this rule is a point of attention in the framework of a tax due diligence.

**Tax grouping**

Until recently, the taxable income of resident companies was determined on an individual basis. A corporate income tax (CIT) consolidation regime was, however, introduced as of assessment year 2020 (relating to the taxable period starting at the earliest on 1 January 2019) and allows the transfer by a Belgian taxpayer of taxable profits to another loss-making qualifying taxpayer via a group contribution agreement. Certain taxpayers that benefit from a special tax regime are excluded. A qualifying taxpayer is a Belgian company or a foreign company established in the EEA that:

- is the parent company, subsidiary or sister company of the Belgian taxpayer owning at least 90 per cent of the capital. In the case of sister companies, this implies that a parent company should own 90 per cent of the capital of both the Belgian taxpayer and the qualifying taxpayer; and
- is affiliated to the Belgian taxpayer for an uninterrupted period of at least five taxable periods (including the current one). Provisions have been introduced that determine the consequence of a restructuring in which one (or both) of the parties to the agreement was involved.

Tax consolidation is achieved via a group contribution agreement that should be filed together with the income tax return. Parties to the agreement are the Belgian taxpayer and either a Belgian qualifying taxpayer or the Belgian PE of a qualifying foreign taxpayer. All of the following conditions should be respected:

- the agreement relates to one and the same assessment year;
- the agreement mentions the group contribution. The (loss-making) qualifying Belgian taxpayer or the Belgian PE of a qualifying foreign taxpayer should include the amount of the group contribution in the income tax return as a profit of the taxable period concerned; and
- the Belgian taxpayer (that transfers its taxable profits) pays a contribution to the loss-making qualifying taxpayer in the amount of the tax saving resulting from the group contribution. This payment is not tax-deductible in the hands of the payer and not taxable in the hands of the payee (i.e., the payment is fiscally neutral).

In addition, Belgium has an optional system of value added tax (VAT) grouping. No VAT is charged between the members of a VAT group, as they are considered as a single taxable person. This system provides interesting perspectives for optimising the VAT position.

**ii Other relevant taxes**

**Value added tax**

VAT is levied at each stage in the production chain, and on the distribution of goods and services. The tax base is the total amount charged for the transaction excluding VAT, with certain exceptions. Owing to deductions in previous stages of the chain, VAT is not cumulative. Every taxable person is liable for VAT on their turnover (the output tax), from which the VAT charged on expenses and investments (the input tax) may be deducted. If the balance is positive, tax must be paid to the tax authorities; if the balance is negative, a
refund is received. The tax paid by the ultimate consumers of the goods or services is not tax-deductible. The tax is based on the VAT rate applicable to the VAT-exclusive price of the goods or services received.

The general VAT rate is 21 per cent. A reduced rate of 6 per cent applies to the supply, import and acquisition of foodstuffs, some real estate services and medicines. A reduced rate of 12 per cent applies to certain goods and services, such as social housing and certain restaurant services. An exemption applies to the intra-community supply of goods or to the export of goods outside the European Union (EU). In business-to-business relationships, goods destined for another EU Member State will be subject to VAT in the EU Member State to which they are transported.

**Capital tax**

In principle, the contribution of cash or other assets to a Belgian company is only subject to a fixed fee of €50.

**Net wealth tax**

Belgium does not levy a net wealth tax.

**Transfer taxes**

Transfer tax is levied on the transfer of ownership of immovable property located in Belgium. The tax is levied at a rate of 10 per cent or 12.5 per cent, depending on the location of the property. The transfer of new immovable property is subject to VAT and not to transfer tax. The sale of shares of a company owning Belgian real estate is in principle not subject to transfer tax.

**Securities tax**

Transfers of public securities for consideration that are concluded or executed through a professional intermediary, whether or not established in Belgium, are subject to Belgian stock exchange tax. The standard rate per party amounts to 0.35 per cent, which is levied on the purchase price (brokers’ fees excluded) if due by the transferee and on the sales price (brokers’ fees included) if due by the transferor. The standard rate applies to all types of securities that do not qualify as, among others, bonds or shares held in real estate companies (0.12 per cent) or a buy-back of capitalisation shares in investment companies (1.32 per cent). The total amount of the securities tax, per party and per transaction, is, however, capped at €1,600.

**IV  TAX RESIDENCE AND FISCAL DOMICILE**

i  **Corporate residence**

A company is a resident of Belgium if it has its main establishment or place of effective management in Belgium. If a company has its statutory seat in Belgium, it is assumed to also have its main establishment or place of effective management in Belgium. This assumption is refutable if the company can establish that it is tax resident in another state according to the tax legislation of that state.

The statutory seat of a company (registered office) can be defined as the official address of the company as included in the articles of association and as mentioned in the registration at the Companies’ Register.
According to the official administrative commentary, the term ‘main establishment’ is quite similar to the notion of ‘place of effective management and control’. Both notions refer to the place where the company is generally managed; that is, where the principal directors meet, where the shareholders’ meetings are held, where the ultimate management of the company takes place and where the impulse in the company is given.

As a consequence of the above, one can conclude that the main criterion, to determine whether or not a company is a resident of Belgium for Belgian income tax purposes, is the place of effective management and control of the company.

Taking into account the above, a foreign company should avoid having its place of effective management in Belgium if it does not want to become subject to Belgian corporate income tax. The place of effective management is a factual discussion. No clear administrative guidelines or conclusive case law exist in this respect.

ii Branch or permanent establishment
A foreign entity that envisions making an inward investment in Belgium may opt not to incorporate a subsidiary, but rather to establish a branch or PE in Belgium.

The taxable income of a branch (taxed at 29.58 per cent; 25 per cent as of 2020) is generally determined in a similar way to the taxable income of resident companies. However, expenses are only deductible if they are attributable to the Belgian taxable income. The participation exemption applies to dividends received by a PE of a non-resident company, under the same conditions as for resident companies.

The theory of the force of attraction is not applicable in Belgium. Only the profits that are realised through the activity of the Belgian branch are taxable in Belgium.

Under certain circumstances, it is possible to obtain beneficial (transfer pricing) rulings regarding the determination of the branch’s taxable income. Known examples are rulings granted to branches that carry out activities as a service or distribution centre.

No withholding taxes are levied on the remittance of branch profits to the head office. Furthermore, no branch profit tax applies.

Most of the Belgian tax treaties are generally in line with the Organisation for Economic Co-operation and Development (OECD) Model Convention and, therefore, offer the international recognised protection at the level of tie-breaker rules, exemption of PE profits, etc.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
The holding regime (participation exemption regime) is part of the general corporate income tax system. It is not a special regime as such. Under the participation exemption, both dividends received and capital gains realised on shares are fully exempt from Belgian corporate income tax.

The application of the participation exemption is subject to the following conditions:

a the company in which the Belgian company holds shares meets the ‘subject-to-tax requirement’. The Belgian Income Tax Code defines this condition in a negative sense by setting out eight exclusions. The two last exclusions were introduced in 2016 and aim at countering hybrid mismatches (qualifying payments that are deductible for the paying entity) and abuse of the participation exemption regime;
the participation is held for an uninterrupted period of 12 months; and
the participation amounts to at least 10 per cent of the nominal share capital or, alternatively, has a historic acquisition price of at least €2.5 million.

ii IP regimes

In accordance with the Lisbon strategy that has insisted on the promotion of ‘research’ within the European Union, Belgium encourages the R&D culture. In this regard, the patent income deduction (PID) enacted in 2007 was introduced to encourage entities to sustain and promote technological innovation in Belgium. Coupled with other tax (and non-tax) incentives (e.g., tax credit, investment deduction, foreign tax credit on royalties), the PID was to make Belgium a tax-friendly environment for R&D.

In 2016 the PID regime was replaced with the innovation income deduction (IID) regime that is in line with the OECD modified nexus approach, requiring a link between expenses made for the development of IP and the IP incentives received with respect to that IP. The deduction has increased from 80 to 85 per cent. As a result thereof, the effective tax rate on qualifying income can be as low as 4.44 per cent taking into account the 29.58 per cent headline rate and will be even lower when the headline rate is reduced to 25 per cent as of 2020. Moreover, the scope of the IID has been substantially extended and can apply to income derived from the following IP of which the company or branch has the full ownership, co-ownership, usufruct or licence or rights to use on:

- patents and supplementary protection certificates;
- breeders’ rights requested or acquired as from 1 July 2016;
- orphan drugs (limited to the first 10 years) requested or acquired as from 1 July 2016;
- data and market exclusivity granted by the competent authorities (e.g., market exclusivity for orphan drugs or data exclusivity for reports with respect to pesticides, clinical studies of generic or animal drugs); and
- IP of copyrighted software and adaptations thereof resulting from a research or development project as defined for the purposes of the partial exemption of wage withholding tax for research and development, to the extent it has not yet generated income before 1 July 2016.

The new deduction applies to royalty income or embedded royalties as well to process innovation gains, indemnities and capital gains. Concerning capital gains, the following conditions need to be met:

- the intellectual property right must have been created during the previous tax year or, in the case of an acquired right, the acquisition must have taken place in the previous 24 months; and
- the deduction only applies if the realised capital gain is reinvested within five years (or before the professional activities stop) in R&D projects that have the objective of obtaining other intellectual property rights.

iii State aid

In principle there is no state aid. Some sectors, however, such as the shipping industry, benefitted from a special tax regime that was notified to the European Commission. On 20 September 2019, the General Court concluded in this respect that the aid scheme exempting Belgian ports from corporate income tax constitutes illegal state aid. The law
of 29 May 2018 already subjected Belgian ports to corporate income tax as of 2018 and provided for transitional provisions. Because the General Court did not annul the decision of the European Commission, the law remains applicable.

Note that the European Commission has held that certain transfer pricing methodologies applied by certain large companies, which were explicitly allowed by the Belgian ruling committee, the ‘excess profit rulings’, constitute state aid. While the Belgian government has filed an appeal with the European Court of Justice against that decision, the practice of these rulings has been put on hold since the beginning of 2015. On 14 February 2019, the EU General Court annulled the European Commission’s State Aid decision of 11 January 2016 on Belgian excess profit rulings on the formal ground that the Belgian rules did not constitute an aid scheme. The General Court did not take a position on whether or not the ‘excess profit’ rulings gave rise to illegal state aid but found that the Commission had failed to establish the existence of a scheme. The European Commission appealed on 24 April 2019 against this decision. Because the General Court argued that the compatibility of the tax rulings with EU state aid rules needs to be assessed individually, the Commission has now also opened separate in-depth investigations into the individual tax rulings granted by Belgium to 39 multinational companies between 2005 and 2014. The procedures are currently ongoing.

iv Notional interest deduction
The notional interest deduction regime (NID) was introduced to encourage Belgian companies to strengthen their equity position, and to reinforce the attractiveness of Belgium as a location for treasury and finance centres, capital-intensive companies and headquarters.

It entitles all companies subject to Belgian corporate income tax, and all non-Belgian companies with either a Belgian establishment or immovable property located in Belgium (or related rights), to annually calculate a fictitious interest expense on their aggregate equity amount, thus reducing their taxable basis. Prior to 2018, the deduction was calculated by multiplying the adjusted accounting equity (‘risk capital’) at the end of the preceding financial year by a fixed percentage, determined by the government on the basis of the average of the monthly reference indices of the interest rate on 10-year linear government bonds in the third quarter of the second year preceding the assessment year. Although the percentage remains, the calculation basis is amended as of assessment year 2019 (relating to taxable periods starting the earliest on 1 January 2018) and will equal one-fifth of the positive difference between the risk capital at the beginning of the taxable period and the risk capital at the beginning of the fifth preceding taxable period. This implies that no NID can be applied if the difference is negative. Adjustments during the taxable period are not taken into account.

The rate for assessment year 2020 (financial year 2018 for most companies) is 0.726 per cent or 1.226 per cent for SMEs.

The starting point to calculate the risk capital is the company’s aggregate equity amount as determined in accordance with Belgian generally accepted accounting principles, and comprises the share capital and share premium, the various retained earnings and carry-forward losses, and the revaluation surpluses and capital subsidies.

Once this base amount has been determined, the following items (among others) must be deducted:

\[ a \] the net fiscal value of own shares;
\[ b \] the net fiscal value of shares held as financial fixed assets;
\[ c \] the net fiscal value of shares, the income of which qualifies under the participation exemption;
d the book value of assets when expenses related thereto exceed reasonable business needs and assets held as an investment when these items do not normally produce taxable recurrent income. This exclusion aims at assets such as jewellery, gold and works of art that usually qualify as private assets, but the tax administration has also applied this exclusion to shares for which the by-laws state that no dividend distribution is possible; 

e the net fiscal value of immovable property used as a personal dwelling by directors of the company or their family; and 

f revaluation reserves and capital subsidies.

Several new anti-abuse provisions were introduced mid-2018. First, a capital contribution by an affiliated company will be excluded from the calculation basis if the contribution was financed with a loan and the affiliated company claims a tax deduction for interest payments on this loan. In addition, it is now foreseen that the contribution of capital by or the fiscal value of a receivable towards a non-resident taxpayer or foreign PE that is established in a country with which Belgium does not exchange information is deducted from the calculation basis unless the taxpayer demonstrates that the transaction can be supported by financial or economic motives.

When the company claiming the NID has real estate or permanent establishments located abroad, the calculated NID to be deducted in Belgium must be reduced with the lower amount of:

- a the NID portion relating to the net accounting value of the assets connected to the real estate or the PE; or
- b (only for real estate or permanent establishments within the EEA) the positive result of the relevant real estate or PE determined in accordance with the Belgian Income Tax Code.

As of assessment year 2013 (financial year 2012), it is no longer possible to carry forward the unused part of the notional interest deduction of the relevant taxable period.

Previously, a seven-year carry-forward was allowed. Under a transitional regime, any unused and carried-forward notional interest deduction (NID stock) available as of 31 December 2011 (or a taxable period ending in assessment year 2012) may still be carried forward for a period of up to seven years. The amount of the deduction for each taxable period is, however, limited. Up to a taxable income (to be determined after certain deductions) of €1 million, the amounts carried forward may be set off without restriction. If, however, the taxable income exceeds €1 million, only 60 per cent of the excess may be set off. The amount of NID stock not deducted because of the latter restriction may be carried forward indefinitely.

VI WITHHOLDING TAXES

i Withholding on outward-bound payments (domestic law)

Under Belgian domestic tax law, the following withholding tax rates apply:

- a dividends: 30 per cent;

2 This modification was introduced because of the ECJ Argenta Spaarbank case.
b. liquidation bonuses (the difference between the liquidation distributions and the fiscal paid-up capital): 30 per cent; 
c. interest: 30 per cent; and 
d. royalties: 30 per cent.

The withholding tax rate of 30 per cent applies as of 1 January 2017.

Under certain conditions, reduced rates apply to dividend distributions in respect of new shares issued from 1 July 2013 onwards by SMEs in return for a cash contribution. For such dividends, the following withholding tax rates apply:

a. 30 per cent for distributions in the first two years after the shares are issued; 
b. 20 per cent for distributions in the third year; and 
c. 15 per cent for distributions in the fourth (and subsequent) years.

As of assessment year 2015 (financial year 2014 for most companies), SMEs are granted the possibility to reserve their current year profit in a separate reserve account and pay a 10 per cent tax on that occasion. Afterwards, upon liquidation, the separate reserve is treated as fiscal paid-up capital (not triggering a withholding upon liquidation) and, after a five-year waiting period, the company is able to distribute dividends out of that reserve at 5 per cent withholding tax rate (outside of a liquidation scenario). During the five-year period, a withholding tax rate of 17 per cent applies for profits reserved until assessment year 2017 and 20 per cent for profits reserved as of assessment year 2018.

ii. Domestic law exclusions or exemptions from withholding on outward-bound payments

**Dividends**

On implementing the EU Parent-Subsidiary Directive of 23 July 1990, Belgium also provided for an exemption from withholding tax on dividends paid by a qualifying Belgian subsidiary to its qualifying EU parent company or to its Belgian parent company. This exemption applies only if the parent company holds at least 10 per cent of the share capital in the Belgian subsidiary uninterruptedly for at least one year. This exemption also applies, under certain conditions, if, at the time the dividend is paid out or attributed, the minimum 12-month holding period has not yet expired. However, in this case, the distributing company needs to provisionally withhold the dividend withholding tax (without a bank guarantee being required). As soon as the minimum holding period has expired, it can also distribute that part of the dividend withheld.

As of 1 January 2007, Belgium has extended this exemption regime from the EU to all countries with which Belgium has concluded a tax treaty. Belgium provides, therefore, under the same conditions, an exemption of withholding tax on dividends paid to parent companies resident in a tax treaty country. For this extended exemption regime to apply, the relevant tax treaty must provide an exchange of information clause and the parent company must be subject to corporate tax without benefiting from a special tax regime.

At the end of 2016, a specific anti-avoidance rule was added to the requirements for the application of the above-mentioned withholding tax exemption. The anti-avoidance rule states that the withholding tax exemption:

*cannot be applied with respect to dividends that are associated with a legal act or a series of legal acts of which the tax administration has demonstrated, taking into account all relevant facts and*
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circumstances and except proof of the contrary by the taxpayer, that the legal act or series of legal acts is not genuine and has been put in place with as main goal or one of its main goals to obtain the participation exemption for dividends received, the withholding tax exemption on these dividends or one of the benefits of the EU Parent-Subsidiary Directive in another member state of the European Union. For the purposes of the above paragraph a legal act or a series of legal acts shall be regarded as not genuine to the extent that it is not put into place for valid commercial reasons which reflect economic reality.

Dividends distributed to non-resident investors (i.e., foreign individuals or entities not using these funds for a professional activity in Belgium) by Belgian public investment companies are exempt from withholding tax to the extent that these dividends do not originate from Belgian-sourced dividends. The Royal Decree of 30 April 2013 has extended this exemption regime to dividends distributed by Belgian institutional investment companies. This modification fills a gap in the Belgian legislation, revitalising the attractiveness of this form of investment company to non-resident investors.

On the liquidation of a Belgian company, the difference between the liquidation distributions and the paid-up capital is subject to a liquidation withholding tax of 30 per cent. Payments to qualifying EU parent companies or to qualifying companies resident in a tax treaty country will generally be exempt (see above).

Further to the Tate and Lyle case of the European Court of Justice, a further exemption of dividend withholding tax was introduced. The exemption applies to dividends paid by a Belgian company after 1 January 2018 to a company established in the EEA or in a country with which Belgium has concluded a double tax treaty that foresees the possibility to exchange information provided the following conditions are met:

a. the exemption is only applicable to the extent that the Belgian withholding tax cannot be credited or is not refundable in the beneficiary’s jurisdiction;

b. the beneficiary must be a non-resident corporate shareholder having a holding in the capital of the distributing company of less than 10 per cent but with an acquisition value of at least €2.5 million;

c. the holding is or will be maintained for an uninterrupted period of at least one year in full ownership;

d. the shareholder must have a legal form as mentioned in the EU Parent-Subsidiary Directive or a similar form;

e. the shareholder is subject to a corporate income tax or a similar tax and does not benefit from a regime that deviates from the common tax regime; and

f. the distributing company has a certificate confirming that the various conditions are met.

Interest

The interest withholding tax can, in most cases, be easily avoided. If the company has, for example, borrowed from an EU-affiliated company, a Belgian bank, or a credit institution located in the EEA or in a tax treaty country, or has issued registered bonds to non-resident taxpayers, no Belgian withholding tax will be due on the basis of domestic exemptions. To qualify for exemption, in some cases, certificates issued by the receiving company must be filed alongside the withholding tax return. This certificate must be issued before the interest payment or attribution.
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Belgian source interest payments made as from 1 December 2015 to certain non-resident EEA investment companies that are similar to certain Belgian regulated investment companies are also exempt from withholding tax.

**Royalties**

Royalty payments to an EU-associated company are generally exempt from withholding tax under the EU Interest Royalty Directive. In addition, most tax treaties concluded by Belgium fully exempt royalties from the royalty withholding tax. To qualify for exemption, a certificate must be filed alongside the withholding tax return. Such certificate must be issued before the royalty payment or attribution.

**iii Double tax treaties**

As the Belgian economy is an open and internationally oriented economy, it has always been one of the objectives of the Belgian government to remove any obstacles that could hinder the international flow of goods and capital. As such, the Belgian government’s policy has been to encourage international investments by minimising withholding taxes on dividend, interest and royalty income.

With this in mind, Belgium has concluded a significant number of treaties for the avoidance of double taxation with respect to taxes on income. As of 1 October 2019, Belgium has concluded 104 tax treaties, of which 95 are currently in force. Currently, the Belgian tax treaty network includes tax treaties with the following countries: Albania, Algeria, Argentina, Armenia, Australia, Austria, Azerbaijan, Bahrain, Bangladesh, Belarus, Brazil, Bulgaria, Canada, Chile, China, Croatia, Cyprus, the Czech Republic, the Democratic Republic of the Congo, Denmark, Ecuador, Egypt, Estonia, Finland, France, Gabon, Georgia, Germany, Ghana, Greece, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, the Ivory Coast, Japan, Kazakhstan, Kuwait, Latvia, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mauritius, Mexico, Mongolia, Morocco, the Netherlands, New Zealand, Nigeria, Norway, Pakistan, the Philippines, Poland, Portugal, Romania, Russia, Rwanda, San Marino, Senegal, the Seychelles, Singapore, Slovakia, Slovenia, South Africa, South Korea, Spain, Sri Lanka, Sweden, Switzerland, Taiwan, Thailand, Tunisia, Turkey, Ukraine, the United Arab Emirates, the United Kingdom, the United States, Uruguay, Uzbekistan, Venezuela and Vietnam.

In addition, the treaty with the Soviet Union continues to apply to the following former Member States of the Soviet Union: Kyrgyzstan, Moldova, Tajikistan and Turkmenistan.

Finally, the treaty with Yugoslavia continues to apply to Bosnia and Herzegovina, Kosovo, Montenegro and Serbia.

Several other tax treaties have been signed but have not yet entered into force, such as those with Botswana, the Isle of Man, Macao, Moldova, Oman, Qatar and Uganda.

Since August 2007, Belgium has had a tax treaty model (the Belgian Model) that officially sets out the policy principles followed by Belgian negotiators. Under this Belgian Model Convention, in its latest, June 2010 version, the beneficial policy towards withholding taxes can be summarised as follows:
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<table>
<thead>
<tr>
<th>Income</th>
<th>Recipient</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>Individuals and non-qualifying companies</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Dividends</td>
<td>Qualifying companies (interest of at least 10 per cent) and pension funds</td>
<td>Zero</td>
</tr>
<tr>
<td>Interest</td>
<td>N/A</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Royalties</td>
<td>N/A</td>
<td>Zero</td>
</tr>
<tr>
<td>Limitation on benefits</td>
<td>N/A</td>
<td>None</td>
</tr>
</tbody>
</table>

The Belgian Minister of Finance signed the Multilateral Instrument on 7 June 2017 on behalf of the federal government and the governments of the regions and communities (six in total). On 6 May 2019, the legislative documents implementing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (also known as the MLI) was finally approved by all six legislative authorities in Belgium. On 26 June 2019, Belgium deposited its MLI ratification instrument with the OECD. Upon condition of the fulfilment of the condition of reciprocity of ratification of the covered tax agreements, for Belgium the MLI will enter into effect at the earliest on or after 1 January 2020 for withholding taxes and, for other taxes, as of taxable periods beginning on or after 1 April 2020. Belgium submitted a list of 99 tax treaties (and corresponding amending instruments) that it designated as ‘Covered Tax Agreements’ (i.e., tax treaties to be modified through the MLI). The tax treaties concluded with Germany, Japan (including the new treaty signed but not yet in force) Taiwan and Norway (including the new treaty that entered into force on 26 April 2018) were not notified. Given the reciprocity needed to change an existing treaty, it is expected that 65 of the Belgian tax treaties will be altered by the MLI.

Belgium has chosen to apply the principal purposes test (PPT). The PPT provides that the benefit of a tax treaty may be denied if one of the principal purposes of an arrangement or transaction is to obtain tax treaty benefits unless granting these benefits is in line with the object and purpose of the applicable tax treaty. It will therefore be imperative in the future to demonstrate business purposes of an arrangement or transaction, and to ensure that there is adequate substance to achieve these purposes. Because Belgium considers an effective mechanism of dispute resolution of primary importance to mitigate any double taxation, it has been willing to implement the mandatory binding arbitration clause.

Although Belgium did initially not opt for the possibility to address the artificial avoidance of the PE status through commissionaire arrangements, it has withdrawn its reservation in the final version now. This is in line with Belgian law. The PE concept under national law has recently been extended so as to include PEs created via commissionaire (or similar) arrangements. This new rule applies as of assessment year 2021 (relating to the taxable period starting on 1 January 2020 at the earliest).

iv Taxation on receipt

Foreign-source income (dividends, interest or royalties) is included in the taxable basis for its net amount (after foreign tax).

Dividends qualifying for the participation exemption regime are exempt for 100 per cent from corporate income tax (see above). No tax credit for foreign withholding tax is available.

With respect to foreign-source royalties, there exists a beneficial foreign tax credit (unless the special IP regime (see above) is applied). It is determined as a lump-sum amount equal to 15/85 of the net foreign-sourced income (foreign taxes), irrespective of the amount of foreign withholding taxes actually paid.
With respect to foreign-source interest, a system of actual foreign tax credit exists. However, owing to the calculation method and anti-channelling provisions, it is in most cases quite limited.

VII TAXATION OF FUNDING STRUCTURES
In Belgium, both equity funding and debt funding are beneficial from a tax perspective. Equity funding will maximise the notional interest deduction, while debt funding will allow the deduction of actual interest expenses. The funding of companies therefore often depends on their activities: holding companies will be debt-funded, intra-group finance companies will be equity-funded, operational companies will often combine both funding methods, etc.

i Deduction of finance costs
Like other business expenses, finance costs are, in principle, deductible if borne to obtain or preserve taxable income. When acquiring a shareholding, a company may incur a certain amount of costs: for instance, interest expenses and other financial charges on loans taken up for the acquisition of a participation, and currency losses on such loans. An important feature of the Belgian corporate tax regime is that such costs are also, contrary to the situation in many other European jurisdictions, generally fully deductible for tax purposes as any other business expenses. This tax deductibility applies regardless of whether the acquisition relates to domestic or foreign shares, or whether the participation qualifies for the participation exemption regime. The deduction can be claimed against all sources of income of the corporate taxpayer.

However, this principle is not absolute. This is demonstrated by the Antwerp Court of Appeals, which ruled on 8 May 2018 that interest expenses with respect to funds borrowed from the grand-parent company to cash-wise fund both a capital reduction and dividend distribution would not be deductible.

Under the general rules, however, interest expenses are not tax-deductible (in whole or in part) in some particular cases; for example, if the interest rate is not at arm’s length (only deduction of the excessive part is denied).

ii Thin capitalisation and general interest limitation rule
Further to the implementation of the European Anti-Tax Avoidance Directive 2016/1164/EU of 12 July 2016, Belgian domestic tax law includes a general interest limitation rule as of 1 January 2019. This interest limitation rule foresees that exceeding borrowing costs will be deductible in the tax period in which they are incurred only up to the higher of 30 per cent of the taxpayer's earnings before interest, taxes, depreciation and amortisation (EBITDA) or €3 million (the ‘threshold amount’).

Exceeding borrowing costs are defined as the positive difference between (1) the amount of the deductible interest costs (and other economically equivalent costs) of a taxpayer that are not allocable to a PE if its profits are exempt in accordance with a double tax treaty and (2) taxable interest revenues (and other economically equivalent revenues) that the taxpayer receives and that are not exempt pursuant to a double tax treaty. For taxpayers that form part of a group:

a interest expenses (or income) paid (or received) by the taxpayer to (or from) a Belgian company or Belgian PE that form part of the group and are not excluded, will be disregarded for purposes of calculating the exceeding borrowing costs; and
the threshold amount is to be considered on a consolidated basis. This implies that:

- the EBITDA of the taxpayer should be increased (or decreased) with the amounts paid (or received) by the taxpayer to (or from) a Belgian company or Belgian PE that form part of the group and are not excluded from this rule; and
- the threshold of €3 million will be allocated proportionally among the members of the group (the allocation key is still to be determined by royal decree).

Interest that cannot be deducted pursuant to this new interest limitation rule can be carried forward indefinitely. The use thereof in a subsequent year is, however, limited to the threshold amount of that year. In case a taxpayer forms part of a group of companies, any non-utilised threshold amount, and even amounts exceeding this threshold amount can, however, be transferred to another Belgian group company or Belgian PE.

In addition to the general interest limitation rule, specific tax thin capitalisation rules apply in the case of financing by Belgian or foreign individual shareholders or directors, or non-EU corporate directors (debt-to-equity ratio of 1:1), and by low-taxed entities (debt-to-equity ratio of 5:1).

iii Restrictions on payments
The distribution of profits may not entail that the net assets of the company would drop below the amount of the paid-up or – if this is higher – the called capital, as increased by the reserves not available for distribution.

iv Return of capital
Prior to 2018, no withholding tax was due on capital reimbursements if the decision was taken in accordance with the provisions of the Companies’ Code and to the extent that it concerned the return of effectively paid-in paid-up capital (i.e., capital constituted through actual contributions by the shareholders). Reimbursements of fiscal capital decided upon as of 1 January 2018 are, however, deemed to relate proportionally to taxed reserves and certain tax-free reserves (if any). Withholding tax is therefore now due on the part of the amount of the capital reimbursement that is deemed to relate to these reserves as it qualifies as a dividend distribution (unless a withholding tax exemption applies). Furthermore, this amount also qualifies as a deemed dividend in the hands of a Belgian shareholder. The rule therefore also applies to foreign companies having a Belgian shareholder. The measure is, inter alia, not applicable to tax-free reserves that are not incorporated in the share capital, the legal reserve up to the minimum required amount, the liquidation reserve and the negative taxed reserve recorded as a result of a corporate restructuring.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
The critical issue upon the acquisition of a Belgian company consists of the fact that the group contribution system that has been introduced as of 2019 (see above) requires an affiliation during at least five taxable periods. It is, therefore, more difficult than in most other jurisdictions to achieve a debt push-down. Alternative solutions to nevertheless achieve a debt push-down include post-acquisition mergers, or refinancing of equity or existing debts. However, recent case law denies the deductibility of interest expenses incurred in
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the framework of a refinancing of equity. Before implementing such an alternative debt push-down, a careful assessment of the file and the risks involved is therefore strongly recommended.

Buyers usually use either a Belgian acquisition vehicle or a Luxembourg one. One of the factors (besides other financial considerations) that will determine this choice is the question of whether the buyers can benefit from an exemption from Belgian withholding tax on future dividend distributions if a Belgian acquisition vehicle is used. As of late 2016, this question will require a thorough analysis of the consequences of the specific anti-avoidance rule of the Parent-Subsidiary Directive (discussed above).

For Belgian sellers, any capital gain realised will in most cases remain (quasi-) tax-free. Corporate sellers will benefit from the participation exemption, and for individual sellers an exemption will apply if it can be established that the capital gain is realised in the normal management of their private wealth. Individual sellers may require from non-EEA buyers that the acquisition vehicle is located in the EU and that this vehicle holds the participation in the Belgian company for at least one year. This is to avoid a substantial interest taxation in their hands.

ii Reorganisation

Further to the implementation of the EU Merger Directive, Belgian tax law now provides that a merger can take place tax neutrally if the following conditions are met:

- the acquiring company is a Belgian or an intra-European company; and
- the reorganisation does not have as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance. The merger is deemed, unless proved otherwise, to have as its principal objective, or as one of its principal objectives, tax evasion or tax avoidance if the merger does not take place based on valid commercial reasons, such as a restructuring or rationalisation of the activities of the concerned companies.

An acquired business and an existing local business can, thus, be consolidated through a merger. Practice demonstrates, however, that the tax administration tends to scrutinise mergers through which a debt push-down is realised.

Cross-border mergers are possible as well within the EU from both a corporate and tax perspective. This cross-border merger is subject to a fourth condition to achieve tax neutrality. The transaction will, indeed, only be tax-neutral from a Belgian perspective to the extent that the assets acquired as a consequence of this transaction are maintained in a Belgian establishment by the EU absorbing or receiving company. The same applies for the tax-free reserves of the absorbed Belgian company.

iii Exit

Through a cross-border conversion, a Belgian company can move its registered office out of Belgium without being liquidated from a corporate perspective. The latter will only be true if, under the laws of the jurisdiction of immigration, the continuation of the legal personality of the company is also accepted.

From a tax perspective though, the emigration of a company will always be considered as a deemed liquidation of the company. Consequently, all latent capital gains, tax-free reserves and goodwill become taxable at 29.58 per cent (25 per cent as of 2020). Arguably, no liquidation withholding tax is due. For an emigration to other EU Member States, this exit taxation does not, however, apply, if, and to the extent that, a PE is maintained in Belgium.
As of 1 January 2019, the transfer of assets from Belgian headquarters to foreign permanent establishments (internal dealings) implying a loss of taxable substance in Belgium is also subject to exit tax. The rules regarding inbound transfers have been adjusted as well. Previously, these rules generally provided that assets entering the Belgian territory had to be registered at their pre-transaction foreign book value (i.e., no step-up in the tax base was provided). Because this was contrary to European Anti-Tax Avoidance Directive 2016/1164/EU of 12 July 2016, the new rules now accept the market value as the starting value of the assets for tax purposes (unless the company immigrates from a tax haven). To the extent that these assets were subject to an exit tax in the country of emigration and Belgium has concluded a treaty with this country that provides for the possibility to exchange information, the value established by this foreign country is refutably presumed to correspond to the market value (unless it is a tax haven). If these conditions are not fulfilled, the market value is presumed to correspond to the book value according to Belgian rules, unless proof to the contrary is provided.

The taxpayer can choose between the immediate payment of exit tax or the deferred payment in five equal instalments, in case of reorganisations or a transfer of the seat, the main establishment or the centre of management to another EU or EEA member state with which Belgium has an agreement on mutual recovery assistance. With respect to the EEA, the rules will in first instance only apply to Iceland and Norway. The payment deferral is forfeited upon the occurrence of 10 different events, of which the most important are: the alienation of all or a part of the assets involved, the further transfer of seat outside the EU/EEA, the non-respect of the payment date of one of the instalments, and the opening of an insolvency procedure against the (ex-) taxpayer. Moreover, the tax administration can require a security in case of deferred payment, based on an assessment of the risk of non-recovery.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Under the domestic anti-avoidance rule (GAAR), a legal act or series of legal acts constituting a single operation cannot be opposed to the Belgian tax administration if the tax authorities prove on the basis of objective circumstances that tax abuse exists.

The statutory provision indicates that tax abuse is deemed to exist if:

a the taxpayer places itself outside the scope of a tax provision in a manner that is incompatible with the objectives of this provision; or

b the taxpayer claims an advantage under a tax provision contrary to the objectives of that tax provision, and the transaction is in essence aimed at obtaining that tax advantage.

The tax administration will have to prove that tax abuse exists, which they may do by all legal means of evidence (including presumptions). The taxpayer then has to show the existence of motives other than tax motives. The Explanatory Notes to the Bill that introduced this GAAR specify that the tax authorities will apply the GAAR in the following situations:

a the legal act has only a tax motive;

b the non-tax motives are very general and not specifically connected with the legal act concerned; and

c the non-tax motives are specific, but the importance of these motives is so small that a reasonable person would not have carried out the transaction because of this non-tax motive; in this case, it can be assumed that this non-tax motive is not the genuine motive.
If the taxpayer does not establish sufficient legitimate non-tax motives for his or her act, the tax authorities may reclassify the act to bring it in line with the objectives of the relevant tax provision. The tax authorities may then determine the taxable base and the amount of tax due as though there was no abuse.

Certainty as to whether an envisaged legal act or series of legal acts does not constitute tax abuse can be obtained through a formal ruling request.

ii Controlled foreign corporations (CFCs)

CFC legislation

Under the Belgian CFC rules, a foreign company qualifies as a CFC if the following conditions are met:

- the Belgian taxpayer owns directly or indirectly the majority of voting rights, or holds directly or indirectly at least 50 per cent of the capital, or is entitled to receive at least 50 per cent of the profits of the foreign company (control test); and
- the foreign company (or foreign PE of a Belgian company) is in its country of residence either not subject to an income tax or is subject to an income tax that is less than half of the income tax if the company would be established in Belgium. In calculating this income tax, the profits that this foreign company would have realised through a PE are disregarded if a double tax treaty applies between the country of the foreign company and the country in which the PE is located that exempts this profit (taxation test).

The Anti-Tax Avoidance Directive left Member States the option to either include non-distributed specific types of income as defined in the Directive (i.e., interest, dividends, income from the disposal of shares, royalties, income from financial leasing, income from banking, insurance and other financial activities, income from invoicing associated enterprises as regards goods and services where there is no or little economic value added) or to include non-distributed income arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage. Belgium has opted for the latter approach. An arrangement shall be regarded as non-genuine to the extent that the CFC would not own assets or would not have undertaken risks if it were not controlled by the Belgian taxpayer where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company's income. The attribution of income is then limited to the income attributable to the significant people functions carried out by the Belgian controlling taxpayer.

If the CFC distributes profits to the taxpayer and those distributed profits were previously taxed in the hands of the Belgian taxpayer, these profits shall be fully deducted from the tax base when calculating the amount of tax due on the distributed profits. Furthermore, capital gains realised on the disposal of shares of a CFC will be exempt to the extent that the profits of the CFC have already been taxed in the hands of the Belgian taxpayer as CFC income and these profits have not yet been distributed and still exist on an equity account prior to the alienation of the shares. Double taxation is, however, not fully eliminated. The taxes that the CFC pays in its country of residence are not allowed as a deduction from the Belgian tax. Moreover, the current rules do not foresee that the allocation of the profit of the CFC to the Belgian taxpayer is proportionate to the taxpayers' participation in the CFC.
Reporting obligation

Furthermore, direct or indirect payments made by Belgian companies to entities, individuals, permanent establishments and even bank accounts established in a tax haven have to be reported in a separate form attached to the resident and non-resident corporate income tax return. The reporting obligation is only applicable if the total amount of payments exceeds €100,000 per tax year.

Failure to report payments to tax havens that qualify as professional expenses for the Belgian taxpayer will lead to the refusal of the (tax) deductibility of these expenses. In a worst-case scenario, an additional fine and tax increase could be imposed. On the other hand, the fact that the new reporting obligation has been observed does not necessarily imply that the Belgian tax authorities will accept that the payments are tax-deductible as professional expenses. The taxpayer must still prove that this payment was motivated by sound business reasons (i.e., the non-artificial character of the parties involved, and of the transaction giving rise to the payments).

The presence of a state on a tax haven list at the moment of the payment is sufficient to require its reporting. Tax havens are determined by two lists:

a. the OECD list, which includes states that, according to the Global Forum on Tax Transparency and Exchange of Information of the OECD, do not effectively or substantially apply the OECD exchange of information standard; and

b. the Belgian domestic list, which contains states without or with low taxation. The criteria used to constitute this list have been expanded with the Program Law of 4 July 2016. A new list still has to be enacted by Royal Decree. The following will be on the list: states outside the EEA, (1) in which companies are not subject to corporate tax on domestic or foreign income; or (2) that have a nominal corporate tax rate of less than 10 per cent or have an effective corporate tax rate on foreign income of less than 15 per cent. The latter (new) criterion may have far-reaching consequences for corporate groups including entities established in states with a territorial taxation system, such as Singapore or Hong Kong.

iii Transfer pricing

Belgian tax law includes rather stringent transfer pricing rules. The main rules can be summarised as follows.

Any abnormal or benevolent advantage granted to another person or entity is added to the taxable basis of a Belgian company, unless it is taken into account to determine the taxable income of the recipient. If the non-arm’s-length benefit is granted to another Belgian company, this transfer pricing adjustment does not apply.

Any abnormal or benevolent advantage received directly or indirectly from an affiliated enterprise constitutes the minimal taxable basis of the Belgian company (no deduction of losses, losses carried forward, notional interest deduction, etc., is allowed).

For financial years starting on or after 1 January 2016, the three-tiered approach to transfer pricing documentation proposed by the OECD, which requires multinational enterprises (MNEs) to submit a country-by-country report, a master file and a local file, applies (Program Law 4 July 2016).

Qualifying groups (with consolidated gross turnover exceeding €750 million) will have to file a country-by-country report (CbCR) with the Belgian tax authorities within 12 months of their consolidated financial statements’ closing date. Belgian taxpayers belonging to a multinational group are in any case required to notify the Belgian tax authorities of the
identity and tax residency of the group’s entity that will submit the group’s CbCR on the last day of the MNE’s financial year. On 2 May 2019, a law was approved including an update on the notification obligation of each Belgian group entity of a multinational group with regard to filing a country-by-country report. The notification by the Belgian group entity with regard to filing the country-by-country report will now only be required if the information to be provided differs from the information that was provided in respect of the previous reporting period.

A mandatory automatic exchange of CbCRs within the European Union applies. Belgium also implemented the Multilateral Competent Authority Agreement for the Automatic Exchange of CbCRs, which is signed by 83 countries. Finally, Belgium concluded a Competent Authority Arrangement for the automatic exchange of CbCRs with the US on 1 August 2017. This agreement will enable the exchange of CbCRs between Belgium and the US.

Belgian taxpayers belonging to a multinational group are required to submit a master file and a local file when exceeding one of the following criteria on an unconsolidated basis during the previous financial year:

- a total amount of revenue including financial but excluding non-recurrent income of €50 million;
- a balance sheet total of €1 billion; or
- an annual average of 100 full-time employees.

The master file should be submitted within 12 months of the end of the MNE’s financial year. The local file should be annexed to the Belgian taxpayer’s annual tax return.

The master file should include, among other things, an overview of the intra-group financial transactions, the financial and fiscal position of the group on a consolidated basis and the group’s general transfer pricing policy.

The local file should include, among other things, detailed transactional transfer pricing documentation identifying the transactions between the Belgian entity and the foreign entities of the group if such transactions exceed €1 million during the previous financial year. The local file requires MNEs to disclose more figures than initially suggested by the OECD. On the other hand, MNEs are not required to enclose transfer pricing policies, transfer pricing studies and intercompany agreements (those documents can, however, voluntarily be included). MNEs only have to indicate whether such documentation is available. It follows that Belgian taxpayers are not explicitly required to provide for transfer pricing documentation containing a functional analysis, economic analysis and benchmark studies. However, in practice, it is highly recommended to have transfer pricing documentation (in line with OECD guidance) available as indicating that no such documentation is available will increase the odds of triggering an audit. In addition, even though it is not explicitly required, it is recommended to prepare a reconciliation between the local file and the financial statements.

iv  Tax clearances and rulings

There is an important ruling practice in Belgium. Under this ruling policy, a taxpayer may apply for a ruling with respect to any tax issue. The introduction of a ruling request is, however, not possible in the following cases:

- the ruling request concerns transactions that are the subject of litigation;
- the ruling request concerns the application of an act regarding the collection of taxes;
- the transaction envisaged does not have economic substance in Belgium; or
the essential aspects of the transaction envisaged relate to a tax haven that does not work with the OECD or to a country with no or low taxation that appear on a Belgian list unless a double tax treaty is available that foresees the exchange of information.

A ruling request must be filed before the transaction is implemented. In principle, the tax administration must decide on the ruling request within three months following its filing. In practice, the actual term is determined on a case-by-case basis within 15 days following the filing of the request. A ruling is usually valid for a maximum of five years, although a longer period can be granted if justified by the taxpayer. A ruling can also be renewed.

A ruling is generally not required at all to acquire a local business. Thanks to the flexibility of the ruling system, it is, however, a popular instrument that is often used by multinational groups to obtain legal certainty on issues such as transfer pricing, restructurings involving a Belgian company and hybrid financing.

Since 27 May 2019, the Belgian Accounting Standards Board (CBN) can issue rulings on the application of the various accounting standards applicable in Belgium. As Belgian tax law follows Belgian accounting law unless tax law expressly deviates from accounting law, the impact of the possibility to obtain accounting law rulings cannot be underestimated.

The EU Directive of 8 December 2015 on the automatic exchange of information has been transposed into national law via the Belgian Act of 31 July 2017. Prior to this Act, Belgium already had a system in place to exchange information (including rulings) spontaneously. However, this system was not applied in practice and was, therefore, not effective. Belgium now exchanges information automatically on advance cross-border tax rulings and advance pricing agreements in conformity with the EU Directive.

‘Catch-all’ provision

Payments made by Belgian taxpayers for services rendered by a related non-resident taxpayer are subject to 16.5 per cent withholding tax in the event Belgium has the power to tax such income pursuant to a tax treaty or, in the absence of a tax treaty, in the event the non-resident beneficiary does not prove that the income has actually been subject to tax in his or her state of residence. The scope of application of the catch-all provision is limited to income or profits derived from the provision of services to Belgian taxpayers that act in a professional capacity and that have a direct or indirect relationship of interdependence with the service provider (i.e., related parties), whether such services are rendered in Belgium or in a foreign country.

Ultimate beneficial owner register

The fourth anti-money laundering directive obliges the Member States of the EU to install a register in which the ultimate beneficial owners (UBOs) of legal entities are identified. UBOs of Belgian companies will need to be identified in the Belgian UBO register. The natural persons who (1) directly hold more than 25 per cent of: the shares, the share capital, or the voting rights of a Belgian company, (2) control a holding company that holds more than 25 per cent of the shares or the share capital of a Belgian company, or (3) control the Belgian company by other means, are considered as UBOs. As a minimum, the name, the date of birth, the nationality and the address will need to be reported, as well as the nature and the extent of the beneficial interest held. A similar obligation applies to UBOs of foundations, (international) non-profit organisations, trusts and fiduciaries. The directors of the entity will need to comply with the obligation to report the aforesaid information to the Belgian UBO register.
Belgium

The Act of 18 September 2017, introducing the UBO register, was published in the Belgian Official Gazette on 6 October 2017. The implementing Royal Decree of 30 July 2018 (published on 14 August 2018) mentions 1 December 2018 as the deadline for the registration. However, this deadline has been postponed until 30 September 2019. In the absence of a proper registration or incomplete or incorrect registration, fines can be imposed ranging between €250 and €50,000. However, on 23 September 2019 the Belgian authorities confirmed that no fines will be imposed until the end of 2019 in the light of an administrative tolerance.

vii Common reporting standard (CRS)
As of 1 January 2016, the CRS applies to Belgian financial institutions such as banks, investments entities and certain insurance companies. Reporting to the Belgian tax authorities should be done by 30 June of each year, after which the Belgian tax authorities will exchange the information to the relevant jurisdictions.

X YEAR IN REVIEW
Most of the changes that were introduced in the course of 2019 are discussed above.

XI OUTLOOK AND CONCLUSIONS
Following the elections in May 2019, a new federal government is still to be formed. Because the budgetary deficit is fast increasing, some major developments in tax legislation may be expected in the course of 2020. However, as long as no new government is formed and no government statement is available, it is difficult to predict the scope and content of these new measures.

In the meantime, some repair legislation is expected on the general interest limitation rule and the group contribution system.
I INTRODUCTION

Brazil ranks among the largest economies in the world (ranked 9th by the International Monetary Fund\(^2\) and the World Bank\(^3\)), with a population of over 210 million\(^4\) and the fifth largest territory on the planet (over 8.5 million square metres). Although it has suffered a severe recession in recent times (especially 2015 and 2016), as an emerging economy the country has huge potential for growth and investment, not only because of its enormous natural wealth (including energy potential), but also because of its large size, potential to increase its consumer market and the need to improve the still insufficient infrastructure available in the country.

Indeed, the government has been working to foster the country’s economic growth, improve the business environment and facilitate foreign investment. As recent examples, we had the easing of labour legislation to facilitate the hiring of formal labour, the approval of the Economic Freedom Law, which introduced innovations to reduce bureaucracy, and the signing of a free trade agreement with the European Union, which, where applicable, will open the door to one of the world’s leading consumer markets for Brazilian products.

The federal government also recently announced a huge privatisation plan for public companies, which was followed by some states, such as São Paulo (the state with the largest economy in Brazil). The plan foresees the privatisation of several companies, notably of infrastructure, and will certainly attract a lot of foreign investors in the coming years. Also, the implementation of the 5G infrastructure will be the subject of a public bid in the near future, with news that major international groups are interested in the business.

In short, the potential for growth and foreign investment in Brazil is enormous. Although there are still some bureaucratic and legal obstacles (especially with regard to tax law), investing in the country is not difficult, as foreign capital flows occur simply (provided that some formalities are fulfilled) and are no longer so time consuming and costly as they used to be. In addition, there are few sectors that have restrictions on foreign direct investment and the list has been shrinking year after year, as has happened very recently with the civil aviation and telecommunications markets.

While there is still work to be done, there is a clear tendency for improvement in the business environment.

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1 Mauricio Barros is a partner at Gaia Silva Gaede Advogados.
2 https://www.imf.org/external/datamapper/NGDPD@WEO/OEMDC/ADVEC/WEOWORLD.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Business usually adopt a corporate form. The first steps a non-resident must take to invest in Brazil are: (1) appoint a representative in Brazil (which needs to be a Brazilian resident); (2) enrolling with the Brazilian Federal Revenue Service by an Individual Taxpayer Number (CPF) if a foreign individual, or Brazilian Taxpayer Registry (CNPJ) if a foreign entity; (3) submit his or her credentials to the Central Bank of Brazil; and (4) initiate the registration process at the Brazilian Securities Commission (CVM) to operate in the capital market (if this is the case). Under Brazilian law, directors of companies must be resident in the country.

The most common types of legal entities in Brazil are the following:

Limited Liability Company (LTDA)
The LTDA is the most common form of corporate organisation in Brazil and is widely adopted because of its many advantages as compared to corporations (S/A): (1) it has a simpler and less expensive organisation; and (2) corporate decisions can be taken easier and quicker. The quotas represent the share of each partner in the company’s corporate capital, with the partners’ liability limited to the value of their quotas.

Corporation (S/A)
The responsibility of each stockholder is limited to the issued cost of subscribed or acquired capital. The capital stock of the company is divided into shares. The company may be considered ‘open’ (publicly held) or ‘closed’ (privately held), depending on whether the securities it issues are traded on the Stock Exchange or not. A publicly traded company must be registered with the Securities Commission, the federal agency in charge of regulating and auditing such firms.

Individual Company of Limited Liability (EIRELI)
The EIRELI may be incorporated by an individual or a legal entity, whether national or foreign, as the sole holder. The holder shall name a legal representative, resident in Brazil, with minimum powers to accept service of process and for representation before the CNPJ. The minimum corporate capital required to incorporate an EIRELI is of at least 100 times the highest minimum wage in force in Brazil. This corporate capital must be fully paid up in the incorporation.

ii Non-corporate

In Brazil there are no non-corporate entities.

II DIRECT TAXATION OF BUSINESSES

In Brazil there are two corporate income taxes: IRPJ and CSLL. Both may be calculated by means of two different methods, which may be chosen by the taxpayer if certain legal requirements are met:

a deemed profit: optional to entities with income lower than 78 million reais during the previous calendar year; and
actual profit: mandatory for entities with income higher than 78 million reais on the previous tax year, and optional in other cases.

i Tax on profits

Determination of taxable profit

Deemed profit calculation method

By means of the deemed profit calculation method, corporate taxes must be paid definitively on a quarterly basis, based on the entity’s revenues, after applying presumed profit margins, such as 8 per cent for income tax (IRPJ) and 12 per cent for social contribution (CSLL) on net profits, in case of sales of products, and 32 per cent for both, in case of services provision.

Once the deemed profit margins are applied, the presumed profit will be taxed by IRPJ, at a rate of 15 per cent (plus 10 per cent applicable on the amount exceeding 60,000 reais per quarter) and CSLL at a rate of 9 per cent, which represents an effective global rate of approximately 3.08 per cent for products sales and 10.88 per cent for services provision over gross revenues.

Actual profit calculation method

Actual profit method consists of IRPJ and CSLL being levied upon the entity’s real net accounting income, after the adjustments (add-backs and exclusions) determined by the legislation. The main add-backs are provisions, donations, penalties and other non-operating expenses. The main exclusions are reversal of provisions, dividends and equity accounting.

Optionally, there are two possibilities for applying the actual profit method: quarterly or annually. On the quarterly calculation, definitive payments are made during the following month after the calendar-quarter-end. Thus, this option may be favourable in situations where income is earned constantly, taking into account that, in this case, tax payments are postponed up to three months ahead, so that only four tax payments are made per year.

The other option is the annual calculation. In this case, IRPJ and CSLL must be calculated definitely at the calendar-year-end, according to the actual profit rules; however, the taxpayer must collect, on a monthly basis, tax prepayments, which may be calculated either by the deemed profit or actual profit method.

Additionally, the tax prepayments paid during the tax year must be deducted from the corporate taxes calculated at year-end to assess either a final payment due or a tax refund.

Capital and income

Capital gains are subject to a progressive rate of 15 per cent to 22.5 per cent, depending on the total amount of the gain. This also applies to capital gains on transfers of Brazilian assets between non-residents.

In the case of foreign entities domiciled in a tax haven jurisdiction or countries considered by Brazilian legislation to have favoured taxation (income tax rate below 20 per cent), the taxation on capital gains is increased to a 25 per cent rate.

Dividends distribution is based on the entity’s net accounting profit, booked at profit and losses (P&L) and after corporate taxation (by IRPJ/CSLL, at an overall rate of 34 per cent). Thus, dividend distribution is not tax deductible at the entity level; however, it is exempt from taxation on the beneficiary level, because the profit that has been allocated has already been taxed.
Brazil

Losses
Losses may be carried forward and accumulated for an unlimited time, but their deduction is limited to a maximum 30 per cent of taxable income per fiscal year.

Rates
Regarding the actual profit method, the net income will be taxed by IRPJ at a rate of 15 per cent (plus 10 per cent applicable on the amount exceeding 240,000 reais per year), and CSLL at a rate of 9 per cent. For most companies, this results in a total tax on profit of nearly 34 per cent.

Administration
The activities of regulation, assessment, inspection and collection of taxes are performed by the tax administration bodies subordinate to these respective federative entities. If those bodies believe that there has been any kind of violation of the tax legislation, whether regarding the payment of taxes or the fulfillment of ancillary obligations, an infraction notice may be issued, in which the tax will be charged.

Upon notice to the taxpayer of the content of the tax assessment, it may pay the required amount with discounts, as the case may be, or file a defence against the assessment.

With the presentation of the defence, the enforceability of the debt under discussion is suspended (that is, the tax authorities cannot pursue judicial collection) and the administrative process begins. The debt will be suspended until the final conclusion of the process without the need to guarantee the debt.

In the event of a favourable decision, the matter is considered closed and the tax authorities cannot appeal to the judiciary (i.e., the debt is definitively extinguished). In the case of an unfavourable decision, the taxpayer can discuss the matter further in court. In most cases, the taxpayer will have to provide a guarantee to discuss the debt in court.

Many ancillary obligations must be prepared by the taxpayers. Regarding indirect tax returns, considering São Paulo Municipality and State, these are the main ones:

a. ICMS:
   • ICMS Information and Calculation Form (GIA);
   • Integrated Information System on Interstate Operations with Goods and Services (SINTEGRA);
   • Information and Calculation Form – Tax Substitution (GIA-ST);
   • Tax Document Electronic Registration (REDF) (only applicable to retailers); and
   • Digital Tax Bookkeeping (EFD).

b. ISS (Municipality Services Tax):
   • Tax Collection for Sao Paulo Municipality (DAMSP);
   • Tax Collection Form (Issued Online Based on Electronic Invoices Issued).

Regarding federal taxes (IRPJ, CSLL, PIS, COFINS and IPI), the following tax obligations must be filed:

a. Accounting books on an annual basis:
   • ECD (‘SPED Contábil’) – standardised accounting plan submitted to tax authorities on an annual basis;

b. IRPJ and CSLL:
   • DIPJ (annual corporate income tax return);

c. PIS and COFINS:
- EFD PIS/COFINS (‘SPED Fiscal’);
  
  d) IPI (Federal VAT – Excise Tax:
  - Digital Tax Bookkeeping (EFD);
  
  e) Other tax returns:
    - DCTF – confirms all the federal tax payments made by a Brazilian entity during the month; and
    - DIRF – annual tax return of withholdings on behalf of third parties.

**Tax grouping**

The concept of tax grouping does not exist under Brazilian law.

ii) **Other relevant taxes**

**Import duty – II**

Import duty is due upon importation of goods. The calculation basis for import duties is the customs value (goods value increased by freight and insurance). Rates vary according to the harmonised system (HS) code of the product in the Brazilian External Tariff Code. II is not recoverable.

**PIS and COFINS**

Federal social contributions levied on gross revenues and on the importation of products and services are basically calculated under two regimes: cumulative and non-cumulative. The non-cumulative system is the general rule, while there are some taxpayers (banks, insurance companies, companies that accrue income tax with the deemed profit regime etc.) and specific activities (civil construction, telecommunication, some kinds of transportation etc.) subject to the cumulative system.

Under the non-cumulative regime, PIS and COFINS are imposed on the gross revenues of the company or on the importation of products and services, at a combined general rate of 1.65 per cent (PIS) and 7.6 per cent (COFINS) for internal acquisitions and services import and 2.1 per cent and 9.65 per cent for imports of goods, respectively. The contributions levied on the purchasing of some goods and services (both domestic and international operations) may be set off against the PIS/COFINS that will be levied on the gross revenue.

Under the cumulative regime, PIS and COFINS are due at a combined 3.65 per cent rate and there are no credits available.

For some specific products, like pharmaceutical, perfumery, toiletries, personal hygiene, gas, oil, cold beverages, among others, PIS and COFINS may be due by the ‘single-phase system’, using higher rates to be applied to the calculation basis (gross revenue). In these cases, they are fully paid by the first one to introduce them into commerce (manufacturer or importer).

**ICMS**

The ICMS is a state tax that applies to operations relating to the circulation of goods and the rendering of certain types of transportation and communication services, including upon the importation of goods.

The ICMS is a non-cumulative tax, where the tax to be paid in a certain month (accrual period) is obtained by the rate applied on sales (debts) minus the tax paid in the later operations (credits).
As a general rule, the calculation basis is the total value of the transaction, including all the expenses (freight, purchase/handling etc.) that are actually borne by the purchaser, excluding discounts or rebates unconditionally granted. It is calculated on its own value (grossed-up basis).

For the import of goods, the calculation basis is the CIF value of the good increased by the import duty, duty expenses, IPI, PIS/COFINS and ICMS itself.

On domestic transactions, the ICMS tax rate is established by each state according to the description or HS Code of the product. Normally, the rate is 17 per cent or 18 per cent, depending on the state where the company is located, but it may vary up to 25 per cent or 27 per cent for products considered as ‘non-essential’.

The ICMS rates on interstate transactions apply as follows:

a 4 per cent for resale of imported products or manufactured products containing more than 40 per cent of imported material;

b 7 per cent when taxpayers located in the southern and south-east areas (except Espírito Santo) remit goods or services to taxpayers residents in the states of the northern, north-east and mid-west regions, and Espírito Santo states; and

c 12 per cent when taxpayers located in the southern, south-east (except Espírito Santo state), northern, north-east and middle-west regions remit goods and services to taxpayers resident in the states in the southern and south-east regions (except Espírito Santo state).

**IPI**

IPI is excise tax imposed by federal government on imports of goods, on the first sale of imported goods and on transactions involving manufactured goods (if the product was previously manufactured by the seller). The definition of ‘manufacturing’ for IPI purposes ‘includes any operation that modifies the nature, functioning, finishing, presentation, or purpose of a given product, or improves it for consumption, like transformation, improvement, assembly, packaging, repackaging, renovation or refurbishment’.

IPI tax rates may vary from 0 per cent to 365 per cent, depending on the traded goods, but are usually between 8 per cent and 20 per cent, and the amounts paid on domestic acquisitions or importations generally become a tax credit to offset the IPI due on subsequent transactions. If the company purchases finished goods from local manufactures and does not perform any sort of manufacturing on them, no IPI will be charged.

**Service tax (ISS)**

ISS is a municipal tax imposed on certain services rendered to or by Brazilian entities or individuals. Federal Complementary Law No. 116/03 determines which types of services are subject to ISS, by means of a taxable services list. Its tax rate varies from 2 per cent to 5 per cent according to the nature of the service and the city where the service provider is located. The import of services (rendered by non-residents to Brazilian residents) is also subject to ISS.

**Payroll taxes – INSS**

Corporate payroll is subject to a social contribution tax regime. These social contributions amount to between 26.8 per cent and 28.8 per cent of the total payroll, and must be paid monthly by the companies. These percentages include the Employer’s Contribution (20 per
cent), the Occupational Accident Insurance, the percentage of which varies from 1 per cent to 3 per cent depending on the risk of accidents at the company, and approximately 5.8 per cent as contributions to parastate entities, such as SESC, SENAT, SENAI, etc.

These contributions are not to be confused with the social contribution that the worker must pay himself or herself, which is deducted at source by the employer. For this, there is a deduction of 8 per cent to 11 per cent of the monthly salary paid to workers, which must be paid by the company regardless of the payment of social contributions on the payroll.

V TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Legal entities are considered as resident in Brazil as long as they have incorporated an entity in the country. The domicile is defined by the company's headquarters.

ii Branch or permanent establishment
In general, foreign companies may not carry out local activities in Brazil except through a registered subsidiary or branch. However, such types of entities are not commonly used in the country as they require previous approval from federal authorities to be registered. Therefore, international investors in almost all situations prefer to incorporate companies in Brazil (SA or Ltda), as mentioned above.

On the other hand, there is no definition of ‘permanent establishment’ for tax purposes in Brazilian law. Income tax legislation contains some provisions for special cases, such as the above-mentioned subsidiaries and branches, in addition to commission contracts and direct sales through an agent or representative, but there is no more general definition. However, the National Tax Code provides that the tax capacity is independent of the regularity of the legal entity, with the presence of an ‘economic or professional unit’ for the company to be taxed. Thus, the Brazilian tax authorities have the possibility, when identifying corporate economic activity, to tax such activity even if there is no formally established company, including non-resident activity.

It is worth remembering that the definition of ‘permanent establishment’ is present in all treaties to avoid double taxation signed by Brazil, with some slight conceptual variations among them. The definition only takes into consideration physical criteria of connection with the Brazilian territory, which makes its application impossible, for example, to the activities conducted in the digital economy.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
In Brazil, there is no special holding company regimes, so companies must apply the general tax legislation in their activities.

ii IP regimes
IP has a strong protection system in Brazil, considering both domestic legislation and international treaties signed by Brazil. However, there is no special IP tax regime.
State aid

There are several tax benefits granted to taxpayers in certain sectors, for both federal taxes and ICMS.

**Manaus Free Zone**

Legal entities located in the Manaus Free Zone benefit from tax incentives imposed on import tax: IPI; Income Tax – IR; PIS; COFINS and ICMS.

To be entitled to tax incentives in the Manaus Free Trade Zone, entities must be located in this geographically delimited area; fulfil a basic production process (PPB); develop increasing levels of productivity and competitiveness; reinvest the profits made in the region in the region itself; grant social benefits to workers, among others, always aiming at the development of the region itself.

**REPETRO**

REPETRO is a special customs regime with the scope of granting the suspension of some federal taxes on the exportation and importation of specific equipment to be used for the exploration and extraction activities of oil and natural gas deposits.

Companies qualified in REPETRO have suspension of the import tax, IPI and PIS/COFINS. There is also authorisation for states to grant ICMS incentives on these operations.

**REIDI**

The Special Infrastructure Development Incentive Scheme (REIDI) covers legal entities that are linked to infrastructure in the transport, sanitation, ports, energy and irrigation sectors.

REIDI was created to grant authorised companies the suspension of PIS/COFINS and PIS/COFINS-Import.

**REPORTO**

The Tax Regime for Incentive to Modernisation and Expansion of Port Structure (REPORTO) has as its fundamental precept to grant the suspension of some federal taxes to goods used in the port and rail sector in Brazil, seeking an improvement in infrastructure.

REPORTO covers the suspension of IPI, PIS and COFINS on domestic transactions. In the case of importation of goods, the tax suspension may be granted, in addition to the taxes levied in the domestic market.

The beneficiaries of REPORTO are the port operator, the organised port concessionaire, the public-use port facility tenant, and the company authorised to operate the private or mixed port facilities.

**Benefits for IT**

There is a special regime for companies that have investments in information technology R&D activities, or that produce automation, telecommunications and information technology goods, observing the basic production process.

Companies that qualify for this tax incentive scheme will be entitled to exemption or reduction of the IPI on goods destined for automation, telecommunications and computer technology. These goods may be produced anywhere in Brazil, except in the Manaus Free Zone, as there is specific legislation for the production of these goods in this area.
Many states also grant ICMS benefits for these products.

**Reintegra**
The Reintegra programme aims to reduce the tax burden on goods exported by Brazilian manufacturers by granting PIS and Cofins tax credits. This measure therefore impacts the benefit of the exoneration of the export transaction. However, in 2019, the federal government reduced the rate for calculating reintegra credits from 2 per cent to 0.1 per cent.

**VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS**

i **Withholding outward-bound payments (domestic law)**
Dividends are exempt from any taxation, as already stated. Interests and royalties paid to non-residents are subject to a 15 per cent or 25 per cent withholding tax (WHT), except if a different rate is applicable because of a double taxation convention.

ii **Domestic law exclusions or exemptions from withholding on outward-bound payments**
There are no exceptions, except for dividends.

iii **Double tax treaties (DTT)**
Brazil still does not have an extensive double tax treaty network, though some important improvements have been made in recent years. Currently there are 34 DTTs in force and some are waiting for congressional approval after being signed. In general terms, the DTTs signed by Brazil follow the Organisation for Economic Co-operation and Development (OECD) model, though Brazilian authorities have different interpretation of certain aspects than international standards.

**VII TAXATION OF FUNDING STRUCTURES**

i **Thin capitalisation**
Brazilian entities with foreign capital must submit the interest incurred related to loan agreements with its overseas stockholder to a control of deductibility of expenses for tax purposes.

In addition to the general rules of deductibility (expenses must be necessary and operational) and TP rules, Brazilian legislation establishes thin capitalisation rules to test the deductibility of interest incurred on loans with related persons abroad.

The methodology is to compare the value of the debt linked to the entity’s stockholder abroad to a certain fraction of the Brazilian entity’s equity (debt to equity ratio). The debt-to-equity ratio is 2:1 for loans with related parties and 0.3:1 for loans taken from tax havens. If the entity verifies that the legal criteria for the deductibility of the interest expenses were not met, the entity will have to add-back those costs to the income tax (IRPJ) and social contribution (CSLL) calculation bases.
ii Deduction of finance costs
In general, necessary interest and finance expenses are tax deductible, including payments to foreign entities. However, payments to entities domiciled in tax haven jurisdictions (black-listed) or with special benefit regimes (grey-listed) may be limited according to thin capitalisation rules.

iii Restrictions on payments
As long as the investment in registered within the Brazilian Central Bank, there are no rules restricting the payment of dividends.

iv Return of capital
Equity capital can be repatriated. Dividends are tax exempt. Interest, capital gains on sale of shares or quotas, and some other remittances are generally subject to 15 per cent income tax rate or lower treaty rate.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES
i Acquisition
Non-resident companies may acquire local businesses using a resident or a non-resident entity. Non-residents are required to be registered with domestic authorities (Federal Revenue Office and Central Bank) to do so.

In general, buyers structure financing through loans, being remunerated by interest on net equity (INE), and equity, being remunerated by dividends.

Though dividends are tax exempt, INE is subject, at the beneficiary level, to a 15 per cent WHT rate, for both domestic and foreign recipients. However, INE is considered a financial expense at the company’s level and, therefore, is deductible at a 34 per cent rate, which could be an important tax saving for the Brazilian entity. This deductibility is limited to 50 per cent of the accumulated profits or 50 per cent of the annual profit (whichever is higher).

ii Reorganisation
In Brazil, mergers and demergers are not subject to any specific taxation. However, if a company with losses is merged into another, the losses will no longer be carried forward. The same does not apply to the latter, because the restriction is only applicable to the company that will be extinguished.

Brazilian legislation does not allow domestic companies to merge with non-local entities unless the latter has a branch or subsidiary in Brazil. In this case, the merger would be between Brazilian entities anyway.

iii Exit
There are no restrictions if a business decides to repatriate investments and exit from a Brazilian company. However, if the Brazilian company is meant to be extinguished, it must present a clearance certificate of debts before the Board of Trade. In addition, if the investment is liquidated with capital gains, the gains will be taxed at a 15 per cent to 22.5 per cent rate, depending on the amount.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Although Brazil has a General Anti-Tax Avoidance Rule (GAAR), this rule is not yet applicable by tax authorities in specific cases, as it requires regulation.

However, while not yet applicable, tax authorities (especially federal) often apply other articles of the National Tax Code to disregard transactions for tax purposes when the acts or business carried out lack a business purpose. Assessments derived from this type of understanding do not always prevail at the administrative level or in court, although it can be argued that any tax planning in Brazil today must have a relevant purpose or motivation that is not simply tax saving.

ii Controlled foreign corporations (CFC)
Brazil has a CFC legislation that is applicable to any controlled and related foreign entities, whether they are involved in business activities or not. Profits are taxable at the Brazilian company at the time the controlled company closes its financial statements at the end of the fiscal year.

iii Transfer pricing
In Brazil, transfer pricing calculation is mandatory for (1) individuals or legal entities, resident or domiciled in Brazil, that conduct business transactions (goods and services importation or exportation and financial transactions) within an individual or legal entity, resident or domiciled abroad, considered a related party, even if acting as an intermediary; and (2) individuals or legal entities, resident or domiciled in Brazil, that carry out transactions with any person or entity, even if unrelated, resident or domiciled in tax havens or in countries with privileged tax regimes.

For import operations, the legislation allows the taxpayer to define the comparable price based on one of the methods outlined below.

**Resale price less profit (PRL)**
This is the weighted average of the resale price, less (1) granted unconditional discounts; (2) taxes and duties incurring on the sale; (3) paid commissions and brokerage fees; and (4) a fixed profit margin, which is set by the law and varies from 20 per cent to 40 per cent depending on the industry of the company. The PRL method is applied to imported goods, services or rights resold in Brazil directly, without any transformation, or incorporated into domestic production.

**Comparable independent price (PIC)**
PIC is defined as the weighted average price of goods, services or rights, that are identical or similar, calculated in the Brazilian market or in other countries, in purchase and sale transactions conducted by a Brazilian company or third parties when acquiring identical or similar goods, services or rights abroad.

**Cost Plus (CPL)**
CPL is defined as the average cost of production of identical or similar goods, services or rights in the country where they were originally produced, plus taxes and charges on exports in that country, plus a 20 per cent profit margin, calculated on the pre-tax cost.
**Price quotation method on import (PCI)**

PCI is a subdivision of the PIC method, specifically to commodities transactions, defined as the daily average prices of goods and rights listed in the internationally recognised Futures and Commodities Exchange.

The deductibility of some expenses is regulated by specific legislation and therefore is not subject to TP rules.

Export transactions may also be subject to transfer pricing rules according to specific methods.

**iv Tax clearances and rulings**

At all levels (federal, state and municipal), Brazilian tax law allows taxpayers, before completing a business transaction or even corporate reorganisation, to submit a formal consultation with the tax authorities regarding the interpretation of the applicable tax law to a given fact.

At the federal level, in addition to questions about the interpretation of tax legislation, it is possible to formulate specific consultations on (1) the tax classification of products and goods; (2) customs legislation; and (3) transfer pricing rules.

Although it is possible to formulate consultation on tax legislation, this practice is not widespread among taxpayers, as decisions made by tax authorities tend to disagree with any interpretation that entails a lower tax burden.

**X YEAR IN REVIEW**

**i Double tax convention (DTC) network**

There have been important Developments in Brazil’s DTC network in the last year. For instance, Brazil and Chile are revising their DTC to align it with the base erosion and profit shifting (BEPS) project’s minimum standards. The protocol of amendment is still under negotiation and has not been signed yet.

In addition, Brazil and Sweden have signed a protocol of amendment to their DTC, modifying several topics, such as withholding tax reductions to some specific incomes. The protocol still has to be approved by the Brazilian Congress and, afterwards, to be promulgated by a presidential decree to become effective.

The Brazilian Congress has recently published Legislative Decree 8/2019, which approved the protocol of amendment to the double tax treaty between Brazil and Denmark. The protocol still has to be promulgated by a presidential decree to become effective.

The amendment protocols to the Denmark and Norway DTCs with Brazil, which modify several topics such as withholding tax reductions to some specific incomes, was also approved and became effective.

Brazil also signed a DTC with Uruguay, which contains several rules aligned with the BEPS project minimum standards, such as general anti-avoidance rules and exchange of information among the contracting states’ tax authorities.

**ii Mercosur-EU Free Trade Agreement**

After 20 years of negotiations, the European Union and Mercosur have moved forward with the free trade agreement between the two blocs.
The agreement provides for international standards for transparency rules, increases access and competition in government purchases and provides efficiency and cost reductions for imports and exports.

The draft document is still subject to a legal review, translation to all participants’ official languages and final signature by the two blocs. Afterwards, the final document will be ready for parliamentary approval in each Member State of the EU and Mercosur.

iii  ‘Lawful Taxpayer’ programme

The Brazilian government has launched the ‘Lawful Taxpayer’ programme, providing regulations for taxpayers and tax authorities to negotiate terms for the settlement of outstanding federal tax debts.

This measure authorises federal tax authorities to reduce interest, penalties and charges by up to 50 per cent of the total debts and allows payment in instalments (up to 84 months). For small companies or individuals, the discount could reach 70 per cent, with instalments up to 100 months.

Provisional Measure 899/2019 must be converted into law within 60 days of its publication to remain applicable.

XI  OUTLOOK AND CONCLUSIONS

Tax reform is a recurring theme on the Brazilian political agenda. Some proposals for tax reform are on the agenda of the National Congress and the one that has made the most progress is Constitutional Amendment Proposal (PEC) 45/2019, which aims to extinguish the five indirect taxes currently collected by the government (IPI, PIS, Cofins, ICMS and ISS) and create a new tax (IBS), which would be levied on goods, merchandise, services and intangibles.

Under the proposal, the collection of the IBS tax would be divided among the federal, state and municipal governments, with each entity having the ability to establish the percentage that would be due to it within the single rate of the tax, according to certain criteria provided for in the proposal. The payments to states and municipalities would be due to the states and municipalities to which the goods and services are sent.

The proposal has several advantages over the current system. Firstly, the simplification would be drastic, not only by replacing the calculation and collection of five taxes with the calculation and collection of only one, but mainly because of the probable reduction of the numerous ancillary obligations and formalities that must be fulfilled by taxpayers today.

In addition, the payment of indirect taxation to the place of destination of the good or service tends to reduce the ‘race to the bottom’ that occurs between states and municipalities.

Another advantage of the proposal is to standardise taxation among the various sectors of the economy, ending the numerous sectoral regimes that make indirect taxation extremely complex and less isonomic. This standardisation is because of the prohibition on the granting of any kind of tax benefits by taxing entities, which has been the target of some criticism, especially for the absence of alternative proposals for regional incentives.
Chapter 5

CANADA

Julie Colden

I INTRODUCTION

Canada has a skilled labour force, a stable economy and political system, and well-developed capital markets. Thus, it is an attractive jurisdiction in which to conduct business. General combined federal and provincial corporate tax rates have been relatively stable in recent years in the range of 26.5 per cent to 30 per cent depending on the provincial allocation of income.\(^2\)

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Business may be conducted in Canada through many different types of arrangements, although corporations and partnerships are probably the most common forms of business organisation. Many factors influence the ultimate decision about how to conduct a business, including the nature of the activity, industry practice, regulatory regime and tax treatment. The most common arrangements are described below.

i Corporate

In Canada, businesses of any significant size are conducted most commonly through corporations,\(^3\) which can be established under provincial, territorial or federal law. Consistent with the principle that a corporation has a legal personality separate from its shareholders, a corporation may own property, incur obligations and carry on business. Absent an agreement to guarantee the corporation’s obligations, the shareholders’ obligations are generally limited to the capital they have invested or, in certain circumstances, to the funds they have extracted from the corporation. A corporation must file certain information, including directors’ names, on the public record, must annually hold a shareholders’ meeting and must provide copies of its financial statements to the shareholders. Shareholders also have rights to certain additional information from the corporation upon request.

Corporations can be incorporated quickly under federal law or provincial law, and without significant cost, once certain basic decisions are made, including identifying the

\(^{1}\) Julie Colden is a tax partner at Davies Ward Phillips & Vineberg LLP.

\(^{2}\) KPMG Canadian corporate tax tables 2019 and 2020.

\(^{3}\) One exception is real estate businesses, which are sometimes carried on by a commercial unitised trust that qualifies as a real estate investment trust (REIT).
terms of shares to be authorised, the directors and the corporate name, with the default being a numbered corporation. Consistent with the principle of limited liability, the name must include ‘Limited’, ‘Incorporated’, ‘Corporation’ or a corresponding abbreviation.

Directors must be individuals. While they need not be residents of Canada, some corporate statutes require a minimum percentage of Canadian-resident directors. Directors generally do not have to be shareholders.

Corporations may authorise and issue common shares only or shares in more than one class, with each class conferring on the shareholders different rights (e.g., dividends, votes, redemption, conversion, etc.). Corporations generally have no minimum capital requirements subject to any applicable regulatory regime (e.g., for financial institutions). Shares cannot be issued until the subscription price is fully paid in money, property or past services.

Corporations may be privately owned or offer their shares and other securities to the public. Securities offerings are regulated by securities commissions in each province (although policies are coordinated to facilitate compliance) and, if the securities are to be listed for trading on a public market, by that market. Both English and French are official languages in Canada, and offering documents delivered to residents of Quebec may have to be translated into French.

Public companies must provide investors with annual audited financial statements, have an audit committee, and hold annual shareholders’ meetings. Prior to the annual shareholders’ meetings, these public companies must send an information circular to their shareholders containing prescribed information, including information about the matters to be considered at the meeting and executive compensation.

The corporate law of three Canadian provinces also permit unlimited liability companies (ULCs) to be established. As the name suggests, shareholders of ULCs may be liable for the debts of the ULC. The principal advantage of a ULC is that it may be disregarded or treated as a partnership (i.e., a flow-through entity) under United States check-the-box regulations. However, ULCs are treated as companies, and thus taxpayers, for Canadian tax purposes. Under the Canada–US Income Tax Convention (1980) payments made by a ULC to US residents may not be eligible for reduced rates of withholding if the anti-hybrid rules in that treaty apply.

Taxation

Although further details are provided below, in general terms, Canadian-resident companies are taxed on worldwide income from all sources and must file returns annually. Generally, any corporation incorporated under Canadian law will be deemed to be a tax resident of Canada.

ii Partnerships

Partnerships are another common form of business arrangement, and are widely used in real estate, private equity and professional businesses. A partnership is generally described as the relationship between persons carrying on business in common with a view to profit. Partnerships may be general partnerships, limited partnerships or limited liability partnerships.

4 Shares of a class may be issued in one or more series.
5 Alberta, British Columbia and Nova Scotia.
6 See Article IV(7) of the Canada-United States Income Tax Convention (1980). When applicable, these anti-hybrid rules deny treaty benefits on any amount received from, or derived through, the hybrid entity.
A general partnership is formed by contract, typically governed by the laws of a province, and has no separate legal personality. Each partner is wholly liable for all of the debts of the partnership.

A limited partnership is formed under the laws of a particular province on obtaining a certificate of limited partnership. Each limited partnership must have at least one general partner. General partners are responsible for managing the partnership activities and have unlimited liability for partnership obligations. A limited partner’s liability is limited to its capital contribution (including any capital it agreed to contribute), unless a limited partner participates in the management of the partnership business, and, thus, assumes unlimited liability.

Limited liability partnerships share features of a limited partnership and a general partnership, but are available only to the business of a profession when permitted by the legislation governing such profession.

Partnerships are contractual relationships and, although not required, are typically governed by written partnership agreements. Accordingly, the members may agree to alter rights and obligations as between themselves. Partners have flexibility in providing for the sharing of profits, for the financing of the partnership activities and how those activities will be managed.

**Taxation**

While a partnership is not a taxpayer, its income or loss from each source is generally computed as if it were a separate person, and each partner must include in its income its share of the partnership income or loss for the partnership fiscal year ending in the partner’s taxation year. The partnership activities are considered to have been carried out by the partners for the purposes of identifying the source of the income, which may affect the rate of applicable tax.

Under special rules (SIFT rules), certain publicly traded partnerships that carry on business activities or earn certain types of income may be liable for tax on that income on the same basis as a public corporation. Any after-tax income subject to that tax is treated as a dividend payable to the partners.

Generally, limited partners are permitted to deduct their share of a partnership loss only to the extent their partnership investment is ‘at risk’. Any losses denied may generally be carried forward to future years for deduction when the partner’s investment becomes ‘at risk’.

Non-resident partners may be obligated to file a Canadian tax return and pay Canadian income taxes on their share of the partnership business income. A partnership with non-resident partners will be subject to withholding tax on certain payments it receives (e.g., dividends, royalties), but a resident partner’s share of such withholding taxes will be credited against its income tax.

Statutory rules generally prevent the deferral of partnership income through selection of partnership fiscal periods ending after the partner’s taxation year-end and tiering of partnerships with different fiscal periods.

**iii Trusts**

Although less common, business activities are sometimes carried on through trusts, most commonly in the real estate and resource industries. Trusts are taxable entities, but may reduce their income by distributing it annually to the beneficiaries, who are then taxed on their share of the distributed income. Unlike a partnership, however, a trust cannot flow any losses through to its beneficiaries and, with limited exceptions, the source of the income to
the beneficiary is income from a trust rather than income of the source (character) earned by the trust. The SIFT rules may apply to certain trusts that carry on business or earn certain types of income. However, REITs that meet certain conditions are exempt from the SIFT rules.

iv Canadian permanent establishment (PE)

A non-resident corporation may carry on business directly in Canada through a branch (PE). A PE is not a separate entity from its foreign ‘parent’. A foreign business that carries on business in Canada generally must register in each of the provinces in which the business is carried on and must designate an agent for service in that province.

Non-resident corporations who carry on business in Canada are subject to tax (including branch tax) on the income from such business (subject to treaty relief) and must file tax returns in Canada reporting their income and other amounts.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Canadian-resident corporations are taxed on their worldwide income from all sources, including business, property and capital gains. Income from business or property is the profit from such activities calculated in accordance with ‘well accepted principles of business (or accounting) practice’, adjusted as permitted or required by the tax legislation. As a practical matter, most corporations start with income as determined under generally accepted accounting principles (GAAP), although those principles are not determinative.

The tax legislation mandates certain adjustments. For example, the rates at which assets are depreciated for accounting purposes will generally differ from the rates at which capital cost allowance (tax depreciation) may be deducted in computing income for tax purposes.

Corporations may choose any taxation year, but no taxation year can exceed 53 weeks. Moreover, once selected, the taxation year cannot be changed unless the Canada Revenue Agency (CRA) agrees. However, certain events will result in a deemed taxation year-end (e.g., an acquisition of control) following which a different taxation year may be selected.

Some of the most common adjustments to accounting profits to compute income for tax purposes are described below.

Expenses

To be deductible for tax purposes, an expense must be reasonable, not on account of capital (except to the extent expressly permitted), not contingent and incurred for the purpose of earning income.

Certain expenses that might satisfy those tests nonetheless may be prohibited from being deducted. For example, no deduction is permitted in respect of stock option benefits conferred on employees. Business entertainment expenses are only partially deductible. Costs related to vacant land held for development generally must be capitalised. On the other hand, certain expenses that might be considered capital expenditures are deductible (albeit over time), including costs incurred to issue shares or borrow money.
Depreciation (capital cost allowance (CCA))

Depreciation taken in computing accounting profits must be added to income for tax purposes. Canada has a CCA system for depreciating assets such as buildings, machinery and equipment; properties of a similar nature are typically included in the same pool for CCA purposes. With few exceptions, property is depreciated for tax purposes on a declining balance basis at rates that range from 4 to 100 per cent.

CCA is recaptured in income if a depreciated asset is disposed of for an amount in excess of the balance of the pool to which it belongs. A deductible loss arises if the last asset in the pool is disposed of and an undeducted pool balance remains.

Capital and income

Capital gains may arise on the disposition of capital property (including depreciable property, where the proceeds exceed the original cost). Only 50 per cent of a capital gain (a taxable capital gain) is included in income. Capital losses may be realised on the disposition of non-depreciable capital property, and 50 per cent of such a loss (allowable capital loss) is deductible, but only against taxable capital gains.

Private corporations add the untaxed half (net of 50 per cent of any capital losses) to a special account (capital dividend account), the balance of which may be paid to its Canadian-resident shareholders as a tax-free dividend. In addition, taxable capital gains realised by a Canadian-controlled private corporation (CCPC) are included in investment income, which is subject to a special higher rate of tax that is refundable when the CCPC pays dividends.

Losses

Losses are generally categorised as net capital losses or non-capital losses.7 Net capital losses (being one-half of a capital loss not deducted in the year realised) generally may be carried back for three taxation years and carried forward indefinitely, but are only deductible against taxable capital gains realised in those years.

Non-capital losses generally may be carried back for three taxation years and may be carried forward for up to 20 taxation years.8 Non-capital losses generally may be deducted against taxable capital gains or income from other sources.

Immediately prior to an acquisition of control, a corporation has a deemed taxation year end, and accrued losses on most assets are deemed realised in that year. Thereafter, the utilisation of losses is restricted. Net capital losses, as well as any non-capital losses incurred in the course of earning income from property (rather than from a business), will expire unless used in the taxation year ending with the acquisition of control. Non-capital losses incurred in the course of carrying on a business may be carried forward for deduction in subsequent taxation years only if the loss business is carried on for profit or with a reasonable expectation of profit throughout the taxation year in which the loss is to be deducted. In

7 There are also special categories of losses not discussed herein, such as farming losses and allowable business investment losses. A distinction is also drawn between non-capital losses and property losses.

8 Non-capital losses realised in taxation years ending before 23 March 2004 had a shorter carry-forward period.
such a case, the loss is deductible against income (but not taxable capital gains) from the loss business or certain ‘similar’ businesses. Similar rules apply to the carry-back of losses from post-acquisition of control taxation years to pre-acquisition of control taxation years.

In the taxation year ending upon an acquisition of control, a corporation may elect to ‘step up’ the tax cost of capital property (including depreciable property) it owns to fair market value by deeming a disposition of such property for the amount it designates (not in excess of fair market value), thereby generating income or taxable capital gains against which the pre-acquisition of control losses may be deducted.

The rules relating to acquisitions of control extend to trusts – the loss restriction event being tied to changes in beneficiaries. However, trusts do not benefit from the elective step-up provisions.

**Rates**

Income tax is imposed by both the federal government and the provinces in which a business has a PE. The combined federal and provincial rate on business income ranges from approximately 26.5 to 31 per cent. A CCPC enjoys a preferential tax rate of approximately 9 to 15 per cent (depending on the relevant province or provinces) on active business income less than a specified threshold (generally C$500,000). While CCPCs are also liable for a higher rate of tax on investment income (50.2 to 54.7 per cent), a portion of that tax is refunded when dividends are paid by the CCPC.

**Administration**

**Tax returns for corporations**

Canada has a self-assessment system of taxation. Although each of the provinces assesses provincial income taxes, the federal government administers the provincial income taxes on behalf of most provinces. A corporation must file an income tax return for each taxation year, due within six months after the taxation year-end. Most corporations with gross revenue in excess of C$1 million must file returns electronically.

The typical taxation year is 12 months, but a corporation is deemed to have a taxation year-end immediately before an amalgamation, an acquisition of control of the corporation, or the corporation ceasing to qualify as, or becoming, a CCPC.

Corporations must pay monthly instalments on account of income taxes (quarterly for small CCPCs), and must pay the balance due by the end of the second month following the taxation year-end (third month for small CCPCs). While not all corporate taxpayers are audited, any taxpayer may be selected for audit. Large corporations rated as high risk (by industry, record, etc.) typically are audited annually.

The normal period for reassessing a corporation is four years (three years for CCPCs) after the initial assessment of taxes, but longer periods are permitted for certain types of income, if misrepresentations are made, for transactions with non-arm’s-length non-residents, and to accommodate loss carry-backs and similar adjustments. A corporation that disagrees with an assessment or reassessment may object (generally within 90 days). If the objection is upheld, the taxpayer may take the dispute to the Tax Court of Canada, from which an appeal to the Federal Court of Appeal is available, as of right. Thereafter, the appeal may be heard (with leave) by the Supreme Court of Canada.

The CRA has a number of well-established published administrative practices that generally may be relied on by the public. Taxpayers can seek an advance tax ruling from
the CRA addressing the tax consequences of proposed transactions. While such rulings are administrative and do not have the force of law, as a practical matter the CRA considers itself bound by its rulings.

**Tax grouping**

Canada does not accommodate consolidated income tax returns, and, thus, each taxpayer must compute its own income (or loss). However, closely connected corporations must share certain tax benefits (e.g., the C$500,000 low-rate threshold for a CCPC must be shared among associated CCPCs).

Following a study of a formal loss transfer system or consolidated tax reporting regime for corporate groups, the government announced that moving forward with a formal system is not a priority. While loss trading is generally precluded, well-accepted techniques may be used to move losses within an affiliated corporate group.

**ii Other relevant taxes**

**Taxes on goods and services**

Canada has a federal goods and services tax (GST) – a value added tax – levied at a rate of 5 per cent. Although the GST is imposed widely, input tax credits are intended to ensure that intermediaries receive a credit for the GST they pay so that the GST is borne only by the final user in the supply chain. Most provinces have adopted a harmonised sales tax (HST) based on the GST, administered for those provinces (other than Quebec, which has its own tax administration) by the federal government.

Of the non-participating provinces, Alberta does not impose a sales tax, and British Columbia, Manitoba and Saskatchewan levy and administer their own retail sales tax.

Property imported into Canada may be subject to customs or excise duties as well as GST and HST, although Canada is party to several free trade agreements.

**Property taxes**

Many provinces (and some municipalities) levy a separate tax on the transfer of land within the province (municipality). Municipalities typically levy annual property taxes on owners of real property, based on the assessed value of commercial and residential real property.

**Income tax and social security contributions**

Personal income tax rates imposed by provinces and the federal government are higher than corporate rates. The rates are progressive, increasing as income levels rise, but individuals with very low income may pay no income tax. The highest combined personal income tax rates in Canada are approximately 54 per cent.

Employers are required to deduct tax at source from remuneration paid to employees and remit the tax on behalf of the employee. In addition to federal and provincial income tax, individuals and their employers are required to make contributions to the federal public pension and employment insurance programmes. Employers are subject to provincial payroll and social security levies that vary among the provinces.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
A corporation will be deemed resident in Canada if it is incorporated in a Canadian jurisdiction. However, a corporation incorporated outside Canada may be resident in Canada if its central mind and management is exercised in Canada. Directors of such corporations should not hold meetings in Canada. Tiebreaker rules in Canada’s treaties may determine in which of two jurisdictions a corporation is resident if it is otherwise unclear. For example, under the Canada–United States Income Tax Convention (1980) treaty, a corporation otherwise resident in both Canada and the US will be deemed resident in the jurisdiction of incorporation; otherwise the competent authorities must decide. Under the Canada–United Kingdom Income Tax Convention, the competent authorities must decide. Other treaties may default to place of management.

ii Branch or permanent establishment
Under Canada’s tax legislation, a non-resident that carries on business in Canada will be liable to income tax on its taxable income earned in Canada regardless of whether it has a PE in Canada. Certain activities are deemed to be carrying on business in Canada (including soliciting orders or offering anything for sale in Canada regardless of where the contract is completed). However, in most of its treaties, Canada has generally agreed not to impose tax on business income except where the non-resident carries on business through a PE in Canada.

As a proxy for dividend withholding tax, Canada imposes a 25 per cent branch profits tax on non-residents that carry on business through a PE to the extent funds are not reinvested in the branch business. The rate is generally reduced to 5 per cent under Canada’s treaties, and some treaties provide for a partial exemption (e.g., under the Canada–United States Income Tax Convention (1980), the first C$500,000 of branch profits is exempt).

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

Canada is an attractive jurisdiction in which to carry on business because it has a relatively low corporate tax rate, a wide treaty network, a sophisticated tax system, relatively generous provisions relating to financing costs and a relatively generous regime relevant to controlled foreign corporations (foreign affiliates) of Canadian multinationals.

i Holding company regimes
Dividends may be tax-free when paid from one Canadian corporation to another. Although dividends paid to non-residents are subject to withholding tax at the statutory rate of 25 per cent, many bilateral tax treaties reduce the rate of withholding to 5 per cent for significant

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9 Subject to certain anti-avoidance rules and a special refundable tax payable by private corporations or certain corporations controlled by an individual on certain dividends (generally from portfolio investments), tax is refunded when the private corporation itself pays dividends. Recent tax changes have tightened the scope of the dividend-received deduction between taxable Canadian corporations.
corporate shareholders. Moreover, capital may be returned to shareholders as a legal reduction in capital free of Canadian withholding tax regardless of whether the paying corporation has significant retained earnings (see below).

Dividends received by Canadian corporations from non-resident corporations are included in income, subject to foreign tax credits and certain deductions available for intercorporate dividends under the Canadian foreign affiliate rules.

Although complex, the foreign affiliate rules exempt from Canadian tax dividends paid by a foreign affiliate to a Canadian corporation if the foreign affiliate has earnings from an active business carried on in a country with which Canada has a tax treaty or tax information exchange agreement (TIEA). Certain ‘passive income’ arising from intra-affiliate payments may be deemed active business income for this purpose.

On the other hand, under this regime, Canadian residents are required to include, on an accrual basis, their share of any foreign accrual property income (FAPI) earned by a controlled foreign affiliate (CFA). FAPI includes passive income, but also is deemed to include income from certain businesses that derive earnings from property (e.g., rents, royalties, interest, dividends, licence fees, etc.).

Canada has foreign affiliate dumping rules (FAD) that make it less attractive for foreign multinationals to establish a Canadian holding corporation for non-Canadian foreign affiliates. In general terms, an investment by a Canadian corporation that is controlled by a non-resident corporation, non-resident individual, non-resident trust or non-arm’s length group of the foregoing, in a foreign affiliate (or a Canadian corporation that derives more than 75 per cent of its value from foreign affiliates) may reduce cross-border paid-up capital or trigger a deemed dividend subject to withholding tax, subject to limited exceptions.

ii IP regimes
While Canada does not have any special IP regime, tax incentives in the form of tax credits or generous write-offs may be available for development of IP in Canada.

iii State aid
Both the federal government and provincial governments provide targeted incentives for particular business activities. These may take the form of tax credits, forgivable loans, tax holidays, subsidies or accelerated write-offs for qualifying expenditures (e.g., renewable energy). Corporations in the oil and gas, mining and renewable energy industries are permitted to renounce certain deductible expenses to shareholders who subscribe for ‘flow-through shares’ to fund corporate expenditures, permitting the shareholders to deduct the expenses rather than the corporation. There are relatively generous incentives for expenditures on ‘scientific research and experimental development’ in the form of immediate deductions for qualifying expenditures and investment tax credits.
VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
Canada imposes withholding tax at a statutory rate 25 per cent rate on most types of passive income paid to non-residents, including dividends, management fees, rents, royalties, trust and estate distributions, and payments for restrictive covenants (e.g., non-competition covenants). Such rate of withholding may be reduced under an applicable bilateral income tax treaty.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
Canada does not impose withholding tax on interest paid to non-residents who deal at arm’s length with the Canadian-resident payer unless the interest is ‘participating debt interest’ (i.e., interest computed with reference to revenue, cash flow, dividends, profits, commodity price or production from property). However, interest that is not deductible pursuant to thin capitalisation rules is recharacterised as a dividend for withholding tax purposes. (See below for a general discussion of the back-to-back rules and their impact on withholding tax.)

iii Double tax treaties
Canada’s extensive treaty network consists of more than 90 treaties that typically reduce the rate of withholding tax on passive income. Dividend withholding is typically reduced to 15 per cent (5 per cent where the shareholder is a corporation with a significant investment in the dividend payer), and rent (other than from real property), royalty and trust distributions generally enjoy a 15 per cent rate. Some treaties eliminate withholding on particular types of royalties, and most treat management fees as business profits governed by the PE article. Where the domestic exemption from withholding tax does not apply, Canada’s treaties typically reduce the rate of withholding on interest to 10 per cent.

iv Taxation on receipt
Canada’s system for taxation of dividends from foreign affiliates operates largely as an exemption system. As discussed above, shareholders of a CFA must include in income, on an accrual basis, their share of FAPI earned by the CFA. Otherwise, income earned by a foreign affiliate generally is not taxed in Canada unless repatriated to Canada. Moreover, active business income earned by a foreign affiliate in a country with which Canada has a tax treaty or TIEA10 may be repatriated to its Canadian corporate shareholders as a dividend without any further Canadian tax.

Dividends from foreign corporations that are not foreign affiliates are taxable in Canada subject to a foreign tax credit. Moreover, in some circumstances, Canada taxes residents on passive income earned offshore and not encompassed within the foreign affiliate regime (see below).

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10 Tax Information Exchange Agreement.
VII TAXATION OF FUNDING STRUCTURES

Canadian corporations are typically funded by a combination of debt and equity (including common and preferred shares). Preferred share dividends may result in the issuer of such shares being liable to a special tax (partially creditable against ordinary income tax) where the preferred shareholder does not have a significant interest in the dividend payer. This regime is intended to discourage corporations that are not in a tax-paying position from using preferred share financing.

i Thin capitalisation

Canada restricts the deduction of interest on debt held by ‘specified non-residents’ (i.e., non-resident shareholders, or non-resident persons who do not deal at arm’s length with shareholders who, alone or together with non-arm’s-length persons, own shares representing at least 25 per cent of the votes or value of the corporation). In general terms, interest on debt held by specified non-residents will not be deductible to the extent that such debt exceeds 1.5 times the relevant ‘equity factors’.

Equity includes the corporation’s non-consolidated retained earnings at the beginning of the taxation year, and its monthly average paid-up capital attributable to shares held by, and its monthly average contributed surplus contributed by, specified non-resident shareholders. Because only paid-up capital and contributed surplus attributable to direct shareholders is included in equity, debt is typically advanced by specified non-residents to the first-tier Canadian corporation rather than a corporation further down the corporate chain. (See discussion below regarding potential reductions to paid-up capital.)

In recent years, Canada has extended the thin capitalisation rules, with modifications considered appropriate, to debt of partnerships, trusts and branches of non-resident corporations.

Any interest that is not deductible because of these rules will generally be treated as a dividend paid to the specified non-resident for withholding tax purposes.

Back-to-back (B2B) loan rules target circumstances in which an intermediary that deals at arm’s length with the Canadian borrower is funded (or given security interests in respect of property to support the loan) by a non-resident (ultimate funder) with whom the borrower does not deal at arm’s length. These rules are intended to prevent arrangements that are perceived as circumventing the thin capitalisation and withholding tax rules. Where they apply, their general effect is to treat the loan, for withholding tax and thin capitalisation purposes, as if it were made by the ultimate funder.

ii Deduction of finance costs

Financing costs are typically considered to be on capital account and therefore not deductible except to the extent expressly permitted. Like other expenses, they are also deductible only to the extent they are reasonable and not contingent.

Financing costs (such as commitment fees, investment banker fees, underwriting fees, placement fees) related to the issuance of shares or debt typically are deductible in equal parts over five taxation years, subject to proration for short taxation years.

11 Technically, the ratio is based on a monthly average of the greatest amount of such debt outstanding in each month.

12 The average is based on contributed surplus and paid-up capital at the beginning of a calendar month.
Interest is deductible only to the extent it is payable in respect of money borrowed, or in respect of an amount payable for property acquired, for the purpose of earning income. Interest borrowed to acquire common shares typically would meet this test. Where a Canadian corporation borrows money to acquire another Canadian corporation and the two corporations merge, the interest generally will be deductible against the earnings of the merged corporation.

Subject to the thin capitalisation rules, simple interest is deductible on an accrual basis, but compound interest is deductible only when paid. Prepayment penalties related to early retirement of debt are typically treated as interest and deductible over the remaining term of the debt rather than in the year paid.

iii Restrictions on payments
Dividends must be declared by directors and may be paid only to the extent that the directors are satisfied that the corporation will meet the relevant solvency test in the governing corporate statute. Although there are variations among the corporate statutes, a common solvency test is that the corporation must, after paying the dividend, be able to pay its liabilities as they become due and have assets with a realisable value not less than the sum of its liabilities and the stated capital of all shares.

iv Return of capital
Corporations may distribute paid-up capital to shareholders regardless of whether the corporation has undistributed income as a return of legal stated capital. A distribution of capital by a private corporation will not be taxable but will reduce the shareholder’s tax cost of the shares. A gain will arise only if the tax cost is reduced below zero as a result.

A distribution of capital by a public corporation will be treated as a taxable dividend absent an applicable exception. Exceptions include distributions of capital occurring on a reorganisation of capital or the business, or distributions following, and funded from the proceeds of, a disposition of assets outside the ordinary course of business.

Distributions of capital usually require shareholder approval and the satisfaction of solvency tests contained in the corporate statute governing the corporation.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Typically, but not universally, a Canadian corporation will be established to acquire a Canadian target. This approach facilitates the deduction of interest expense associated with the acquisition financing against the target’s earnings through a post-acquisition merger of the acquirer and target. Secondly, a non-resident acquirer typically wants to establish cross-border paid-up capital to maximise the opportunity to repatriate funds free of Canadian withholding tax. Finally, in certain circumstances, the acquirer will be able to ‘bump’ the tax cost of the target’s non-depreciable capital property to fair market value. This may facilitate a sale, or a distribution to the foreign parent, of the asset free of Canadian tax.

On the other hand, paid-up capital may be reduced where a Canadian-resident corporation controlled by a non-resident corporation uses capital, retained earnings or borrowed funds to make an investment in a foreign affiliate (or in a Canadian corporation.
that derives 75 per cent or more of its value from foreign affiliates) under Canada’s FAD rules. If the investment in the foreign affiliate exceeds the paid-up capital, the excess may be deemed a dividend paid to the non-resident controller.

ii Reorganisation

Corporations can merge on a tax-deferred basis in Canada either through an amalgamation or by the winding-up of a wholly owned subsidiary into its parent corporation, provided both are taxable Canadian corporations. Amalgamations generally require the corporations to be governed by the same corporate statute (e.g., the same provincial statute or the federal statute). However, it is not difficult to continue a corporation from one Canadian jurisdiction to another with shareholder approval. As a general matter, the tax attributes of the two merging corporations are carried over to the merged corporation, subject to there not being an acquisition of control.

Assets typically can be moved between Canadian corporations or into Canadian partnerships on a tax-deferred basis if the transferee issues equity to the transferor and a tax-deferral election is made. Generally, shares of one foreign affiliate may be transferred on a tax-deferred basis to another foreign affiliate in exchange for shares of the acquiring affiliate.

Spin-off transactions can be effected on a taxable or tax-deferred basis, although in the latter case extensive conditions must be satisfied and restrictions may be placed on the corporation that spins off the assets as well as the corporation that is the subject of the spin-off.

iii Exit

Provided that the governing corporate law permits it, corporations may continue from one jurisdiction to another. A Canadian corporation that emigrates to a jurisdiction outside Canada generally will be considered to have disposed of all of its assets for fair market value proceeds, and to have realised any resulting income or losses in the taxation year that is deemed to end immediately before it emigrates. In addition, the corporation will be liable for a special departure tax, analogous to a dividend withholding tax, levied at 25 per cent on the corporation’s surplus (subject to reduction to a treaty rate). The tax is applied to the difference between the fair market value of the corporation’s assets and the total of the paid-up capital of its shares and its debt or other amounts payable outstanding at that time.

Corporations that are established outside Canada and continue into Canada generally will enjoy a step up in the cost of their assets, generally to fair market value, and generally thereafter will be treated as if they had been incorporated in Canada.

A non-resident of Canada that disposes of shares of a Canadian corporation or partnership interest will not be subject to Canadian tax on exit unless the shares or partnership interest constitutes ‘taxable Canadian property’. Generally, shares or a partnership interest will constitute taxable Canadian property if they derive more than 50 per cent of their value from Canadian real property, resource property, or timber resource property at any time in the sixty-month period preceding the date of disposition. In certain cases, an applicable bilateral income tax convention may provide relief from taxation. A non-resident that disposes of taxable Canadian property is subject to clearance certificate obligations and related back-up withholding (discussed below) and must file a Canadian income tax return reporting the disposition.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Canadian tax legislation contains many specific anti-avoidance rules, but also a general anti-avoidance rule that may be applied to recharacterise a transaction or series of transactions where a tax benefit has been enjoyed, and there has been a misuse or an abuse of tax legislation or treaties.

ii Controlled foreign corporations (CFCs)
As discussed above, passive income (FAPI) earned by a CFA is included in the Canadian shareholder’s income on an accrual basis. Moreover, passive income earned in offshore entities other than CFAs, and not repatriated to Canada, may give rise to deemed Canadian income, based on prescribed rates applied to the ‘designated cost’ of the investment.

iii Transfer pricing
Canada’s transfer pricing rules apply to transactions between Canadian residents (or non-residents carrying on business in Canada) and non-residents with whom they do not deal at arm’s length. Their objective is to preserve the Canadian tax base by ensuring that Canadian taxpayers do not inappropriately reduce income (and thus tax liability) through advantageous or disadvantageous pricing with non-arm’s-length persons. Related persons are deemed not to deal at arm’s length, but unrelated persons may be considered not to deal at arm’s length as a factual matter.

These provisions permit the CRA to make adjustments to any amounts relevant to taxation of the Canadian resident where the terms and conditions of the transaction differ from those that would have been agreed to by arm’s-length persons. The Canadian resident has contemporaneous documentation obligations, and failure to meet them may result in the imposition of penalties.

Transactions between non-arm’s-length Canadian residents also may be subject to adjustment if not carried out at fair market value, albeit not under the transfer pricing rules. In some circumstances, the adjustments are one-sided such that an expense may be reduced (or receipt may be increased) without an adjustment to the income of the recipient (payer) of the amount. Contemporaneous documentation is not required for purely domestic transactions.

iv Tax clearances and rulings
Tax clearance certificates are required where a non-resident disposes of taxable Canadian property. In the absence of such certificate, the purchaser is obligated to withhold a portion of the purchase price of the property and remit it on the non-resident’s behalf. In general terms, taxable Canadian property is now limited to Canadian-situated real property (including mineral resource properties, oil and gas properties, and timber limits) and shares and partnership or trust interests that, at any time in the 60 months preceding the disposition, derived more than 50 per cent of their value from such property.

Tax clearance certificates are not generally otherwise required, but may be advisable before assets are distributed to shareholders or trust beneficiaries. Failure to do so may result in those who make the distribution being liable for unpaid taxes to the extent of the value of the assets distributed.

The CRA will provide advance income tax rulings on particular tax issues to named taxpayers who apply for a ruling in advance of the relevant transaction. Such rulings are
considered binding on the CRA with respect to the taxpayer who makes the application. Obtaining an advance tax ruling typically takes at least six months, but may take significantly longer.

X YEAR IN REVIEW

Canadian corporate tax rates have remained relatively low while income tax rates applicable to individuals have remained high by global standards.

A number of legislative changes aimed at preserving the tax base have been introduced in recent years, including extending loss restriction rules to trusts, extending the thin capitalisation rules to trusts, partnerships and non-residents carrying on business in Canada, introducing the FAD rules targeting foreign-controlled Canadian corporations using corporate surplus or capital to make investments in foreign affiliates, strengthening the FAPI system and broadening the anti-avoidance measures in the thin capitalisation rules. A number of legislative changes were made to deny the benefits of transactions that sought to change the character of amounts recognised for tax purposes from income to capital gain and to further restrict the inter-corporate dividend deduction. The B2B rules were extended to royalty and rental arrangements, and a character conversion element was introduced where the B2B arrangement includes a combination of royalty payments and interest payments. For this purpose, royalty is broadly defined and may include payments for services.

In July 2017, the federal government announced broad changes to the taxation of private corporations in Canada and launched a 75-day consultation period. These measures were stated to be motivated by a political desire to prevent high-income individuals from gaining an unfair tax advantage over the middle class. However, many of the proposals were sharply criticised, and the government received some 21,000 submissions. While the federal government has determined to abandon a number of the proposed changes, it moved forward with changes to prevent income splitting and to discourage the accumulation of significant passive investment portfolios. Intergenerational business transfers are also a stated focus of the government. The 2019 federal budget contained proposals to limit the monetary value of stock option grants by ‘mature’ businesses that can be eligible for taxation at capital gains rates.

Canada has continued to expand its network of TIEAs and negotiate changes to its existing treaties and additional treaties. In 2019, Canada ratified the Multilateral Instrument13 (MLI). Canada initially chose to adopt the minimum standards in the MLI plus a binding arbitration provision for treaty disputes, stating that Canada has accepted the principal purpose test as an interim measure regarding treaty abuse but will consider limitation of benefits provisions in its treaty negotiations. In 2019, Canada announced the adoption of the following additional provisions: (1) a one-year holding period test for shares to benefit from treaty-reduced rates for dividends; (2) a one-year lookback test in determining whether shares derive their value principally from immovable property; and (3) the use of certain factors by competent authorities to resolving dual residency. As a result, provisions of the MLI may come into force for covered tax agreements in January 2020.

13 The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.
XI OUTLOOK AND CONCLUSIONS

As a member of the Organisation for Economic Co-operation and Development, Canada is involved in the multilateral process to develop international standards for the taxation of digital services. However, the government indicated in its 2019 re-election platform that it plans to introduce a new federal digital services tax. The province of Quebec has already enacted legislation requiring certain non-resident suppliers and digital platforms to collect tax on taxable supplies made to Quebec consumers.

A federal budget is expected to be released in early spring 2020. Part of the federal government’s 2019 re-election platform was to limit the amount of interest that certain corporations can deduct and to limit the tax benefits of hybrid debt mismatch arrangements and continue its commitment to strengthen and grow the ‘middle class’. The federal government remains committed to augmenting tax enforcement, both domestically and internationally and working collaboratively with revenue authorities in other countries to enhance tax administration and transparency.
I INTRODUCTION

Colombia is currently the country in Latin America that is growing faster and that is seen abroad as one of the best alternatives to invest in the region. Although Colombia is friendly with foreign investment and is making efforts to improve legal conditions for foreign investors, unfortunately tax regulations are not helping this purpose. Colombia has already had 10 major tax reforms in the past 20 years. The result is a much more complicated tax system with many new rules and much more control tools for the tax authorities; all these changes have created legal uncertainty and a very high tax burden for businesses.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

From a corporate perspective there are two alternatives to run a business in Colombia: (1) by incorporating a local legal entity; or (2) by creating a Colombian branch of a foreign entity. In general, when performing short period activities there is no need to adopt a corporate form in the country; when activities become permanent, a branch or a local entity has to be incorporated.

i Corporate

The most common corporate vehicles incorporated in Colombia are as follows.

Limited liability companies (LLCs)

LLCs are required to have at least two quota holders but no more than 25. Quota holders’ liability is limited to the amount of their contributions, except for labour and tax purposes for which they are severally and jointly liable. They do not require an external auditor unless they meet the income or equity cap (approximately US$1.2 million of equity and US$730,000 of income for 2019). A board of directors is not mandatory.

Corporations (SA)

Corporations are required to have at least five shareholders. Shareholders’ liability is limited to the amount of their contribution. They are required to have an external auditor. A board of directors is also mandatory.

1 Benjamin Cubides is a founder-partner at Cuval Abogados.
**Simplified companies by shares (SAS)**

This is the most popular investment vehicle. Its main characteristics are its flexibility and the simplicity of its incorporation process. SASs are also allowed to have a unique shareholder and indefinite duration. Unless the SAS meets the income or equity cap applicable for limited liability companies, it does not require an external auditor. A board of directors is not mandatory.

**Branches**

Branches are a business establishment incorporated by its home office in Colombia to carry out its corporate purpose. They do not have an independent legal personality. The home office is jointly and severally responsible for the liabilities of its branch.

**ii Non-corporate**

**Corporate trusts managed by a supervised financial entity**

This non-corporate vehicle is fiscally transparent and, as a general rule, is not considered a taxpayer to the extent the beneficiary of the trust can be identified, in which case the profits of the trust will be taxed at the beneficiary level. It is of common use to manage investors’ funds and use them as instructed by investors.

**Foreign capital investment funds**

Foreign capital investment funds are not taxpayers; foreign investors are considered taxpayers in Colombia for profits obtained in the country through the foreign capital investment fund. Every month the fund manager in Colombia will withhold the income tax on profits obtained at the special 14 per cent rate (25 per cent for payments to investors located in any of the listed low tax jurisdictions)\(^2\) which is the final tax for the foreign investors. A reduced 5 per cent withholding tax rate applies on profit obtained from private or public fixed income securities, or financial derivatives with an underlying asset that is a fixed income security.

Current rules oblige the fund manager to inform about foreign beneficial owners when required by tax authorities.

### III DIRECT TAXATION OF BUSINESSES

**i Tax on profits**

**Determination of taxable profit**

The taxable profits (i.e., net taxable income) for the taxable year (i.e., from 1 January to 31 December) are calculated as follows: to any taxable ordinary or extraordinary income obtained by the taxpayer, deductible costs and expenses will be applied to obtain the taxable profit. As a general rule, accounting income, costs and expenses will be the base to calculate the taxable profit, unless special rules apply. The most common adjustments made for income tax purposes are: (1) accounting income from valuation of investments or other assets will

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\(^2\) The list is contained in Article 1.2.2.5.1. of Decree 1625 of 2016 and includes, among others Antigua and Barbuda, Hong Kong, Bahamas, Marshall Islands, Mauritius, Seychelles, St Kitts and Nevis, etc.
not be considered for tax purposes; (2) depreciation periods, which may differ for accounting and tax purposes; and (3) provisions, which are not deductible for tax purposes (except for provision on commercial account receivables). Profits are taxed on an accrual basis.

The net taxable income may not be lower than the presumptive taxable income, which for the year 2020 is equal to 0.5 per cent of the taxpayer net equity of the previous year; from 2021 the applicable percentage will be zero.

The deduction of costs and expenses incurred abroad that relate to local-source income are limited to 15 per cent of the taxpayer’s net income determined before subtracting said expenses. Taxpayers are entitled to deduct the depreciation of assets that are used in their income-generating activity, following any methods acknowledged by the applicable international accounting standards. Accelerated depreciation is allowed if certain requirements are met. For tax purposes, there is maximum yearly depreciation percentage depending on the type of asset, as follows:

- buildings: 2.22 per cent;
- aqueduct, plants, netting, transportation routes: 2.5 per cent;
- air fleet and equipment: 3.33 per cent;
- railway fleet and equipment: 5 per cent;
- river fleet and equipment: 6.67 per cent;
- weaponry and surveillance equipment, electric equipment, transport fleet and equipment, machinery and equipment, furniture and fixtures: 10 per cent;
- scientific and medical equipment: 12.5 per cent; and
- packaging, packing and tools, computer equipment, data processing networks, communication equipment: 20 per cent.

Taxpayers are entitled to amortise all investments related to their income-generating activity; yearly amortisation cannot exceed 20 per cent of the cost of the intangible asset. Payments to related parties located abroad for the exploitation of an intangible asset formed in Colombia will not be deductible.

Colombian tax residents are taxed on their worldwide income. Permanent establishments of foreign companies or individuals are taxed in Colombia on their attributable worldwide income. Non-residents are taxed only on their Colombian-source income.

**Capital and income**

Capital gains tax is a complementary tax with its own taxable base. Capital gains include the sale of fixed assets (i.e., assets that are not habitually sold by the entity) held for more than two years. Capital gains are taxed at a 10 per cent rate and they can only be offset with capital losses or reduced by costs and deductions related to such gains.

**Losses**

Tax losses generated up to fiscal year 2016 can be carried forward with no time limitation or cap while losses generated from fiscal year 2017 can be carried forward and compensated with ordinary income of the following 12 years. Although tax losses are not transferred to shareholders or quota holders, they may survive mergers and spin-offs according to the portion corresponding to their participation in the net worth of the new, surviving or resulting
entities and to the extent the corporate purposes of the new, surviving or resulting company and the company that originated the loss are the same. Statute of limitations for income tax return in which fiscal losses are assessed or compensated increases from three to five years.

**Rates**

The current corporate income tax rate is 32 per cent; this rate will decrease to 31 per cent for the fiscal year 2021 and 30 per cent for the fiscal year 2022 and onwards.

**Administration**

From a national perspective, in general businesses file an annual income tax return that has deadlines in the second half of April and according to their tax identification number. There are also monthly withholding tax returns and bimonthly and quarterly valued added tax (VAT) returns. Taxpayers are also required to file electronic tax information with the national tax authorities on an annual basis.

Form a local perspective, businesses have to file the local industry and commerce tax return accrued in the industrial, commercial or services activities performed within the jurisdiction of the correspondent municipalities. The tax return, if filed on an annual basis (except for Bogotá, which has a special regime) requires a bimonthly return. Municipalities also require the submission of electronic tax information on an annual basis.

The tax return due dates’ schedules are issued yearly for national and local duties.

Colombia has enacted 10 major tax reform in the twenty-first century and currently a new reform has been approved in Congress (in December 2019), which in general has the same content as the one approved in December 2018 but that was declared unconstitutional by the Constitutional Court and with effect only for 2019. All the recent reforms were intended to increase collections and to improve anti-evasion and anti-avoidance rules. Because there have been so many changes in recent years, there is no case law regarding all changes and the position of tax authorities is always changing and oriented to protect collections; all this creates legal uncertainty. In Colombia, our tax authorities are lacking enough officials to be able to audit taxpayers in a timely and effective manner; this implies that the risk of being audited is low, but in case of an audit tax authorities always maintain that no-one leaves with ‘empty hands’, which means that when facing an audit the risk of an official assessment is very high. As a new member of the Organisation for Economic Co-operation and Development (OECD), Colombia will continue adopting all recommendations of this entity along with the special recommendations in base erosion and profit shifting (BEPS).

The national tax authority known as DIAN is in charge of all national taxes, such as income tax, VAT, equity tax and financial transaction tax. Each municipality and state has their own tax authority. There are 32 states and over 1,000 municipalities.

As a general rule, the statute of limitations for the tax authorities to initiate an audit expires within a three-year period counted from the due filing date of the related tax return. If the related return was not filed in a timely basis, the statute of limitations for an official tax audit expires within a three-year period counted as from the date of filing. If an income tax return reflects a tax loss, or the taxpayer is subject to transfer pricing rules, the statute of limitations for a tax audit expires after a five-year period counted as from the date of filing of the related return. If the tax return was not filed, the statute of limitations for the tax authorities to request the filing and impose penalties is a five-year period counted as form the due filing date of the related tax return.
Although there are no regular routine audit cycles, the most common audits originate in: (1) a request for tax refunds; (2) tax losses carry-forward; (3) special tax benefits; and (4) complaints of third parties (i.e., a third party goes to tax authorities and gives information on possible acts of elusion or evasion).

Tax authorities do not issue advance tax rulings. Taxpayers may file questions to the tax authorities to obtain a general opinion on the tax treatment of an operation, but the tax authorities are not allowed to issue an opinion regarding a specific transaction or operation. Tax opinions are only binding to the tax authority and not for the taxpayers; this means that tax officials are obliged to apply the general tax opinion issued by tax authorities. Tax opinions issued by the tax authorities may be challenged by directly requesting the tax authority to reconsider the position or by filing an annulment suit before an administrative court.

**Tax grouping**

There is no consolidated tax grouping in Colombia. Therefore, assets, losses, dividends, interests, etc., may not move tax-free within the group. Groups are only obliged to: (1) report the subordination or control status and register the group with the chambers of commerce where they are domiciled; and (2) prepare a consolidated financial statement.

**ii Other relevant taxes**

**Value added tax (VAT)**

The general rule is that the sale of all tangible movable goods (immovable assets such as real estate are not taxed) and the rendering of services are taxed at 19 per cent unless an exemption is available, or a different rate applies.

To the extent the goods and services are subject to VAT, the seller will be entitled to credit VAT paid to vendors. Imports are also taxed except where an exemption applies. While the general rate is 19 per cent, the 5 per cent rate applies to specific goods and services. The sale of movable goods that are fixed assets of the seller is not taxed with VAT.

The VAT paid upon the purchase of goods and services may be treated as tax credit and reduce the VAT to be paid in the proportion represented by the income derived from taxable and exempt operations regarding the income generated in the corresponding period (i.e., bimonthly or quarterly).

Although the VAT is paid by the final customer, the following taxpayers are responsible for its collection: (1) in the sale of tangible movable goods, the seller; (2) in the rendering of services, the service provider; and (3) on imports, the importer.

As a general rule, the taxable base is the amount of the transaction.

VAT withholding, direct collection by purchaser or services user is applicable, among others, when the services are rendered by foreign non-residents or non-domiciled entities to local beneficiaries, in which case these the local party is obliged to self-asses and withhold the total VAT accrued in the corresponding transaction. If the local party is not a withholding agent, the foreign seller or services provider will be considered as responsible for the VAT in the transaction and will have to file VAT return and pay the tax due. For some digital services, services providers may opt for the payment intermediary (i.e., credit card issuer, bank, etc.) to withhold the VAT.
Net worth tax

A new net worth tax was approved in 2018 and renewed in 2019, and applies in 2020 and 2021. The main characteristics of this tax are the following:

- **taxable event**: the possession of net equity – as calculated for tax purposes, which may differ from equity as calculated for accounting purposes – equal or greater than 5 billion Colombian pesos as of 1 January 2020;
- **taxable base**: the net equity described in (a); this base may not change from one year to the other in more than 25 per cent the inflation of the previous year as certified by DANE, which is the official national statistics entity; this means that the taxable base of 2019 is almost a fixed base for the three taxable years;
- **taxpayers**: individual that are fiscal residents in Colombia on the worldwide patrimony; foreign individuals on their patrimony in Colombia; foreign companies on their patrimony in Colombia, excluding shares, accounts receivables, portfolio investments and assets under financial lease agreements;
- **rate**: 1 per cent; and
- **payment**: the net worth tax is due each year in two equal payments.

Industry and commerce tax

Industry and commerce tax is levied on the performance of industrial, commercial or service activities within a municipal jurisdiction. As a general rule, exports are not subject to industry and trade tax. The tax rate may vary from zero to 1.38 per cent. The taxable base is based on gross income. Regarding deductibility, 100 per cent of the industry and commerce tax that is effectively paid during the given taxable year is deductible for income tax purposes or 50 per cent of the tax effectively paid may be treated as a tax credit against the tax due; if the taxpayers chooses to apply the 50 per cent tax credit, the remaining 50 per cent will not be treated as a deducible expense.

For mining industry and commerce, tax is not applicable to the extent the amount paid for royalties for the extraction of minerals is equal to or greater than the industry and trade tax calculated (which is usually the case).

Financial transaction tax

Financial transactions tax is levied on the performance of financial operations that result on the disposition of funds that are deposited in bank, savings or deposit accounts (including those with the Colombian Central Bank), and debits on accounting records to make payments or transfer funds to third parties.

The tax rate is 0.4 per cent. The taxable base is the value of each financial transaction.

With regard to accrual and collection, financial transactions tax accrues when the disposition of funds takes place as a result of the underlying transaction. The tax is collected via tax withholdings, by the entities that are subject to the surveillance of the Financial Superintendence, in which the relevant bank, savings or deposit account is held, or in which the accounting records related to the transfer of rights to third parties or the disposition of funds occur.

In terms of deductibility, 50 per cent of the financial transactions tax that is effectively paid during the given taxable year is deductible for income tax purposes.
Real estate tax
Real estate tax is levied on property located in urban, suburban or rural areas, whether constructed or not, at rates that range from 0.4 per cent to 3 per cent depending on the kind of property. The taxable base is generally the official appraisal of the real estate, although in certain jurisdictions (such as Bogotá) the appraisal is done directly by the taxpayer.

The real estate tax paid during the given year on property that has a cause and effect relationship with the income-producing activity of the taxpayer is fully deductible for income tax purposes.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Legal entities incorporated in Colombia or with their main domicile in the country, or entities with the effective place of management in Colombia are considered tax residents. Although permanent establishments of foreign entities are not considered tax residents, they are subject to tax on their worldwide attributable income. Foreign non-domiciled entities are not considered tax residents.

ii Branch or permanent establishment
Since 2012, Colombia has local rules on permanent establishment (PE). These rules follow the OECD Model Tax Convention in its 2010 version, meaning that to determine whether a foreign entity has a PE in Colombia or not the criteria of the OECD Model Convention will be followed. In addition, under Section 471 of the Colombian Commerce Code foreign companies doing business in Colombia, if they carry out permanent activities in Colombia, are required to incorporate a branch or a subsidiary (as explained in Section II); the branch will be treated as a PE for tax purposes.

Profit of the PE or branch for tax purposes will be attributed based on assets, functions, risks and personnel of the PE or branch.

In the case of double tax treaties signed by Colombia, PE and tie breaker rules of the treaty will apply. Unfortunately, Colombia has a short treaty network that comprises only 13 treaties signed and nine of them enforceable.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Free-trade zones
Industrial goods and service users of a free-trade zone are subject to a special 20 per cent income tax rate. This special rate does not result on dividends being taxed at the shareholder level.

ii Investments in the tourist sector
Investments in new or remodelled hotels or in new theme parks or agricultural or ecotourism parks or in new nautical docks will be subject to a 9 per cent income tax rate; for small cities investment has to be made within the following 10 years and the benefit is for twenty years; for big cities investment has to be made within the following four years and the benefit is for 10 years. This benefit does not result on dividends being taxed at the shareholders level.
iii Holding company regimes
There is a new holding company regime introduced in 2018 and renewed in 2019. Under this regime, dividends and profits in the sale of stakes are exempted for Colombian companies that have as a principal purpose the holding of securities, investment in shares in Colombia or abroad or the management of said investments. It has to be a company with a direct or indirect participation in at least 10 per cent of the capital of each entity for a period of at least 12 months.

The substance requirement is having at least three local employees, domicile in Colombia and proof that strategic decisions of investments are taken in Colombia.

The exemption is transmitted to foreign shareholders of the holding company, but not to Colombian shareholders. Distribution of the premium in the placement of shares to foreign shareholders is also tax exempt.

iv IP regimes
There are no special IP regimes in Colombia. Any benefits related with IP payments were eliminated following BEPS recommendations.

v State aid
There is no state aid in Colombia for specific sectors.

vi General
There are few incentives in the tax law and the trend is introducing more anti-avoidance rules. In addition, various differences in the accounting and fiscal treatment may apply, which results in an effective taxation on commercial profits much higher than the nominal income tax rate. Nevertheless, with a proper tax planning, any business in Colombia can manage to pay an effective rate on commercial profits equal to the nominal tax rate.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)
Regarding dividends there are two taxation rules: (1) corporate tax will be paid by the company or will be levied on dividends, therefore dividends paid out of profit that were taxed at corporate level will be considered as non-taxed dividends for the shareholders, while dividends paid out of profit that were not taxed at corporate level will be taxed when received by shareholders at the corporate rate and in the case of foreign shareholders the tax will be paid via withholding tax; and (2) after applying the previous rule, on net dividend payments a dividend tax will apply and will be paid via withholding tax; for foreign shareholders the withholding tax rate will be 10 per cent.

As a general rule, interest payments to foreign creditors for credits with a term higher than one year or for financial lease agreements are subject to a withholding tax of 15 per cent; for credit with a term lower than one year the withholding tax rate is 20 per cent. A special rate of 1 per cent applies on financial lease agreement on ships, helicopters and aeroplanes; a special rate of 5 per cent applies on financing with a term higher than eight years to finance public infrastructure under the Private-Public Association scheme.
Payments for royalties, such as exploitation of any kind of industrial property of know-how, including software, regardless of the source of the income, are subject to a 20 per cent withholding tax.

Any other payments made to foreign residents that, according to law, are considered domestic-source income are subject to an income tax withholding of 20 per cent in the case of services in general and lease agreements, and 15 per cent on any other domestic-source income not listed and with no special rate. Benefits from technical assistance, technical services or consulting services are considered domestic-source income, even if services are rendered from abroad.

Payments for management services to a related party located abroad are subject to a 33 per cent withholding tax.

In general, in case of payments subject to withholding tax, tax withheld will be considered the final tax and the foreign resident will not have to file an income tax in the country; in the case of payments for other concepts not listed, subject to the 15 per cent withholding tax, tax withheld is not final and the foreign resident has to file income tax in Colombia and asses the tax due in which case the withholding tax will be credited against it.

**ii Domestic law exclusions or exemptions from withholding on outward-bound payments**

In general, payments considered non-domestic-source income are not subject to tax in Colombia (i.e., the payor does not have to apply withholding tax and the recipient does not have to file income tax in the country). These payments will be deductible to a limit equal to 15 per cent of the taxable income of the Colombian payor before subtracting the limited payment.

Payments related to the following foreign indebtedness, among others, are considered as non-Colombian source income and therefore are not subject to withholding taxes in the country: (1) short-term credits, up to six-month term, originated in the import of goods and in bank overdrafts; (2) credits for the financing or pre-financing of exports; and (3) credits obtained abroad by financial corporations and banks.

**iii Double tax treaties**

The double tax treaty network is very small. Currently only nine double tax treaties are in force. There are four additional signed treaties that are pending Congress and Constitutional Court approvals. There is also the Andean Pact rule on double taxation for Andean Pact members (Bolivia, Colombia, Ecuador and Peru); these rules assign exclusive taxing rights to the source state for all types of income except for transport income, which is assigned to the residence state.

The following chart shows the most important tax reliefs derived from the double tax treaties:

<table>
<thead>
<tr>
<th>Country</th>
<th>Dividends**</th>
<th>Interest</th>
<th>Royalties</th>
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<tr>
<td>Spain</td>
<td>5% / 0% for shareholder with more than 20% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>Chile</td>
<td>7% / 0% for shareholder with more than 25% of capital</td>
<td>15%, 5% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>Switzerland</td>
<td>15% / 0% for shareholder with more than 20% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
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<td>Canada</td>
<td>15% / 5% for shareholder with more than 20% of capital</td>
<td>10% in all cases</td>
<td>10%***</td>
</tr>
<tr>
<td>Mexico</td>
<td>Taxed in residence country</td>
<td>10%, 5% or 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>India</td>
<td>5%</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>South Korea</td>
<td>10% / 5% for shareholder with more than 20% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>Portugal</td>
<td>10%</td>
<td>10% in all cases</td>
<td>10%***</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>15% / 5% for shareholder with more than 25% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>France*</td>
<td>15% / 5% for shareholder with more than 20% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%****</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>15% / 5% for shareholder with more than 20% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%****</td>
</tr>
<tr>
<td>United Arab Emirates*</td>
<td>15% / 5% for shareholder with more than 25% of capital</td>
<td>10%, 0% for qualified entities</td>
<td>10%***</td>
</tr>
<tr>
<td>Italy*</td>
<td>15% / 5% for shareholder with more than 20% of capital</td>
<td>10%, 5% or 0% for qualified entities</td>
<td>10%****</td>
</tr>
</tbody>
</table>

** Dividends paid with profits not taxed at corporate level are taxed when distributed, at the corporate income tax rate.

Treaty relief is granted under special rules contained in the protocol or in Article 10 of each treaty; relief reduces the tax to 0 per cent (Spain and Chile under certain conditions and Switzerland according to Article 10, 15 per cent (Canada, South Korea, India, France, United Kingdom and Italy) or 25 per cent (Check Republic); no relief is granted in the case of Mexico, Portugal and United Arab Emirates.

*** Includes technical services, technical assistance and consultancy.

**** Does not include technical services, technical assistance and consultancy.

iv Taxation on receipt

Tax credits are available in Colombia for income taxes charged abroad to taxpayers on foreign-source income, including dividends paid by foreign companies. However, such credits may not exceed the amount of tax that the foreign-source income would have paid in Colombia. The taxable income after tax credits may not be lower than 75 per cent of the presumptive taxable income.

There is a double credit on dividends: (1) tax credit for taxes paid at source on dividend distributions; and (2) indirect tax credit for taxes paid by the entity distributing dividends on profit obtained and from which dividends were paid; there is also the possibility to add another indirect credit for taxes paid on profits that were later distributed as dividends and are part of the profits later distributed by the entity distributing dividends to the Colombian shareholder. All credits are limited to the tax payable in Colombia on the dividends received.

The excess of foreign tax credit may be carried forward with no time limit, buy applying the same limits mentioned for any year in which the tax credit is applied.

VII TAXATION OF FUNDING STRUCTURES

The most common funding alternatives for companies held by foreign investors are: (1) capital contributions; and (2) foreign indebtedness.

The cost of capital contributions is 0.7 per cent on the amount of capital contributed and 0.3 per cent on the part of the contributions qualified as premium in the placement of shares. Foreign indebtedness does not trigger any costs.
i  Thin capitalisation
In general, interest paid on interest bearing indebtedness with related parties in Colombia or abroad will be deductible only on the part of the debt that does not exceed during the taxable year two times the patrimony of the entity as of 31 December of the previous year.

ii  Deduction of finance costs
Finance costs, including interest, premiums, bank fees and bank commissions, are fully deductible for income tax purposes to the extent they were subject to income tax withholdings when applicable. When not subject to income tax withholding, the 15 per cent deduction limit applicable to costs and expenses incurred abroad that relate to local-source income is applicable.

iii  Restrictions on payments
Companies and branches are required to set up a legal reserve with 10 per cent of the profits of each year until the legal reserve reaches 50 per cent of the subscribed capital (or assigned capital for branches). Each year, companies are required to distribute at least 50 per cent of the net profits, unless the shareholders’ meeting, with the vote of at least 78 per cent of the shares, decides to the contrary. In the SAS, the legal reserve and the minimum distribution rules are not mandatory.

iv  Return of capital
Equity capital can be repaid as a result of a winding-up process, capital reduction or reduction of the supplementary investment to the assigned capital (only available for branches). Capital reduction requires a previous authorisation of the Superintendence of Corporations and the Ministry of Social Protection. Capital returns are tax free.

VIII  ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i  Acquisition
Due to the rules on indirect sales, the controlled foreign corporation regime and the general anti-avoidance rules, any direct or indirect sale of a local business will be subject to tax in Colombia. Any profit obtained in the sale of a business will be subject to income tax at a rate of 32 per cent for 2020, 31 per cent for 2021 and 30 per cent from 2022. If the shares or assets sold were held for more than two years, the profit will be subject to capital gains tax at a rate of 10 per cent.

The sale of shares in Colombia is not subject to withholding taxes if the seller is a local entity; for a foreign entity selling to a local purchaser, there is a withholding tax of 15 per cent or 10 per cent if shares were held for more than two years by the seller.

ii  Reorganisation
Mergers and spin-offs are tax-free transactions provided they comply with certain requirements. Considering that there is a wide range of mergers and spin-off operations worldwide, in order for the reorganisation to be tax free it must comply with the Colombian Commerce Code requirements.
International reorganisations are allowed. However, if the reorganisation results on a local entity being wound up, the new, resulting or surviving foreign entity may be required to set up a branch in Colombia.

iii Exit
Relocation is, from the commercial law perspective, not possible.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Colombia has a general anti-avoidance rule that up to date have not been applied by tax authorities. This rule allows tax authorities to recharacterise any transaction that is considered to be abusive.

Colombia currently has a list of low tax jurisdictions that are qualified as such following the criteria in the Tax Code. In the case of preferred tax regimes there is no list and according to tax authorities’ position taxpayers have to determine base on the criteria in the law if a regime qualifies as a preferred tax regime or not.

ii Controlled foreign corporations (CFCs)
Colombia has OECD-oriented CFC rules, according to which any passive income (i.e., in general dividends, interest and royalties) obtained by a directly or indirectly controlled foreign entity will be considered as received by the controlling individuals or entities if they hold more than 10 per cent of the controlled entity or have a benefit greater than 10 per cent in the controlled entity. Taxable income of the foreign controlled entity will be determined by applying the Colombian tax rules. CFC rules apply to any foreign controlled entity regardless of where it is located; in the case of entities located in low tax jurisdictions or in a preferred tax regime, they will be deemed to be controlled entities.

iii Transfer pricing
Colombian transfer pricing rules are OECD-oriented. These rules affect income tax and the determination of assets and liabilities. Transfer pricing rules are applicable for taxpayers engaging in cross-border transactions with foreign related parties.

In general, taxpayers exceeding thresholds (i.e., gross equity of the year over approximately US$1.050 million or gross income over approximately US$640,000) for the year 2020, are required to comply with transfer pricing formal obligations. Formal obligations include: (1) the filing of transfer pricing informative returns for all transactions with related parties located abroad; and (2) preparing a transfer pricing study comprised by a master file and the local report for transactions worth more than approximately US$105,000 for the year 2020.

Regardless of the requirement to comply with formal obligations, all transactions with related parties located abroad have to be at arm’s length.

iv Tax clearances and rulings
No tax clearances or rulings are required to acquire a local business.
X YEAR IN REVIEW

We had a new reform enacted in Law 1943 of 2018 that came into force on 1 January 2019. During the first semester, all work was focused on understanding the new rules and for the government in issuing the decrees needed to apply the reform.

During the second semester of 2019, the Constitutional Court decided that the tax reform contained in Law 1943 of 2018 was unconstitutional for errors in its discussion and approval and would apply only for 2019. To avoid having revived all rules changed and derogated by Law 1943, the last part of the year was dedicated to negotiating and approving Law 2010 of 27 December 2019, which has similar content to that of Law 1943 of 2018.

All this is an unfortunate event that confirms how Colombia lacks legal certainty when it comes to tax regulations.

XI OUTLOOK AND CONCLUSIONS

Colombia is a country that offers excellent conditions for foreign investors. Unfortunately, the recent and common changes to tax rules made taxes one of the main obstacles to attracting foreign investment to the country. Hopefully, by following the recommendations of the OECD and once intended changes have been introduced to tax authorities, this will create a more friendly tax environment for inward investment; in any case, positive changes will be seen in the long term while negative aspects of taxation will still be there in the short term.
I INTRODUCTION

Cyprus has a very advantageous environment for inward investment. Different incentives exist, able to encourage non-residents to set up a business in, or invest through, Cyprus. In a nutshell, no restrictions on foreign share ownership exist, there are no withholding taxes on dividends or interest, the sale of shares and other titles is exempt from tax, the corporate tax rate is one of the lowest in the European Union (EU), while non-Cyprus tax residents (or non-domiciled) enjoy a number of tax exemptions. These, and other characteristics of the Cyprus tax system, shall be further analysed below.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Although different vehicles for carrying out business are recognised by Cyprus law, the most common type of business entity used is the private limited liability company. Various benefits surround the existence, operation and tax treatment of a limited company; these will be examined below.

i Corporate

Businesses usually adopt a corporate form; that of a private (or public) limited liability company with shares. A Cyprus company is fiscally opaque for tax purposes. Pursuant to Cyprus law, a company is a legal person with a separate legal personality, while its members are not personally liable for its debts and obligations (their liability is limited to the share capital contributed). A Cyprus company is a legal entity distinct from its members and as such it enjoys rights and is subject to duties that are not the same as those of its shareholders. Furthermore, the existence of the company does not depend on the existence or continuation of its members, as stipulated by the principle of perpetual succession. All of the above constitute the Cyprus company as a flexible corporate form for the purposes of conducting business.

1 Stella Strati is a partner at Patrikios Pavlou & Associates LLC.
ii Non-corporate

The establishment of partnerships is also possible. A partnership is not treated as a separate taxable person. It is a transparent entity and the tax is imposed on the actual partners and not on the partnership. Partnerships are widely used in joint venture projects and in smaller (usually family-owned) enterprises.

Also, Cyprus recognises the concept of trusts and in particular Cyprus international trusts (for settlors and beneficiaries that are non-Cyprus tax residents on the year preceding the year of the trust settlement). A Cyprus trust is not a taxable person. The income of a trust is assessed in the name of the trustee; however, because the beneficiaries are the persons entitled to the income, they are liable for any tax thereon. Trustees need to follow a matching approach when making distributions to the beneficiaries, so that any Cyprus tax is deducted and paid. Hence, a look-through approach must be applied.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Business profits of a Cyprus company, adjusted for various allowances and exemptions, are subject to tax at 12.5 per cent. Cyprus tax residents are taxed on their worldwide income. Profits are taxed on an accrual basis and the International Financial Reporting Standards are followed. Generally, expenses, wholly and exclusively incurred by a company in the production of taxable income are allowable. Private expenses, expenses not matched to taxable income or not validated through proper supporting documentation, provisions (depreciation, amortisation, impairment, obsolete stock), expenses linked to non-taxable assets, exchange differences, are included among others in the non-deductible expenses. However, capital allowances, balancing allowance computed on the disposal of non-current assets, notional interest deduction and notional loss in related party transactions are also deductible.

Capital and income

The corporation tax rate is 12.5 per cent. For individuals, the progressive rates for income tax are provided below. No capital gains tax exists, apart from the taxation of gains from the disposal of immovable property situated in Cyprus.

Losses

On a company level, tax-adjusted losses can be carried forward and be set off against tax-adjusted profits for the next five subsequent years. Losses cannot be carried back.

On a group level (subject to the existence of certain criteria and the formation of a tax group), group members may surrender losses from one loss-making member to another profitable one. A direct or indirect holding of at least 75 per cent for the entire tax year is necessary for a company to be considered as forming part of a tax group. As from 2015 onwards, the interception of companies established in the EU or in countries with which Cyprus has a double tax treaty or have signed the Organisation for Economic Co-operation and Development (OECD) terms for exchange of information, can be taken into consideration, for the calculation of an indirect holding. Furthermore, group relief is
available between companies established in an EU Member State, provided that the EU subsidiary has exhausted all means of surrendering or carrying forward the losses in its own state.

**Rates**

Business profits of Cyprus tax resident companies, adjusted in relation to allowances and exemptions, are subject to a flat tax rate of 12.5 per cent.

Income for individuals is subject to progressive tax rates. The first €19,500 is tax free, the next €8,500 is subject to a tax rate of 20 per cent, the next €8,300 is taxed at 25 per cent, the next €23,500 at 30 per cent and any amount above €60,000 at 35 per cent. A number of deductions and personal allowances are available.

**Administration**

The key tax authority in Cyprus is the Tax Department (under the Ministry of Finance). The Tax Department deals with all matters that relate to direct and indirect taxation. Local or municipal taxes are paid to the local municipalities, as applicable.

The tax year is the calendar year, both for legal and physical persons.

For income tax purposes, records must be retained for six years after the end of the relevant tax year. Taxpayers are required to submit tax returns once a year.

Legal persons are required to prepare audited accounts based on generally accepted audit standards. Companies should be registered online and submit their annual tax returns electronically. The submission deadline of the income tax return for companies for a given tax year is 31 March of the second year following the year-end. The provisional tax payment for entities is made in two instalments, on 31 July and 31 December each year. The payment of the final corporation tax under the self-assessment method is done by 1 August of the following year. This also applies for individuals preparing audited financial statements (i.e., having an income above €70,000).

Self-employed individuals who are not required to prepare audited financial statements must submit electronically their personal income tax return by 30 September of each year.

Employers are required to pay the employee’s income tax through the PAYE (pay as you earn) system one month after the salary payment. Salaried individuals must submit their personal income tax return by 31 July, while employers are required to submit their return of payments to employees and tax deducted for each tax year no later than 31 July of the following year.

The Cyprus tax process is that of self-assessment. Following the filing of a tax return, the Cyprus tax authorities have six years from the end of the relevant tax year to raise an enquiry (or 12 years in case of fraud or willful default).

Tax authorities’ decisions can be challenged by applying to the Tax Tribunal, which is an independent body, not forming part of the Tax Department. This application must be filed within 45 days from the notification of the relevant decision of the Tax Commissioner. The Tribunal must issue a decision within a year from the submission of the application. Also, taxpayers may submit a petition to the Administrative Court, which has jurisdiction to review at first instance the lawfulness of decisions, actions or omissions of any executive or administrative authority and has the power to validate or nullify any such decisions. The decisions of the Administrative Court are subject to appeal before the Supreme Court.
Tax grouping
No rules for tax grouping exist, except for the basic rules for group tax relief, described above.

ii Other relevant taxes
Other taxes in Cyprus include Value Added Tax (VAT), Special Defence Contribution (SDC), Capital Gains Tax and Stamp Duty.

The standard rate of VAT is 19 per cent, while reduced rates of 5 per cent and 9 per cent apply to certain supplies.

SDC is payable by Cyprus tax resident companies and individuals that are both tax residents and domiciled in Cyprus on passive income; namely rents, dividends and passive interest income. Dividends received by individuals (resident and domiciled in Cyprus) are subject to an SDC rate of 17 per cent. Dividends received by Cyprus tax resident companies are not subject to SDC (subject to specific exceptions mentioned below). The SDC rate for interest for both natural and legal persons is 30 per cent. Rent received by companies and by tax resident and domiciled individuals is subject to SDC at the effective rate of 2.25 per cent (3 per cent on gross rents less 25 per cent).

Capital gains tax applies only to direct and indirect disposals involving immovable property situated in Cyprus. It is imposed at the rate of 20 per cent on gains from the disposal of immovable property or gains from the disposal of shares in companies that directly or indirectly own immovable property situated in Cyprus.

Stamp duty is payable on any document that concerns any property located in Cyprus or on matters to be executed there. For contracts the value of which ranges between €5,001 and €170,000, the current rate of stamp duty is €1.50 for each €1,000 or part thereof; for contracts the value of which is over €170,000, the current rate of stamp duty is €2 for every €1,000 or part thereof, with a ceiling of €20,000. This maximum amount is payable on any document or on any transaction that has several documents. In such case, the parties may choose which of the transaction documents is the main document and only that main transaction document will be subject to the full stamp duty; the other transaction documents may be stamped as secondary documents, in the amount of €2 each, provided they are dated the same day (or very close) as the main transaction document. A number of instruments carry a fixed stamp duty, as per the provisions of Cyprus Stamp Duty law.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Cyprus income tax legislation does not include a clear provision on how an entity becomes a Cyprus tax resident. General practice looks at the ‘management and control’ thereof. The minimum requirements for an entity to be considered as a Cyprus tax resident are quite general and include: (1) the place of residence of the majority of the directors; (2) the place where the meetings of the board of directors are held; and (3) the place where the general policy of the entity is formulated. Therefore, it is possible for a non-locally incorporated entity to become a Cyprus tax resident if the above criteria are met.
ii Branch or permanent establishment
A non-Cyprus entity can have a fiscal presence in Cyprus through a branch or a permanent establishment (PE). The definition of a PE as included in Cyprus legislation generally follows that of the OECD model tax treaty. Therefore, for an entity to be deemed to have a Cyprus PE, a ‘fixed place of business’ is required to be established there (i.e., branch, office etc.).

Cyprus also recognises the concept of the agency PE. The relevant legislative provisions state that where a person – other than an agent of an independent status - is acting on behalf of an enterprise and has and habitually exercises in Cyprus an authority to conclude contracts in the name of the enterprise, that enterprise will be deemed to have a PE in Cyprus in respect of any activities which that person undertakes for the enterprise. An enterprise shall not be deemed to have a Cyprus PE merely because it carries business there through a broker, general commission agent or any other agent of an independent status, provided that they are acting in the ordinary course of their business. Usually an agent is considered to be independent if such person does not act upon detailed instructions of the enterprise; is subject to entrepreneurial risk; and provides similar services towards other enterprises.

In case a foreign entity has a Cyprus PE, then such a PE will be subject to tax in Cyprus on income accrued or derived from the business activity that is carried through such PE and on income arising from sources therein.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT
A lot of features of the Cyprus tax system can encourage inward investment. These include, among others, the IP regime, the Tonnage Tax System, the absence of withholding taxes, the expatriate relief and others mentioned below.

i Holding company regimes
No particular regimes exist in relation to Cyprus holding companies. However, a number of tax law provisions identify Cyprus as an attractive holding jurisdiction. Namely, dividend income received by a Cyprus holding company is generally exempt from any income tax in Cyprus (subject to the hybrid instrument exception explained below) and SDC (subject to the passive dividend rule explained below). Also, no withholding tax applies on any outgoing dividend or other profit distributions or interest, irrespective of any double tax treaty clauses. Furthermore, profits arising from the disposal of titles are tax exempt. Non-Cyprus tax residents, or Cyprus tax residents but not domiciled, shareholders of a Cyprus company are not subject to any SDC. Also, no restrictions on foreign share ownership exist; thus, a foreign investor can be the sole shareholder of Cyprus entity.

ii IP regimes
As of 1 July 2016, a new IP tax regime is applicable in Cyprus. This follows the nexus approach, according to which a direct link between qualifying income and own qualifying expenses is essential for the intellectual property to qualify. The level of the qualifying profits is positively correlated to the extent that research and development activities are performed by the same entity.

Under the previous IP regime, an overall 80 per cent deduction on profits was granted. Under the new rules, 80 per cent of the overall income derived from the qualifying intangible asset is treated as a deductible expense. A qualifying intangible asset is an asset that has been
acquired, developed or exploited by a person within the course of carrying out their business that is the result of research and developments activities. Such assets specifically comprise of (1) patents; (2) compute software; and (3) other intellectual property that is legally protected and comprises of utility models, intellectual property assets that provide protection to plants and genetic material, orphan drug destinations and extensions of protection for patterns or non-obvious, useful and novel (which are certified as such by an appropriate authority) where the person utilising these does not generate annual gross revenues in excess of €7.5 million from all intangible assets (or €50 million for groups). Qualifying intangible assets specifically exclude trademarks, business names, brands image rights and other intellectual property rights used for the marketing of products and services. Persons that may benefit from the Cyprus IP regime include: Cyprus tax resident taxpayers, tax resident PEs of non-tax resident persons as well as foreign PEs that are subject to tax in Cyprus.

iii State aid
There are limited approved State Aid schemes in Cyprus; however, the majority of these aim to enhance productivity in specific areas, such as rural tourism, high tech and innovative enterprises.

iv General
There are a lot of characteristics rendering the Cyprus tax system attractive.

Apart from the new IP regime described in Section V.ii, Cyprus tax resident ship owners or ship management companies that qualify under the relevant legislation in relation to qualifying ships (as defined therein) engaged in qualifying shipping activities (as defined therein) can fall under the Tonnage Tax System (TTS). The TTS refers to flat given rates of tax based on the net tonnage of the ship (i.e., no requirement for a computation of tax adjusted profits exist). It is also important to note that there is no tax levied on the disposal of qualifying ships and dividends distributed out of companies under the TTS are not subject to SDC.

Furthermore, various benefits are provided for natural persons. Individuals that were not Cyprus tax residents for any three out of the last five years prior to commencement of employment in Cyprus and at the same time were not Cyprus tax residents in the previous year, and provided that they receive emoluments over €100,000 per year, are granted a tax deduction of 50 per cent on emoluments for a period of 10 years.

Also, non-Cyprus tax resident individuals or Cyprus tax residents but non-domiciled in Cyprus are not subject to SDC on dividends, interest or rents.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)
Cyprus does not apply any withholding tax on dividends or interest paid to non-residents. Regarding the payment of royalties to a non-Cypriot tax resident, a maximum 10 per cent withholding tax applies on the gross amount of such payment if the royalty rights were used in Cyprus. Also, in relation to dividends, interest and royalties paid to entities incorporated in another EU member state, the provisions of the relevant EU directives apply.
ii  **Domestic law exclusions or exemptions from withholding on outward-bound payments**

Cyprus does not apply any withholding taxes on dividends, interest or royalties, save as mentioned above. The EU parent/subsidiary directive and the EU parent interest and royalties directive are fully applicable in Cyprus.

iii  **Double tax treaties (DTT)**

The Republic of Cyprus enjoys a wide network of double tax treaties, as it has entered into these with more than 60 countries. The majority of these treaties follow the OECD Model Convention (with the exception of the DTT with the United States, which follows the most recent model of United States Agreements).

iv  **Taxation on receipt**

Dividends are generally exempt from income or corporation tax in Cyprus. There is an exception in that dividends received from a foreign company will be subject to corporation tax if paid out from hybrid instruments; this applies from 2016 onwards.

Dividends are subject to SDC if received by a natural person who is Cyprus tax resident and domiciled. The relevant SDC rate is 17 per cent. Dividends received by a Cyprus tax resident company from a foreign entity are usually not subject to SDC unless the passive dividend rule applies; namely that the company distributing the dividend engages directly or indirectly in more than 50 per cent activities leading to investment income and the foreign tax burden on the income of the paying company is substantially lower (less than 6.25 per cent) than the Cyprus tax burden. Dividends received by a Cyprus company from another Cyprus company are not subject to SDC, subject to the four-year non-exemption rule; a dividend indirectly paid after four years from the end of the year in which the profits were generated is subject to SDC.

Any foreign tax suffered is credited against the equivalent Cyprus tax on the foreign income. In no case can the tax credit in respect of the foreign tax exceed the equivalent Cyprus tax. Credit is always granted to Cyprus tax residents on foreign tax suffered on foreign income irrespective of the existence of a double tax treaty or not.

Underlying tax relief applies only for Cyprus tax resident companies in relation to dividend income received from such companies from foreign sources. A number of double tax treaties entered into by Cyprus allow for relief from both withholding tax suffered and for underlying tax paid by the foreign paying out entity. However, because the majority of dividend income received is exempt from any Cyprus taxes, underlying tax relief is not common.

VII  **TAXATION OF FUNDING STRUCTURES**

i  **Thin capitalisation**

No thin capitalisation rules exist. Nevertheless, interest limitation rules (ILR) were introduced in 2019 as part of the wider implementation of the EU Anti-Tax Avoidance Directive (ATAD).

The underlying purpose of the ILR is to limit the provision of financing facilities to companies (based in high-tax jurisdictions) in low-tax jurisdictions through subsidiaries belonging to the same group. To do so, the ILR requires that the excess borrowing cost (EBC) that is greater than 30 per cent of taxable earnings before interest, tax, depreciation
and amortization (EBITDA) is not to be deductible for income tax purposes. As such, it limits the otherwise deductible EBCs to 30 per cent of taxable EBITDA. However, the EBC is deducted up to a de minimis threshold of €3 million per fiscal year. Standalone entities (not part of a group) are excluded from the ILR. Moreover, grandfathering has been provided for loans concluded before 17 June 2016. Finally, a group equity ‘escape’ or ‘carve-out’ is provided, according to which where the Cyprus resident company is part of a consolidated group for financial reporting purposes, the taxpayer may be given the right to fully deduct its EBCs, provided that the ratio of its equity over its total assets is equal to (or even up to 2 per cent lower) or higher than the equivalent ratio of the group.

ii Deduction of finance costs

In general, expenses wholly and exclusively incurred by a Cyprus company in the production of taxable income are deductible and allowable.

Interest expense and charges are generally allowable expenses provided they do not specifically match to the acquisition of non-taxable assets. Non-taxable assets include: private assets, saloon cars, paintings etc. A restriction of interest expense exists if the company has acquired such non-taxable assets. Generally, this restriction is calculated by applying the average borrowing rate of the company to the cost of the non-taxable assets. The result of this calculation is compared with the actual interest and charges appearing in the profit or loss of the relevant company. The lower between the calculation and the actual expenses is disallowed for tax purposes. Further specific rules also apply for the calculation of this interest restriction.

iii Restrictions on payments

Generally, there are no restrictions on the distribution of dividends. Nonetheless, the payment of dividends from a Cyprus company to its shareholders should only be made out of realised profits.

iv Return of capital

The share capital of a Cyprus company, or the share premium attached to shares, can be returned to the shareholders thereof following a reduction of capital or share premium as per the provisions of the Cyprus Companies Law, Cap. 113 as amended (the ‘Companies Law’). In order for a Cyprus company to reduce its share capital or share premium: (1) a shareholders’ special resolution must be passed (at least 75 per cent majority); (2) a court order sanctioning the reduction must be issued; and (3) the relevant court order, along with the special resolution approving the reduction, must be filed with the Cyprus Registrar of Companies (ROC), because the reduction will have no effect unless and until it is registered with the ROC.

There is a requirement in relation to the protection of creditors; namely, a list of creditors needs to be drawn up or published in the official gazette of the Republic giving notice to any creditor or interested party of the hearing date of the court application, enabling any such person to file an objection. This can be overcome if the consent of all creditors is obtained and produced to the court, along with the relevant application.

Return of capital or share premium to the shareholders (to the extent that such capital or premium was paid or contributed by the shareholders in exchange of shares) is tax-neutral.
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

There is no limitation for foreign investors acquiring shares in Cyprus companies. They can acquire such shares on their name or use a foreign or a local entity for this purpose. Profits from the disposal of titles are exempt from any tax in Cyprus; hence, the actual structuring of the payment of the consideration is irrelevant with respect to the sale of shares. Titles are defined to include shares, bonds, debentures, founders' shares and other titles of companies or other legal persons incorporated in Cyprus or abroad and rights thereon.

From the tax year 2015 (inclusive) and onwards, notional interest deduction (NID) is available in Cyprus. NID is granted on new equity as a tax allowable deduction. NID can essentially reduce effective corporate tax rate to as low as 2.5 per cent. However, deduction granted can in no case exceed 80 per cent of tax adjusted profits.

After the introduction of NID it became more appealing for buyers to structure financing through equity. Financing through loan is also possible; the overall transaction structure will need to be considered before investors decide what best suits the needs of the specific acquisition.

ii Reorganisation

Cyprus allows for the reorganisation of entities both on the local and on the European level. Reorganisations are attractive from a tax perspective as they result in a total exemption from tax in Cyprus, provided that they fall within the scope of the Cyprus Income Tax Law No. 118(I)/2002 (the 'Income Tax Law').

The definition of reorganisations includes a number of types thereof, such as mergers (by acquisition, by the creation of a new company and by way of a holding company absorbing a subsidiary), divisions, partial divisions, transfers of assets and share exchanges.

The Income Tax Law classifies all the above types of reorganisations as arrangements, all of which are carried out pursuant to Sections 198 to 201 of the Companies Law, relating to compromises and reorganisations. Local reorganisations must also receive court approval before they can be effected.

An approved reorganisation has a number of tax benefits. No balancing statement is required for assets transferred, no capital gains or corporation tax on the transfer of Cyprus immovable property is applied, any losses carried forward of a transferring company can be transferred to the receiving company, no transfer fees or stamp duty is applied and there are no taxes whatsoever on the transfer of any assets. Cross-border mergers are possible on the EU level pursuant to the EU Directive 2017/1132/EC relating to certain aspects of company law, which repealed the EU Directive on Cross-Border Mergers (2005/56/EC). Cross-border mergers can be performed between limited liability companies incorporated in accordance with the legislation of an EU member state that have their registered office, central administration or principal place of business in the EU, provided at least two of them are governed by the laws of different member states.

The consequences of a cross-border merger are contained in Article 131 of the said directive. In all cases, all assets and liabilities are transferred without the need for any other action (save for any necessary notifications) and likewise, the company or companies being absorbed cease to exist. From a tax perspective, an application can be made to the tax authorities, accompanied by the reorganisation plan and relevant information on the
merging entities, for a reorganisation certificate, confirming the exemption from taxes. The tax authorities retain the discretion to issue a tax exemption certificate if they take the view that the merger or reorganisation was at arm’s length and reflected economic reality.

There is no procedure in relation to the reorganisation of Cyprus companies with third country entities (i.e., outside the EU). However, such third country entities can first be re-domiciled into Cyprus and following their re-domiciliation can enter into an arrangement with a Cyprus company.

### Exit

No exit taxes currently exist in Cyprus. Nevertheless, because of the implementation of the ATAD, it is expected that such rules will be put in place in 2020.

### IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

#### i General anti-avoidance

As from 1 January 2019, a general anti-abuse rule (GAAR) is applicable and it was introduced as part of the general implementation of the ATAD. Cyprus legislation now provides that non-genuine arrangements, having as a main purpose the procurement of a tax advantage, are ignored. Those arrangements are considered to be ‘non-genuine’ as their mere existence does not reflect valid commercial reasons or economic reality.

#### ii Controlled foreign corporations

The Controlled Foreign Companies (CFC) rule, applicable as from 1 January 2019, results in the re-attribution of the income of a low-taxed controlled non-Cyprus subsidiary to its parent company to avoid revenue diversion to a jurisdiction with a more favourable tax regime. The CFC rules apply to both Cyprus tax resident companies and non-Cyprus tax resident companies having a PE in Cyprus.

A CFC is a low taxed non-Cyprus tax resident company or PE in which the: (1) Cyprus taxpayer, alone or together with its associated enterprises, holds a direct or indirect interest of more than 50 per cent; and (2) the actual corporate tax paid on the profits of the company or PE is lower than the 50 per cent of the tax that would be paid in Cyprus. The non-distributed income of a CFC that is the result of non-genuine arrangements is added to the taxable income of the Cyprus tax resident controlling company. The CFC rule is not applicable when the company or the foreign PE has: (1) accounting profits of no more than €750,000, and non-trading income of no more than €75,000; or (2) accounting profits of no more than 10 per cent of its operating costs for the tax period.

It is possible for the Cypriot controlling entity to claim credit for any overseas tax imposed on the CFC profits that are included in its tax base.

#### iii Transfer pricing

Cyprus has adopted transfer pricing rules only in relation to intra-group financing activities. These rules are effective as from 1 July 2017. Therefore, financing transactions between related companies are obliged to follow the arm’s-length principle as set out in the OECD Transfer Pricing Guidelines.

The said rules apply to Cyprus tax resident entities and PEs that are involved in back-to-back intra-group financing transactions. Such transactions have been defined by the
tax authorities as the granting of loans or cash advances to related companies remunerated by interest (or should be) and are financed by financial means and instruments, such as debentures, private loans, cash advances and bank loans.

A transfer pricing study should be provided to the Cyprus tax authorities, evidencing that the conducted intra-group financing transaction (and the agreed remuneration; i.e., interest) complies with the arm’s length principle. A transfer pricing report should be prepared by a transfer pricing expert and submitted to the tax authorities by a person who has a licence to act as an auditor of a company according to the Companies Law and is required to carry out an assurance control confirming the quality of the transfer pricing report.

Nevertheless, a simplification measure was also introduced. In case that a group financing company pursues a purely intermediary activity (intercompany loans receivables and payable) and has an actual presence in Cyprus (economic and physical substance), then the transactions are deemed to comply with the arm’s length principle and the minimum return accepted is 2 per cent after tax on assets (profit after tax), which effectively means a minimum taxable profit of 2.2857 per cent on assets.

iv Tax clearances and rulings

It is possible to obtain advance tax rulings from the Cyprus tax authorities. Such rulings are issued on the application by or on behalf of a taxpayer on actual or proposed transactions, relating to tax years for which the due date for filing a tax return has not yet passed. Requests for rulings must be in writing and must comprise of the information required by the relevant circulars of the tax department. Rulings will be binding only with regard to the taxpayers specifically mentioned in the ruling request, and provided that the circumstances described therein continue to be applicable and that there is no subsequent modification in the tax legislation that renders the ruling inapplicable.

The tax department will express an opinion on the applicable tax treatment of the proposed transaction or scenario presented to it and will not be responsible for verifying the facts and circumstances described in the application. In case of any subsequent discrepancy between the scenario presented and the actual transaction, the tax authorities can either decline to apply the tax ruling or inform the tax rulings division of the actual facts, for the purposes of confirming or altering the initial ruling.

In any case there is not a requirement or obligation for a taxpayer to obtain a tax ruling for the purposes of acquiring a local business or entering into a particular transaction.

X YEAR IN REVIEW

One of the most important developments on the tax field in Cyprus during the last 12 months was the partial implementation of legally anti-abusive measures, in accordance with the ATAD. This also demonstrates the intention and commitment of Cyprus to follow the base erosion and profit shifting (BEPS) recommendations and remain BEPS and OECD compliant.

One of the current ‘hot topics’ in Cyprus is the existence of substance or real presence for entities. In the second part of 2018, the Central Bank of Cyprus issued two circulars setting out the definition of shell companies or entities. Although these circulars aimed at providing guidance to Cyprus banking institutions for the purposes of deciding on whether
to engage in or maintain business relationships with legal entities, it can be considered as an important development because it provides a more practical overview of the substance requirements in Cyprus.

A recent trend is the relocation of the headquarters of international groups (especially enterprises dealing with IP) in Cyprus and the creation of substance and the establishment of real presence on the island, for the purposes of becoming Cyprus tax residents and obtain the advantages of the Cyprus tax system.

XI OUTLOOK AND CONCLUSIONS

There are a number of anticipated changes on the tax legislation. The two measures stipulated by the ATAD (exit taxes and rules to tackle hybrid mismatches) are expected to be implemented in Cyprus in 2020.

Moreover, because the commitment of Cyprus to follow the BEPS recommendations and remain OECD compliant continuous to be evident, it is expected that further amendments will be introduced in the domestic legislation for the purposes of achieving this. We also anticipate additional detailed transfer pricing rules, including the requirement of performing transfer pricing studies in more areas and not just intra-group financing transaction.
I INTRODUCTION

During recent years, Denmark has adopted a number of reforms aimed at improvement of the framework conditions for operating a business in Denmark, including the reintroduction of favourable taxation of employee share programmes and a reduction of the corporate income tax rate.\(^2\)

From a tax perspective, the following highlighted features might be considered attractive for investors seeking business opportunities in Denmark:

- the participation exemption regime, which includes tax-free receipt and distribution of dividends from and to all European Union (EU) Member States, as well as countries with whom Denmark has formed a tax treaty (however, with certain exceptions);
- the tonnage tax regime under which income from shipping activities and capital gains on vessels are taxed very favourably;
- depreciation rates for tax purposes that are higher than the economic decrease in value;
- the absence of social security contributions in respect of employees;
- the possibility of obtaining binding advance rulings on tax issues;
- the possibility of tax-free reorganisation of businesses without documenting sound commercial reasons; and
- the possibility of awarding employees’ shares, options, etc., with a favourable tax treatment.

On the other hand, Denmark has implemented a wide variety of specific anti-avoidance rules (SAAR) aimed at, inter alia, hybrid entities and instruments as well as limitations for interest deductions. Further, Denmark has introduced general anti-avoidance regulation (GAAR). The anti-avoidance regulation makes Denmark unattractive in terms of tax-planning techniques involving excess debt push-down, use of hybrid entities and instruments, as well as arrangements that are not put into place for valid commercial reasons that reflect economic reality.\(^3\)

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1 Jakob Skaadstrup Andersen is a partner at Gorrissen Federspiel.
2 The current corporate income tax (CIT) rate is 22 per cent; gradually decreased as laid out in Section 17 CITA. One notable exception is for business covered by the Hydrocarbon Tax Act, which pays CIT at a rate of 25 per cent.
3 Under the new transposition of the GAAR from the Anti-Tax Avoidance Directive (ATAD I), the criterion reads as ‘non-genuine arrangements’; at this point it is not known whether this should be construed in accordance with the artificiality test, as set out in C-196/04 Cadbury Schweppes.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Generally, there are two main forms of organising a business in Denmark: entities with limited liability and entities with unlimited liability. Parties are free to choose business form.\(^4\)

Common entities with limited liability are the private limited company (ApS) and the public limited company (A/S). Other entities include associations, cooperative societies and commercial foundations.

Common entities with unlimited liability are the general partnership (I/S) where the partners are jointly and severally liable, the limited partnership with limited partners and at least one general partner with unlimited liability (K/S), and the limited partnership company (P/S).

Generally, entities with limited liability are subject to corporate taxation, whereas entities with unlimited liability are transparent for Danish tax purposes (i.e., any income derived from a transparent entity must be recognised by and becomes taxable at the level of the owner).

i Corporate

Due to the limited liability, and the relative tax benefits of deploying such entities, businesses are generally set up as an ApS or an A/S.

In general, companies are only subject to a few formal requirements, such as registration with the Danish Business Authority, preparation of annual accounts and conducting of annual general meetings.

The key difference between public limited companies and private limited companies is the required minimum share capital (ApS: 40,000 Danish kroner; A/S: 400,000 Danish kroner). Further, public limited companies are required to operate a two-tier management, while private limited companies are only required to have one governing body.

Moreover, the EU law based Societas Europaea is recognised as a limited liability corporation, from a Danish tax law perspective.

ii Non-corporate

The most common non-corporate entities are I/S with unlimited personal liability for all participants, and K/S or P/S with limited partners and at least one general partner with unlimited liability. Most K/S and P/S entities are structured with a limited liability entity as the general partner. Except for a requirement to register with the Danish Business Authority, such businesses are not subject to formal requirements upon formation, and no capital requirements apply.

Due to the tax transparency and the limited liability of the limited partners, a limited partnership is generally the preferred investment vehicle for private equity investments, venture capital funds etc.

\(^4\) Certain industries may entail special requirements, such as businesses within the financial services industry.
III  DIRECT TAXATION OF BUSINESSES

Companies resident in Denmark for tax purposes are, as a general rule taxed on their worldwide income; excluding income from foreign permanent establishments (PE) and foreign real estate. Non-resident companies are taxed on income allocable to any PE in Denmark, as well as income deriving from certain sources in Denmark.5

i  Tax on profits

Determination of taxable profit

Corporation tax is imposed on taxable net profits consisting of business income, passive income and taxable capital gains. The taxable profits are determined based on the figures reported in the company's annual accounts; adjusted in accordance with Danish tax law, such as deductions and depreciations. The basic principle is that the taxable income comprises gross income less the expenses of acquiring, securing and maintaining that income, whereas expenses necessary to establish or expand income sources are not deductible. Interest and royalties payments are generally deductible, with certain limitations. Dividends should most often not be included in the taxable income. Conversely, the distribution of dividends is not deductible.

Depreciation

Most capital assets are depreciated as a consolidated asset pool, at a rate up to 25 per cent a year, on a declining balance basis. The taxpayer is free to apply any rate up to 25 per cent, and may change the rate every year. Operating equipment with a long economic life, such as certain vessels, aircraft, drilling platforms and offshore equipment may only be depreciated at a rate of 15 per cent. Further, depreciation of certain infrastructure facilities may only be depreciated at a rate of 7 per cent.6

Assets with an estimated lifetime of less than three years, and assets with a value below 13,800 Danish kroner (2019)7 may be fully deducted in the year of acquisition.

Binding contracts concerning the acquisition of certain commercial equipment and some vessels may be eligible for advance depreciation provided that delivery or completion is within four years; and the contract price (i.e., asset value exceeds 1,572,900 Danish kroner (2019)).

Buildings and installations are generally depreciated at a rate of up to 4 per cent, while acquired goodwill and other intangibles may be depreciated on a straight line over seven years.

Recaptured depreciations or losses are recognised as taxable income in the year of realisation.

5 Most types of passive income are generally subject to withholding tax under domestic Danish law. However, under EU law, and Denmark's large treaty network, most of these provisions are either waived or applicable at a reduced rate. See Section 2 CITA for further information.

6 Infrastructure assets subject to the 7 per cent depreciation rate is specified in Section 5 C of the Act on Capital Allowances. Wind turbine generators are explicitly exempt from the low depreciation rate, see Section 5(6) of the Act on Capital Allowances.

7 The base value is set to increase to 14,100 Danish kroner.
**Capital and income**

Capital income is subject to CIT at a rate of 22 per cent.

**Losses**

Tax losses may be carried forward indefinitely. Tax loss carry-forwards (net-operating losses or NOLs) from previous income years may only be fully deducted in taxable income up to a base amount of 8,385,000 Danish kroner (2019). In excess of the base amount, NOLs may only reduce the remaining taxable income up to 60 per cent.

The rules on NOLs apply at a consolidated level for tax groups. Companies parties to a tax group share the threshold of 8,385,000 Danish kroner after offsets against losses of the year internally within the tax group.

Danish companies might consider whether voluntary depreciation and amortisation for tax purposes should be made if this leads to higher NOLs than the company is in a position to utilise. In certain situations, these rules may also lead to a strain on liquidity for companies with large NOLs. To counter such strain on liquidity, companies can consider trying to convert tax losses into depreciable amounts, as the rules do not set up any restrictions on tax depreciations. One way to convert tax losses would be to make an intra-group transfer of assets leading to a higher depreciable amount in the purchasing entity.

Restrictions apply in the case of direct or indirect changes to more than 50 per cent of the share capital or voting rights during an income year. In addition, a subsidiary’s tax loss carry-forward may be restricted if a change of control takes place in the parent company. The restrictions do not apply to listed companies, and special rules exist for financial companies.

Carry-back of tax losses is not permitted under Danish tax law.8

**Rates**

The corporate income tax rate in Denmark is 22 per cent. The rate applies for both income and capital gains.

**Administration**

The Danish Tax Authority is responsible for the administration of all tax legislation, including excise taxes and duties. Information concerning the tax system is available on the Danish Tax Authority website9 and the Danish Ministry of Taxation’s website.10

Complaints against decisions made by the tax authorities may be filed with the Danish Tax Appeals Agency, which will either refer cases to a regional appeals board or the National Tax Tribunal, which decides on cases of a principled nature. Decisions by an appeals board or the National Tax Tribunal may be brought before the courts.

Corporations pay tax on account twice a year, and must file an annual tax return no later than six months following the end of each income year. The actual tax liability for the year is calculated on this basis, and may result in either a tax refund or a claim for payment of remaining tax.

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8 One exception to this applies in regard of taxpayers covered by the Hydrocarbon Tax Act, which explicitly allows for carry-back of losses, see Section 20 E of the HcTA.
10 www.skm.dk/english.
The statute of limitations for an (re)assessment is three years and four months after the end of the income year (five years and four months for transfer pricing adjustments). In addition, an extraordinary (re)assessment may be made in certain specific situations.

**Tax grouping**

There are two types of consolidated tax grouping in Denmark: mandatory joint taxation, which applies to all group-related Danish companies and Danish PEs; and voluntary international joint taxation, under which all group companies and PEs, regardless of tax residency, may opt for joint taxation with Danish entities.¹¹

A parent company and its subsidiaries constitute a group. Further, a company, foundation, trust or association will qualify as a parent company if it directly or indirectly holds the majority of voting rights in another company (the subsidiary) or if it controls the subsidiary in any other way.

Each entity party to a tax group is, as a general rule, treated as a separate entity, and must compute its taxable income at the entity level, while losses in one entity may be offset against income in another group entity. The consolidated income constitutes the sum of taxable income for each company. The income of a subsidiary, which is not wholly owned, will be fully included. Only income relating to the period of consolidation will be included.

The ultimate parent company and wholly owned entities within the group are jointly and severally liable for the payment of income taxes and withholding taxes on dividends, interest and royalties from other companies within the tax group. Other entities within the group are liable on a subordinated, pro rata basis.

**ii Other relevant taxes**

The most important indirect taxes are VAT and salary withholding tax. The VAT rate in Denmark is 25 per cent. Other indirect taxes are excise duties, real estate taxes and stamp duties. Employees must pay a labour market contribution of 8 per cent of their gross salary.

**IV TAX RESIDENCE AND FISCAL DOMICILE**

**i Corporate residence**

A company is considered to be a tax resident of Denmark if it is incorporated and registered in Denmark. A foreign company may be considered tax resident in Denmark if the place of effective management is in Denmark. Under Danish law, the ‘place of effective management’ primarily refers to day-to-day management of the company. Accordingly, a non-domestic company may be regarded tax-resident in Denmark if day-to-day management is performed in Denmark.

**ii Branch or PE**

Non-resident companies may be subject to (source-)limited tax liability; through having a PE in Denmark,¹² income derived from Danish real estate or through withholding taxes on income from certain Danish sources.

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¹¹ A voluntary election of international joint taxation is binding for a period of 10 years.

¹² The legislative remarks to the Danish PE provisions explicitly states that Denmark relies on the Organisation for Economic Co-operation and Development (OECD) Model Convention and the related
V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i  Holding company regimes
The taxation of dividends payments and capital gains on shares under Danish participation exemption rules depends on the classification of the shares:

a  Subsidiary shares: the shareholder owns directly at least 10 per cent of the share capital in a company resident in Denmark or in a country where taxation of dividends must be waived or reduced under the PSD\textsuperscript{13} or a tax treaty;

b  Group shares: shareholding in a group company (controlling interest whereby the companies are subject to mandatory Danish joint taxation or qualify for voluntary Danish international joint taxation); and

c  Portfolio shares: shares that do not qualify as subsidiary shares or group shares.

Dividends on subsidiary shares and group shares are tax-exempt, whereas dividends on portfolio shares are subject to taxation.\textsuperscript{14} However, anti-avoidance rules may apply.

Capital gains on subsidiary shares, group shares and unlisted portfolio shares are tax-exempt, whereas capital gains on listed portfolio shares are subject to taxation. Losses on subsidiary shares, group shares and listed portfolio shares are not deductible, whereas losses on listed portfolio are deductible. Deduction of losses on listed portfolio shares are not subject to basket treatment, if the company uses the mark to market principle. However, if the company uses the realisation principle, the deduction will be subject to basket treatment. Losses may be carried forward to future income years.

ii  IP regimes
No specific regimes concerning the tax treatment of IP exist under Danish tax law.

iii  State aid
Denmark has a tonnage tax regime, which has been approved by the EU Commission.\textsuperscript{15} State aid is not available in other sectors.

iv  General
Eligible shipping companies may elect to apply the Danish tonnage tax regime. Under this regime, tax is computed and levied on the basis of the net tonnage of the vessels operated by the shipping company, regardless of the actual financial performance of the company. Noticeably, the regime includes capital gains on the vessels, which are therefore de facto tax-exempt.

\textsuperscript{13} Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States; in the jargon commonly abbreviated as ‘the PSD’.

\textsuperscript{14} Dividend payments derived from portfolio shares by a corporate shareholder, are generally only taxed at a rate of 15.4 per cent.

\textsuperscript{15} The European Commission has granted Denmark an extension of duration and scope of the Danish tonnage tax regime (ruling published as SA.45300). As such, the current Danish tonnage tax regime is approved until 31 December 2026.
The regime is optional, with an election being binding for a period of 10 years and must comprise all eligible vessels and assets.

VI WITHHOLDING AND TAXATION OF LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Danish companies are generally obliged to withhold tax on outbound dividend payments, royalty payments and interest payments, related to controlled debt. However, many exceptions apply as set out below, and in practice the main rule is that no tax is withheld at source, as Denmark often waives taxation on dividends, royalties and interest paid to a beneficial owner resident in another state that has a tax treaty with Denmark or is a Member State of the EU.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Outbound dividend payments

Dividend payments from a Danish company to a non-resident shareholder are generally subject to Danish withholding tax at a rate of 22 per cent.

The rate is reduced to 15.4 per cent (or less) where the recipient holds less than 10 per cent of the Danish company and the Competent Authority of the recipient’s domicile state of residence are obliged to exchange information with the Danish tax authorities under a bilateral tax treaty, international treaty or an administrative agreement.

However, dividends on subsidiary and group shares are exempt from withholding tax if Denmark is required to reduce or waive taxation under the PSD or a tax treaty. The exemption will not apply if the Danish entity is deemed a conduit, which merely serves to route dividends to a parent company outside the EU, to achieve a tax benefit.

Similarly, most of Denmark’s tax treaties contain a beneficial ownership criterion to qualify for benefits under the treaty. Case law shows that the Danish courts rely heavily in the OECD Commentary when interpreting beneficial ownership as it relates to Danish tax treaties.

Furthermore, the Danish tax authorities have been engaged in litigation to determine whether a beneficial ownership criterion is embedded in Article 1(4) of the PSD. A number of the cases were brought before the Court of Justice of the European Union (CJEU), which rendered its ruling early 2019. The CJEU found that while no beneficial ownership requirement per se was embedded in Article 1(4), the provision did contain the general principle of prohibition of abuse of law, which requires Member States to deny any benefits derived from EU law, if those benefits are obtained by way of abusive behaviour. Alongside the transposition of the general anti-avoidance rule contained in Article 6 of the ATAD, and a history of aggressive pursuit of perceived aggressive behaviour by the Danish tax authorities,

16 From an investment perspective, this is a key point to observe, as domestic law effectively precludes Denmark from applying withholding tax on dividends, even if an applicable tax treaty grants Denmark a limited right to tax.

17 Formerly Article 1(2), but renumbered as a consequence of the amendment directive EU/2015/121.

18 See joined cases C-116/16 and C117/16, ECLI:EU:C:2019:135.

19 See Section 3 of the Danish Tax Assessment Act. Noticeably, Section 3(5) of the Danish Tax Assessment Act contains a provision, similar to the Primary Purpose Test (the PPT), created by the OECD, and
foreign investors looking to invest in, and especially through Denmark, should be aware that the Danish participation exemption regime, while generous, is not ideal for pure tax planning structures.

**Outbound interest payments**

For all practical purposes, no withholding tax is levied on interest payments. However, Danish law provides a withholding tax at a rate of 22 per cent be withheld on interest payments related to controlled debt if:

- one of the companies directly or indirectly owns more than 50 per cent of the share capital or the voting rights in the other company;
- the same group of shareholders directly or indirectly holds more than 50 per cent of the share capital or the voting rights in the companies; or
- the foreign company exercises joint control over the Danish company together with one or more other shareholders (e.g., by a shareholder agreement between the foreign company and such other shareholders).

Similarly, to dividend taxation, no withholding tax is levied if Denmark must waive or reduce withholding tax under the IRD\(^{20}\) or under an applicable tax treaty (no tax is levied even if the treaty grants Denmark a reduced right of taxation).\(^ {21}\)

**Outbound royalty payments**

Royalty payments from Danish sources to non-resident recipients are subject to Danish withholding tax at a rate of 22 per cent.

However, royalty payments are exempt from withholding tax if Denmark is obliged to waive taxation under the IRD.

For tax purposes, royalty payments are defined as payment received as consideration for the use, or the right to use any patent, trademark, design or model, print, secret formula or process of manufacture, or as consideration for information on industrial, commercial or scientific knowledge.\(^ {22}\)

**iii Double taxation treaties**

Denmark has concluded a large number of tax treaties, most of which are based on the OECD Model Convention, and contain provisions concerning permanent establishments, tax residency and withholding tax on outbound dividends, interest and royalty payments.

\(^{20}\) Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, commonly referred to as the Interest and Royalty Directive, abbreviated as the IRD.

\(^{21}\) See footnote 16.

\(^{22}\) Noticeably, Danish domestic tax provisions do not include payments related to industrial, commercial and scientific equipment, commonly referred to as ICS equipment, in the definition of royalty payments.
iv Taxation on receipt

Inbound dividends, interest and royalty payments are generally taxed as corporate income. Denmark grants credit for any paid foreign taxes. However, the credit is limited to the amount of Danish tax payable on the foreign net income calculated according to Danish principles.

Furthermore, all income recognised by non-resident subsidiaries and PEs is explicitly outside Danish tax jurisdiction, unless the foreign entities are encompassed by a voluntary election of international joint taxation.

VII TAXATION OF FUNDING STRUCTURES

Danish entities are normally funded partially by way of equity capital and debt. Contributions of equity are generally not a taxable event under Danish tax law.

Interest payments on debt are generally deductible. However, the deductibility of interest expenses may be limited under the following three rules:

a the ‘thin capitalisation test’ imposes a debt-to-equity ratio of 4:1 on controlled debt;
b the ‘asset test’ limits the deduction to 2.7 per cent of the operating (non-financial) assets; and

c the ‘EBITDA test’, which limits the deduction to 30 per cent of the earnings before interest, taxes, depreciations and amortisation (EBITDA).

i Thin capitalisation

The thin capitalisation rule is a special anti-avoidance rule aimed towards eliminating excessive debt push-downs within corporate groups. It follows from the rule, that insofar as: (1) a Danish debtor has controlled debt; (2) the controlled debt exceeds a minimum threshold of 10 million Danish kroner; and (3) the debtor’s debt-to-equity ratio exceeds 4:1, interest expenses and capital losses relating to debt in excess of the 4:1 ratio cannot be deducted (however, only for such part of the excess debt that would need to be qualified as equity for the 4:1 ratio to be complied with). An exemption exists if a Danish debtor can demonstrate that a similar loan could have been obtained from an unrelated third party, the restriction of deductibility may be waived (arm’s-length exemption).

Certain sectors, such as the financial services sector, may generally operate with higher debt-to-equity ratios, and such market practices may be used to demonstrate arm’s length compliance.

ii Deduction of finance costs

The general right for companies to deduct finance costs, including interest payments, is subject to several limitations, primarily to prevent foreign equity funds from eroding the tax base by assuming excessive leverage.

Alongside the thin capitalisation rule, which is only applicable to controlled debt, Danish tax law contains the following two interest limitations, which are applicable insofar as the company’s net finance costs exceeds a threshold of 21.3 million Danish kroner.23 For companies covered by the Danish joint taxation scheme, the threshold is applied on a (consolidated) group basis.

23 With effect from 1 January 2014, the threshold of 21.3 million Danish kroner was frozen. Accordingly, the automatic yearly adjustments are no longer applicable.
Asset test

Under the asset test, net financial costs exceeding a cap calculated as the standard rate of return (2.7 per cent for 2019) multiplied by the tax base of the company’s qualifying assets (i.e., on group basis) cannot be deducted.\(^{24}\)

Net finance costs reduced according to the rules on thin capitalisation will not be included in the net finance costs when assessing a reduction according to the asset test.

EBITDA test

With effect from 1 January 2019, Denmark has transposed the EBITDA provision contained in the ATAD I. Under the EBITDA test, net financial costs exceeding 30 per cent of the company’s earnings before financial expenses, taxes, depreciations and amortisations cannot be deducted in the tax year, but are eligible for carry-forward to future years.\(^{25}\) Conversely, any excess EBITDA absorption availability may be carried forward for up to five income years.

iii Restrictions on payments

There are no restrictions on payments contained in Danish tax law. However, it follows from company law statutes that dividend distributions are contingent upon the decision of the shareholders’ meeting and approval by the board of directors, which is obliged to ensure that the company has sufficient unrestricted reserves at all times.

iv Return of capital

Repayment of equity capital to investors requires a capital reduction or liquidation of the company.

For Danish tax purposes, a capital reduction is considered to be a dividend distribution unless prior permission to consider the payments as capital gains is obtained from the tax authorities.

Liquidation proceeds are generally treated as capital gains of shares if the distributions take place in the income year in which the company is dissolved. As foreign shareholders are normally not subject to taxation on capital gains on shares, such shareholders should not be taxed on liquidation proceeds from a Danish company.

Liquidation proceeds distributed in the income year in which the company is dissolved will, however, be treated as dividends if the recipient owns at least 10 per cent and dividends would be subject to Danish withholding tax, or owns less than 10 per cent of the share capital, but is affiliated with the company being dissolved and is liable to Danish withholding tax on dividends.\(^{26}\)

\(^{24}\) The computation of the interest deduction limitation under the asset test is a sophisticated technical exercise; an elaboration on which would exceed the scope and length of this contribution. See Section 11 B CITA.

\(^{25}\) Under ATAD I, Article 11(3), the minimum threshold for interest deduction limitation is set at €3 million (converted, and transposed, as a minimum threshold of 22,313,400 Danish kroner). Noticeably, this entails that the asset test and the EBITDA test operate with diverging minimum limitation thresholds.

\(^{26}\) See Section VI.ii.
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

A Danish business may be acquired as an asset transfer or as a share transfer.

If the seller is not resident in Denmark for tax purposes, disposal of shares is not a taxable event in Denmark. Moreover, a valuation of the assets is not necessary.

Capital gains on transfers of shares are exempt from Danish taxation if the seller is a corporate shareholder holding subsidiary shares, group shares or unlisted portfolio shares.\(^{27}\)

Asset transfers are for tax purposes regarded as selling assets individually. Accordingly, gains and recaptured depreciations are taxable, and losses are deductible.

Danish corporate law prohibits certain types of financial assistance, meaning that investors cannot finance an acquisition with the target company’s capital unless such acquisition is financed with the target company’s distributable reserves. Further, investors should be aware of the limitations on thin capitalisation and deduction of financing costs (see Section VII).

ii Reorganisation

Denmark allows for tax-exempt corporate reorganisations if certain conditions are met, and that tax evasion or tax avoidance are not the principal objectives of the reorganisation.

Tax-exempt reorganisations may be executed with or without prior permission. Prior permission requires the reorganisation to be justified by commercial reasons. This is not a requirement if the reorganisation is carried out without obtaining prior permission, but in such case a three-year holding requirement applies.

A tax-exempted merger between a foreign and a Danish company requires prior permission in certain cases. The merger will be tax-exempt at the shareholder-level, but Danish exit tax will be levied on the entity-level on assets not remaining under Danish taxation.

A partial demerger (e.g., the demerged company continues to exist) made without prior permission is subject to certain restrictions: the transferred assets and liabilities must constitute an operational branch, and the ratio between assets and liabilities must be the same prior to and following the demerger.

The date of the reorganisation must generally coincide with the date of the beginning of the financial year of the receiving company. In this sense, it is possible to give the reorganisation retroactive effect.

iii Exit

It is generally not possible to relocate an incorporated company without liquidation; however, company migration may be done into another Member State, insofar as the domestic law of the target country allows such migrations. Furthermore, Denmark may be obliged to waive or reduce taxation under a double taxation treaty if the management becomes resident in another state.

If a corporation ceases to be resident in Denmark for tax purposes, Danish exit taxation is imposed on taxable assets and gains. Denmark has rules that allow for deferred payment of exit tax assets transferred from Denmark to another Member State.

\(^{27}\) See Section V.i, for an in-depth discussion on share taxation.
Assets remaining in Denmark may constitute a PE, with the result that no Danish exit taxation is incurred.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Denmark has transposed Article 6 of the ATAD I, with effect from 1 January 2019. Generally, the GAAR seeks to deny taxpayers the benefits of domestic tax rules, as well as benefits under a double-taxation agreement (DTA) or a EU Directive, insofar as the taxpayer obtains said benefits through arrangements, or series of arrangements that have been put into place with one of the main purposes being the obtaining of a tax benefit and that are not genuine.

Besides the GAAR, the most important Danish SAARs are the rules on the mitigation of hybrid mismatches, controlled foreign corporations (CFCs) and transfer pricing regulations.

ii Hybrid mismatches

As part of the transposition of the ATAD II, Denmark has made significant alterations to the provisions on hybrid mismatches. Essentially, the rules have been made more transparent, and Denmark has adopted rules similar to those envisioned in the base erosion and profit shifting (BEPS) Action 2.

As such, Denmark generally relies on the classification of the other state whose domestic rules are used to achieve the hybrid mismatch, and makes the necessary adjustments. The primary hybrid mismatches encompassed by the new rules, are:

- deduction or no inclusion;
- double deduction;
- double non-inclusion; and
- significant timing arbitrage relative to recognition of income or deductions.

The rules are designed to counter the (intended) mismatch aspect of the hybrid structure or instrument, by adapting the Danish tax treatment to effectively mirror that of the other involved country (i.e., a non-inclusion in the domicile country would entail non-deduction in the source country (Denmark being the ‘source country’), when applying mismatch rules). As such, Denmark has a robust, and very dynamic, set of provisions to counter and mitigate the effect of hybrid mismatches.

28 See Section IV.ii for further discussion on this.
29 The terminology ‘non-genuine’, is an EU innovation, and encompasses arrangements, which are not put in place for valid commercial reasons that reflect economic reality having regard to all the relevant facts and circumstances.
30 A bill transposing the CFC rules of the ATAD I is currently pending before the Parliament. One very significant change is the inclusion ‘any other income derived from IP’ (i.e., the equivalent of income derived from embedded royalties, as known from US tax law). The final language of this Bill is still being debated, but if the current language of the Bill prevails, all taxpayers with either operational structures or holding structures in Denmark will be met with significant uncertainty. Furthermore, the Bill introduces a new concept of ‘control’, which now also constitutes taxpayers, which are entitled to more than 50 per cent of the profit of the subsidiary’s profit.
ii  CFCs

Danish CFC rules apply to foreign subsidiaries and PEs as well as to Danish subsidiaries of Danish companies if:

a  the Danish company controls, directly or indirectly, more than 50 per cent of the voting power in the subsidiary;

b  more than 50 per cent of the total income of the subsidiary is of a financial nature (taxable interest, taxable gains on securities and foreign currency, etc., certain deductible commissions concerning loans, taxable dividend payments, taxable gains on shares, licence fees relating to intellectual property, taxable income from finance leases and taxable income from insurance business); and

c  at least 10 per cent of the subsidiary’s assets are of a financial nature as described above. 31

If these conditions are met, the entire income of the subsidiary will be included in the parent’s taxable income, and the parent is granted credit for taxes paid by the subsidiary in its country of residence.

iii  Transfer pricing

Transactions made between affiliated companies must be carried out on arm’s-length terms. Companies are generally regarded as affiliated if:

a  one of the companies directly or indirectly owns more than 50 per cent of the share capital or the voting rights in the other company;

b  the same group of shareholders directly or indirectly owns more than 50 per cent of the share capital or the voting rights in each of the companies; or

c  the company exercises joint control over the other company in conjunction with one or more other shareholders (e.g., by a shareholders’ agreement on voting rights and management).

A company and its PE are also regarded as related entities.

Related companies must prepare and file transfer pricing documentation showing how the companies have set the prices for inter-company transactions.

If the prices agreed by the companies are different from what would have been negotiated in an arm’s-length transaction between independent parties, the tax authorities are authorised to adjust the prices. 32 Denmark generally follows the OECD Transfer Pricing Guidelines.

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31 Under the proposed Bill, as mentioned in footnote 30, the asset test will be revoked, as being incompatible with EU law.

32 A Bill currently pending before Parliament would give the Danish tax authority additional discretion to fixate the taxable income under the transfer pricing provisions, by disregarding facts and documents that are submitted after the deadline. The deadline for the submission of transfer pricing documentation is furthermore proposed to be mandatory, and should be filed no later than the due date for the taxpayer’s annual tax return.
iv Tax clearances and rulings

It is possible to obtain binding advance rulings from the tax authorities to obtain certainty as to the possible tax implications of a planned or already undertaken transaction. Such ruling is binding on the tax authorities for a period of up to five years. Denmark has amended the rules on binding advanced rulings in relation to the valuation of assets when exiting Denmark. The amendment reduces the binding effect of such rulings to a maximum of six months.

In general, a tax clearance is not required to acquire a local business.

X YEAR IN REVIEW

While 2019 from the onset looked to be another year in which unilateral approaches by national states would lead to enhanced uncertainty for multinational enterprises (MNEs), the EU and OECD headed the call, and ramped up the speed on the introduction of harmonised measures to counter the tax planning schemes identified throughout the OECD BEPS project, and colloquially referred to as ‘aggressive tax planning’.

In Denmark, this has materialised in new legislation that, for example, transposed the DAC6, introduced legislation to implement the MLI into national Danish law, as well as a (re)introduction of the Bill concerning the CFC rules contained in the ATAD I.

As such, Denmark has continued to play a strong part in the development of the international tax landscape, and has continued to pursue venues to strengthen and enhance anti-abuse measures, to create a more level playing field. This is also evident in the increased awareness of ‘fairness in taxation’, which has resulted in not only an increase in investor focus on matters related to tax policy, but also several MNEs as well as institutional investors have produced and published official tax policies, according to which the taxpayer must act. This movement should be seen as a meeting of the minds between corporates, which must navigate an increasingly global and complex tax landscape, and consumers concerned about rampant disregard by market players taking advantage of these complexities and the possibility of exploitation this provides.

Furthermore, the Danish tax authorities have continued the pursuit of the alleged perpetrators of abusive cum-ex transactions, while the decentralisation of the Danish tax authority into seven quasi-independent agencies has not yet proven to remarkably strengthen the just enforcement of Danish tax laws. This is evident by, for example, Danish real estate tax being further stayed, as well as continued problems with the recollection of tax debts; from corporates and individuals alike.

XI OUTLOOK AND CONCLUSIONS

i CFC rule of the ATAD I

As of submission of this contribution, a Bill is currently undergoing debate before Danish Parliament, concerning the transposition of the CFC rules contained in Article 7 and Article 8 of the ATAD I.

The Bill, as it is currently worded, would mean a significant expansion of the current scope of Danish CFC rules, not only by lowering the threshold of the tainted income, or CFC income, required to constitute a CFC from half to one-third of all income, but also by widening the scope of the definition of tainted income, in accordance with Article 7(2)(a)
(ii), to cover ‘other income generated from intellectual property’. Conversely, the asset test of determining CFC status is set to be abolished, as no such test is included in the ATAD I, wherefore the test becomes incompatible with EU law.

The main concern for taxpayers, stakeholders and lawmakers, is the exact implication of the widened scope of IP income to cover other income from intangibles; a concept known in US tax law as income from embedded intangibles. As of the public consultation, the introduction of the Bill before Parliament, and the first reading of the Bill, no conclusive measures have been taken to mitigate the uncertainty this expansion of Danish tax jurisdiction related to CFC entities will incur.

This uncertainty is furthered by the lack of a substance requirement in the Bill, which would essentially mean that foreign subsidiaries of Danish entities, even though engaged in significant economic activities in the market jurisdiction, could become liable to Danish CFC taxation, as no concrete mechanisms for computing this other income from IP has been proposed, other than the use of the OECD Transfer Pricing Guidelines. It remains unclear whether a foreign entity of a Danish entity, having in place a compliant arm’s-length transfer pricing policy, could still be targeted using the transfer pricing guidelines to impose Danish tax on these arm’s length residual profit allocations.

ii  Bill concerning an enhanced mechanism for reimbursement of dividend taxation
Due to the continued outfall of the cum-ex transactions, which is estimated to have incurred costs of 12.7 billion Danish kroner for the Danish treasury, all reimbursements of dividend tax have been indefinitely postponed. The Danish Ministry of Taxation has announced a Bill is under way that would fundamentally change the dividend withholding tax mechanism, which would alleviate the need for reimbursements of (over)paid tax.

How this Bill will be worded, and derived thereof, how the payment of withholding tax for non-resident taxpayers will be handled going forward remains an unknown factor that contributes to tax uncertainty in the short term, although it is expected, at least from a government perspective, that the long-term impact will lead to increased certainty with regard to actual tax liability and actual dividend tax withheld.

iii  Adjustment of the rules on cost reimbursement
A new Bill has been proposed that would preclude taxpayers from reimbursement for costs borne in relation to taxation advice or assistance in matters related to cum-ex transaction abuse schemes, which have been widely deployed across the EU.

iv  Adjustments to the taxation of carried interest
A change has been proposed, according to which carried interest is measured as a supernormal return on investments of private equity fund managers. The Bill mainly concerns that the return on invested capital will also include debt issued by the carrying entity, rather than just measured as a return on equity, as stipulated under the current rules.
Chapter 9

ECUADOR

Alejandro Ponce Martínez

I INTRODUCTION

Ecuador was a private investment-oriented country until 2006, when the government changed its direction and unilaterally amended the participation contracts for oil exploration and exploitation, introducing a clause establishing a legal requirement for government participation of up to 99 per cent of the difference between the international price of crude oil in force at the time such contracts were entered into (mostly in 1995) and the actual price. Shortly after this, during 2007 and 2008, the Constitutional Assembly heavily amended the taxation laws, imposing barriers to the judicial discussion of tax determination, increasing the taxation rates for private individuals and limiting tax incentives for corporate reinvestment of profits. Additionally, the scheme of taxation on corporate profits was also amended to double tax dividends, with both a corporate tax on profits and tax on personal income, and introducing a system where, even without taxable profits, companies and corporations were submitted to income tax on unearned profits, based on a rate of taxation of net worth. Public enterprises, on the contrary, were widely promoted, and privatisation was eliminated. This trend has smoothly changed since August 2018, when incentives were established for business located outside the main two cities of Ecuador: Quito and Guayaquil. In June 2019, amendments to the judicial procedural code reduced, but did not eliminate, the restrictions to access for taxpayers to judicial review of governmental rulings on taxation. Recent changes enacted on 31 December 2019 introduced provisions establishing different corporate taxation systems for certain areas of production businesses and for small enterprises, based, not on net income, but on gross revenues.

Bilateral investment treaties (BITs) were affected by Constitutional Court decisions holding some of them as contrary to the Constitution. Several BITs were denounced by Ecuador between 2007 and 2016, as was the ICSID Convention. The still-in-force BITs with Italy, Peru, Spain, the United States, Canada, Venezuela, France, the Netherlands, Sweden, Switzerland, China, Germany and the United Kingdom were denounced in May 2017, during the last days of the term of former president Rafael Correa. The Ministry of Foreign Commerce under new president Lenin Moreno has proposed new negotiations with the United States and other countries based on a draft prepared by his office. However, no new BIT has, in fact, been entered.

The free trade agreement originally signed between Peru and Colombia with the European Union, to which Ecuador adhered has been in force since 1 January 2017, with good results for free commerce.

1 Alejandro Ponce Martínez is a senior partner at Quevedo & Ponce.
The new government of Lenin Moreno, inaugurated on 24 May 2017, announced changes to encourage new investments, some of which became effective on 1 January 2018 and others on 21 August 2018.

The Constitutional Court has decided that the judges should not fulfil the provisional measures ordered by international investment arbitration panels, under the theory that they affect the sovereign state. Civil judges fulfilled the Constitutional Court order and compelled a foreign investor to enforce a judgment that the panel of arbitrators had ordered to temporarily stay, provisional measures that were extended in a first award that declared the liability of the Republic of Ecuador for denial of justice. The Council of Citizenship Participation and Social Control, empowered by the results of a referendum called by President Moreno, dismissed the nine judges of the Constitutional Court on September 2018 grounded on allegations of corruption. A new Constitutional Court was appointed, and changes have taken place in the National Court of Justice.

In October 2019, president Moreno decreed the suppression of fiscal subsides to fuels in order to overcome the fiscal deficit projected in 2020. However, he was forced to revoke his decision because a turmoil affecting private and public activities and casing damages to public and private buildings was conducted by indigenous organisations led by extreme left-wing leaders aimed to conduct a coup d’état to overthrow the democratic system.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

For taxation purposes there is no distinction between corporations (stock corporations), limited liability companies, partnerships, joint ventures, consortia or any other kind of business associations for profits, whether legally established or formed de facto.

The most commonly used forms of business structures are stock corporations (SA) and limited liability companies. The main differences between these two kinds of enterprises are that shares may be freely negotiated in stock corporations, while quotas of limited liability companies may only be transferred with the unanimous consent of all the partners or quota holders, and as a consequence, quotas of limited liability companies may not be seized or sold in public auction, although profits declared as dividends may be subject to seizure by debtors of the partners of limited liability companies.

All of the above types of associations for business are considered under the general term of ‘companies’, and all of them are taxed under the same taxation principles. All companies are under a duty of registration before the Internal Revenue Service (SRI).

Branches of foreign companies authorised to conduct business in Ecuador are also taxed under the same general rules, as are permanent establishments of foreign companies.

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2 Prophar SA v. Judge Gabriela Lemos.
3 Prophar SA v. Merck & Co. Inc.
4 Merck & Co. Inc. v. the Republic of Ecuador.
ii  Non-corporate
Commercial trusts conducting entrepreneurial activities, independent or autonomous patrimonies (whether with or without juridical personality), and any other entity with economic unity not linked with its members are considered as companies for the purposes of taxation, and their benefits are treated in the same way that corporate profits are and are subject, in general, to the same formal tax obligations. Managers of trusts are liable for estate and donation taxes when trusts are devised to transfer assets. Civil companies incorporated with the approval of any notary are subject to the same taxation scheme. Benefits and profits derived from companies, financial funds and trusts devoted to investment or management of real property are tax exempted, provided the assets are not transferred to the beneficiaries and they have at least 50 beneficiaries, representing at least 49 per cent of the capital investment, not linked among them.

Limited liability unipersonal enterprises (i.e., established by only one person as managing owner) are treated for taxation purposes as stock corporations concerning profits and declared dividends.

In practice, ‘civil and commercial companies’, which are not recognised by any law, have also developed as businesses, and are subject to the same taxation treatment as all companies.

III  DIRECT TAXATION OF BUSINESSES
i  Tax on profits
Companies are subject to a flat-rate income tax of 25 per cent, which is calculated after the 15 per cent workers’ and employees’ profit share is deducted. The tax rate is increased to 28 per cent if 50 per cent of the corporate capital is owned by residents or beneficiaries located or resident in tax-haven jurisdictions. However, companies intending to use their profits to increase their capital for the purpose of investments in new industrial plants or other specially determined capital investments are taxed at a rate of 12 per cent.

All company revenues and earnings are subject to income tax in Ecuador, except income obtained abroad if it was taxed abroad unless such income is obtained in tax havens. Under specific tax treaties implemented to avoid double taxation, including the Andean Community of Nations regulations on double taxation, source-of-income principles on income taxation are applicable.

All expenses directly incurred to obtain, maintain and increase revenues by the company are deductible provided that they are shown in legally approved invoices, and if such expenses were incurred for payments abroad, a withholding income tax of 22 per cent is withheld.

Generally, 20 years’ amortisation is applicable to buildings and constructions, while three to five years’ amortisation is applicable to movable property, although under specific conditions faster amortisation might be applied considering the obsolescence of the assets, while amortisation of investments, including pre-operational investments, is five years. Intangibles are amortised over 20 years. However, under international accounting standards rules, companies may establish their own amortisation and depreciation rates according to the effective life of each asset. Amortisation of 100 per cent is provided for the acquisition of equipment destined to improve clean production, the generation of renewable energy or reduction of environmental harm.

Losses may be amortised or carried over for a period of five years, with a maximum of 25 per cent of the losses per year.
Individuals, including those conducting commercial business without a company structure, are taxed at a progressive rate from 5 to 35 per cent. Dividends earned from companies are added to individuals’ income, and taxed on the amount equivalent to 40 per cent of the received dividend.

Fiscal years correspond to calendar years. Income tax returns are filed during the first four months of the year by companies, and during the first three months by individuals, when the income tax or any balance thereof is also paid. Advanced income tax payment for the next year is equivalent to 50 per cent of the income tax of the preceding year, calculated after deduction of the amounts withheld at the source of the income. This is paid in two instalments during July and September. Such advanced income tax is calculated on the basis of the mathematical addition of 0.2 per cent of the net worth, 0.2 per cent of the expenses, 0.4 per cent of the total assets and 0.4 per cent of taxable income if such sum is higher than the advanced payment calculated on the basis of 50 per cent of income tax. Tax returns and tax payments are filed and made through private banking institutions.

The SRI is the only national administrative body regarding income tax, VAT, tax on special consumption and tax on remittances of money abroad, and other national taxes except customs duties, which are under the control of the National Customs Corporation. Municipalities administer and control municipal taxes such as, inter alia, real property tax, tax on transfers of real property, tax on capital gains derived from the sale of real property, tax on business capital assets and business year authorisation tax. The SRI has offices and agencies in all cities in Ecuador.

The SRI and other tax authorities have the power to regulate the application of taxes and answer matters raised by taxpayers, which become binding. The SRI has the power to audit national taxes and to decide on administrative claims filed by taxpayers concerning the results of tax decisions. Taxpayers may claim against original tax decisions or final administrative decisions before the courts. However, to suspend the enforcement of the decision of the taxing authorities, in the event a judicial claim is filed, a bond equivalent to 10 per cent of the tax debt should be rendered, otherwise the action brought will not be admitted.

Holding companies – that is, companies whose only corporate purpose is to own shares, quotas or rights in other companies with the purpose of having direct control over such other companies – may consolidate the financial results of all of the controlled companies, but for the purposes of taxation, each company forming the economic group is an independent taxpayer.

For the purposes of control by the SRI and other tax authorities, economic groups are those where one or more persons have at least a 40 per cent participation in other companies. The importance of economic groups relates to the rules on transfer pricing either internally or externally.

**ii Other relevant taxes**

VAT is applicable to the transfer of ownership or to the importation of movable goods of a corporeal nature in all phases of trading, as well as to the transfer of copyright and connected rights, and industrial property rights, and to services rendered as provided in the law. The ordinary rate is 12 per cent of the price or value of the good or service, except for some transactions that are subject to a zero per cent rate (which means that, in practice, there is tax).
Transfers for the purposes of the application of VAT are any act or contract intended to transfer ownership of the above-mentioned goods or rights, either by sale or gift, and the use or consumption of corporeal movable goods produced by the user or consumer.

Certain transactions are not subject to VAT, including:

- contributions to the capital of companies;
- sales of total assets and liabilities of all kinds of businesses;
- adjudications in the case of partitions of estates or liquidated companies, or dissolved marital property;
- mergers;
- company divisions;
- donations to public entities or to non-profit organisations; and
- transfers of shares, quotas or participations in companies.

VAT paid in the acquisition of goods or services are tax credits with respect to VAT generated in the transfer of goods or rendering of services by a taxpayer subject to VAT.

Tax on special consumption is applicable to the importation or transfer of specific movable goods of a corporeal nature or to specific services determined by law, such as cigarettes, alcoholic beverages, sodas, perfumes, video games, firearms, incandescent bulbs, vehicles, aeroplanes, ships, paid television services, casino services and social club affiliation services. The rates vary from 10 to 300 per cent of the price of the goods or services.

Other important taxes are:

- the 5 per cent tax on any transfer of money abroad, except importations and the payment of registered foreign loans;
- the annual contributions to the Superintendence of Companies by companies controlled by such entity, mainly stock corporations and limited liability companies, and to the Superintendence of Banks and Insurance by the companies controlled by such entity;
- the annual municipal taxes on total assets of commercial business (at a rate of 0.15 per cent); and
- customs duties.

All transfers of assets or rights to juridical persons or individuals domiciled in tax heaven jurisdictions are deemed as donations and subject to the applicable tax.

The municipalities also collect taxes on real property and on the transfer of real property, including taxes on capital gains derived from the sale of real property. There is also a tax on funds maintained abroad by financial companies and banks, and by companies managing funds and trusts.

Under the Environmental Development and State Resources Optimisation Act of 2012 (Act of 2012), banana production is subject to income tax calculated on the basis of a rate of 2 per cent on gross revenues. This way of determining income tax might be applicable, if requested by the producers’ associations, to agriculture, fisheries and aquaculture activities. The Law on tax incentives for certain sectors, in force since 12 October 2016, imposes on other subsectors of agriculture activities, as well as on other subsectors of the fishery industry and of the aquaculture industries, a tax of 1 to 2 per cent on gross revenues.

Under the Act of 2012 and its amendments, rates for a special consumption tax on beer and cigarettes were increased through different models of calculations of taxation on
units and *ad valorem*, or a mixture of both. Special consumption tax rates on other goods were also changed, especially in connection with vehicles, to encourage the production and importation of hybrid or electrical vehicles.

A special tax on environmental contamination is applicable to persons or companies that are owners of motor vehicles. The rates are established on the basis of the impact to the environment (based on the size and the age of the vehicle).

**IV TAX RESIDENCE AND FISCAL DOMICILE**

**i Corporate residence**

Companies incorporated in Ecuador should determine the city of their domicile. Foreign companies that have decided to conduct activities in Ecuador may obtain the approval of the Superintendence of Companies to establish a branch in Ecuador, while financial institutions, insurance companies and banks may obtain the same authorisation from the Superintendence of Banks and Insurance. With such authorisations, the entities involved establish the tax domicile of such branches as Ecuador at the same time. Like most taxpayers in Ecuador, they should register as taxpayers with the SRI.

Foreign companies receiving earnings from an Ecuadorian source may appoint an attorney-in-fact to represent them with respect to tax obligations in Ecuador. Taxpayer registration should also be obtained.

Financial institutions may have representatives in Ecuador, but they are not allowed to transact business.

**ii Branch or permanent establishment**

Branches of foreign companies authorised to conduct business in Ecuador are subject, in general, to the same tax regime as domestic companies.

Permanent establishments of foreign companies are qualified by the SRI if specific factors or elements of permanent presence in Ecuador exist, such as places to conduct economic activities in Ecuador, factories, warehouses, offices or a person with enough power to act as an agent of the foreign company. Such permanent establishments are taxed on the same basis as other companies doing business in Ecuador, whether incorporated in Ecuador or established as branches of foreign companies.

**V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT**

**i Holding company regimes**

Holding companies, namely, companies whose only corporate purpose is to acquire and maintain shares in other companies for the purposes of controlling them, may consolidate their balance sheets with the controlled companies, but each one of the controlled companies has an independent taxation regime. It is deemed that economic groups are formed by companies whose shares are owned in a proportion of 40 per cent or more by the same company or by the same group of companies, or belonging to the same physical persons. Holding companies are not subject to advanced payment of income tax that other companies and other taxpayers are.
ii  IP regimes
Special tax regimes have been incorporated to the legislation. These regimes are based on taxation on gross revenues. Besides, special incentives consisting in exoneration of income tax during certain periods of time have been granted to new investment in several areas, including the industries of fresh food, forestry, metal and mechanical, petrochemical, pharmaceutical, tourism, renewable energy, cinematography, audiovisuals, biotechnology, applied software, logistic services, hospital infrastructure, educational services, and cultural and artistic services.

A special taxation regime on income tax, VAT and special consumption tax has been established for microenterprises, with the exception of those devoted to construction and land development and to professional services.

iii  State aid
Investors conducting business as concessionaires of state-owned resources may enter into investment contracts with the government, whereby the state may guarantee that the economic equilibrium in the contract will be maintained if laws increasing the taxation affecting the concessionaire are implemented.

iv  General
Reinvestments of company profits through capitalisation, if such capitalisation is destined for the acquisition of capital assets destined for production and scientific development (except real property), are subject to income tax at a rate of 12 per cent instead of 25 per cent.

Foreign investors not domiciled in tax havens are not subject to income tax on profits or dividends earned from local companies in which they own shares or have participation. However, as previously explained, the companies pay income tax on the companies’ profits, which, with the exception of dividends received by physical persons, dividends received by companies as stockholders or partners of other companies, are not double taxed.

Special deductions are granted for five years for expenses incurred in training aimed at research, development and innovation conducted by medium-sized companies, as well for the expenses of such companies aimed at improving productivity or incurred during travel for commercial promotion and access to international markets.

Newly incorporated companies that have their activities in cities other than the urban areas of Quito and Guayaquil, and that are carrying out food production, forestry and products thereof, or are producing or involved in metal mechanisms, petrochemicals, pharmaceuticals, tourism, renewable energy, logistical services in foreign commerce, biotechnology, software and strategic sectors determined by the president, are income tax-exempted for five years after starting productive activities on revenues derived from new investments. This tax exemption to new companies has extended to companies devoted to services on hospitals structures, educational services and cultural and art services.

New productive investments, made after 21 August 2018, in agriculture, forestry, metallic mechanical industries, the petrochemical and oil chemical sector, pharmaceuticals, tourism, cinematography, audiovisuals, renewable energy, logistic services for foreign commerce, biotechnology and applied software, exported services, development and services of software, production and development of technological hardware, digital infrastructure, digital content, online services, energy efficiency, sustainable industries on materials and technology of construction, industrial, agro-industrial and agro-associative sectors, as well as sectors considered as strategic substitutes of import will be exempted for 12 years after the
first year of generation of revenues, except if such investments are located in the urban areas of the cities of Quito and Guayaquil, which will enjoy such exemption for eight years after the first year of revenues earnings.

However, private financial companies, banks and issuers of credit cards do not enjoy the benefit of a 10 per cent deduction on income for reinvestment of profits, and have the duty to anticipate income tax on the basis of 3 per cent on gross revenues (with a possible reduction to 1 per cent). The monthly tax rate on funds and investments abroad of financial institutions and companies devoted to investment funds and trusts is established at 0.25 per cent, which increases to 0.35 per cent in the case of deposits or investment in tax havens.

Financial services are subject to 12 per cent VAT, instead of zero per cent. Banks and financial institutions are under the duty to supply the SRI with any requested information of concern to taxpayers as the clients of such entities, without restriction.

The banana industry, including growing and production, either for local sale or export, is not subject to income tax provision but to taxation on gross revenues in rates from 1 per cent to 3 per cent, under detailed special regulations, including quality control. Agricultural and cattle productive activities and industries are taxed on the basis of gross sales at rates from 0 per cent to 2 per cent. Microenterprises have a flat tax rate of 2 per cent on gross revenues and are subject to special treatment concerning withholding taxes, VAT and special consumption tax.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

All kinds of payments or credits abroad representing taxable income or reimbursement of taxable income are subject to 25 per cent withholding by domestic companies and business entities. Because companies’ profits are taxable income for the companies, no withholding is applicable on taxes, unless the person or company receiving the dividend is a resident of a tax haven or of a country having a tax burden lower than the tax rate in force in Ecuador. Withholding is not applicable to reimbursement of expenses if certified by international firms of auditors doing business both in Ecuador and in the foreign country, unless reimbursement corresponds to fees, royalties or commissions.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

No withholding is applicable to:

a payments for imports;

b commissions paid for exports and tourism promotion if they do not exceed 2 per cent, except if the beneficiary is a party related to the exporter, a beneficiary of the tourism promotion or domiciled in a tax haven;

c 60 per cent of the interest in foreign loans registered with the Central Bank;

d payments abroad incurred by air or sea transportation companies connected with their operations in Ecuador, and similar expenses of high sea fishing companies related to such high sea activities;

e 96 per cent of reinsurance premiums paid to reinsurers not established or not having a representative in Ecuador;

f 90 per cent of payments made to international press agencies registered in Ecuador;
g 90 per cent of ship freight; and

h payments for international leasing of capital assets if the interest is no higher than the LIBOR rate, unless the lessee does not opt to acquire the leased assets, provided that the leasing is not made with persons linked with the lessee or payments made to tax havens, or the lease term is lower than the estimated life of the asset.

Indirect expenses charged from abroad to companies domiciled in Ecuador by their related parties are deductible expenses for the local company or the company doing business in Ecuador, provided such expenses do not exceed 5 per cent of the basis of the taxable income. In the case of companies conducting activities in the area of non-renewable natural resources, expenses connected with technical and administrative services are also considered among these indirect expenses.

iii Double tax treaties

Ecuador is a member of the Andean Community of Nations (CA) and is, therefore, ruled by Andean decisions on double taxation that establish, as a general principle, that income tax is only applicable in the country where the activity of the company is located, and that no withholding tax may be applied in connection with payments from one member country to another member country of the CA.

Treaties to avoid double taxation are in force with Argentina, Belgium, Brazil, Canada, Chile, France, Germany, Italy, Mexico, Romania, Spain and Switzerland. The treaty with Argentina is limited to air operations.

Ecuador is also a member of the 1979 Madrid Convention to avoid double taxation on copyright royalties and droit de suite.

Bilateral treaties are framed on the basis of the principle of origin or source of the income to establish the power to tax and the right of taxpayers to credit tax paid abroad. Some of them, such as the treaty with Italy, provide for a maximum rate of withholding tax.

If income has been imposed abroad to companies domiciled in Ecuador, there is no taxation in Ecuador, irrespective of any treaty provisions, unless income was taxed in tax haven jurisdictions.

iv Taxation on receipt

All companies should withhold 25 per cent of all dividends paid or advanced. In the case of dividends received by physical persons residing in Ecuador, such withholding constitutes a tax credit. If received by other companies established in Ecuador, it is a final income tax. If dividends are remitted abroad, the withholding is attributed as income tax for the person who has received the dividends so as to enable such foreign taxpayer to use it as a tax credit.

VII TAXATION OF FUNDING STRUCTURES

Together with original capital contributed by stockholders, quota holders or, in general, partners, companies are funded with credit, including credit from partners and issuance of debentures or bonds, which is only permitted for stock corporations.
i  **Thin capitalisation**

Tax laws do not establish restrictions on debt or equity restrictions, but regulations on banks do provide such restrictions. Company losses should not exceed 50 per cent of net worth, otherwise companies should be dissolved unless such losses are offset either by direct contribution of the stockholders or partners, or through an increase of capital.

Investment funds should reach a net worth of at least US$52,578 within six months of starting operations provided they have at least 75 participants, otherwise they should be liquidated. Funds are under the control of the National Securities Council that works within the Superintendence of Corporations, which issues regulations for their operations.

Investment funds and complementary funds are tax-exempt, provided they withhold income tax, as applied to dividends, to participants.

ii  **Deduction of finance costs**

In general, all finance costs are tax deductible except costs, including interest on foreign credit if the credit has not been registered with the Central Bank, or interest exceeding the tariffs established by the board of directors of the Central Bank, on the portion above the tariff. To deduct interest on foreign loans registered with the Central Bank, the amount of such loans should not exceed 300 per cent of a company's net worth or 60 per cent of the total assets of physical persons.

iii  **Restrictions on payments**

The general principle is that net profits should be distributed unless intended for other uses, such as capital contributions or the offset of losses. Stock corporations and limited liability companies should distribute at least 50 per cent of net profits unless there is a decision otherwise unanimously approved by the general meeting of stockholders or quota holders. Therefore, the payment of dividends on such 50 per cent of net profits is compulsory, unless otherwise approved unanimously by such general meetings. To overcome the objection to direct profits towards other objectives, after declaring dividends on the proportion established in the law, the general meeting may approve a capital increase by the offset of credits on the amount declared as dividends.

iv  **Return of capital**

Reduction of capital is allowed if the remaining capital permits the company to continue the business. Such reduction of capital does not generate income tax.

VIII  **ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES**

i  **Acquisition**

Unless foreign companies already have a corporate entity in Ecuador, they acquire companies in Ecuador through a company incorporated abroad. Normally the business is created through an acquisition of shares, after due diligence, because such transfer does not generate any tax.

ii  **Reorganisation**

Mergers do not generate any taxes. The surviving company is liable for all tax obligations of the merging companies. Only mergers between companies established in Ecuador are allowed.
Divisions of companies do not generate taxes. The agreement to split a company must determine how the companies will divide the profit and losses for the period the division is registered. Such agreement may provide that one of the companies will have the profits and losses of the original company. If the losses and profits are divided among the new companies, the profit and loss statement should establish an equitable allocation of the revenues with the costs.

iii  Exit
A change of corporate domicile within Ecuador does not incur any tax penalties or effects. A change to a domicile abroad causes the dissolution of the company.

IX  ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i  General anti-avoidance
Companies established in tax havens or low-tax jurisdictions, when transacting with local companies, are deemed related companies and, therefore, the costs incurred in such transactions are tax deductible only if their value corresponds to the commercial principles of arm’s-length dealings.

Dividends received by companies established in tax haven jurisdictions or low-tax jurisdictions are not tax-exempt, and are therefore deemed taxable income.

An important decision was entered on 18 July 2013 by the Taxation Chamber of the National Court of Justice5 declaring as acceptable tax-deductible expenses the interest paid to related companies based on a contract between the Republic of Ecuador and a company operating an oil pipeline. However, through an action for extraordinary protection that under the Constitution is designed to guarantee due process of law, and to defend constitutional, human rights and civil liberties, the SRI obtained from the Constitutional Court vacation of the final decision6 and ordered the alternate judges of the Taxation Chamber of the National Court of Justice to enter a new decision, which was issued on 24 July 2014,7 by newly appointed associate judges, which considered that interest paid by the company operating the pipeline under a contract with the Republic was not a deductible expense, and established a new income tax with a surcharge of 20 per cent as a sanction for the taxpayer corporation. Previously, the Council of the Judiciary, without granting the judges that issued the 18 July 2013 decision the right to a hearing, had suspended and dismissed these judges.8 The Council of Citizenship Participation and Social Control dismissed all the Constitutional Court judges that rendered the decision.

ii  Controlled foreign corporations
No special tax rules exist with respect to companies established in Ecuador that are controlled by foreign corporations.

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5 Compañía Oleoductos de Crudos Pesados v. Servicio de Rentas Internas.
6 Servicio de Rentas Internas v. Taxation Chamber of the National Court of Justice, 26 December 2013.
7 Oleoducto de Crudos Pesados (OCP) Ecuador v. Servicio de Rentas Internas.
All companies under the control of the Superintendence of Banks or the Superintendence of Companies having foreign companies as share or quota holders should remit to such entities the list of the partners of such foreign companies or a certificate providing evidence that they are public companies whose shares are registered on a stock exchange.

**iii Transfer pricing**

The transfer pricing regime is established with the purpose of ensuring that prices between related parties are established under the same parameters as prices between independent parties. Therefore, such prices should reflect principles of competition and comparability, and a methodology for establishing such prices is submitted for the approval of the SRI.

However, the transfer pricing regime is not applicable if the taxpayer pays income tax equivalent to at least 3 per cent of total gross revenues, does not conduct business with residents in tax havens or low-tax jurisdictions and does not have contracts with the state for the exploration and exploitation of non-renewable resources.

**iv Tax clearances and rulings**

It is possible to consult the SRI or other tax authorities on the interpretation and application of tax laws. The answers to such consultations are compulsory for both the tax authorities and the taxpayer, which constitutes a risk for the taxpayer. There are no cases of legal requirements to have such tax ruling in advance with respect to acquiring local business or in other cases linked to income tax.

**X YEAR IN REVIEW**

Since 2009, all physical persons having a patrimony higher than US$200,000 have been required to present each year a declaration concerning their assets and liabilities. Purportedly, this information will permit the establishment of a tax on the patrimony of physical persons in the future—a tax that has the support of the SRI’s main officers as a means to reduce alleged inequalities. Regulations enacted during 2012 have established that physical persons not having the obligation to bear accounting books but with a certain level of gross revenues should report (in online form) all their expenses on a monthly basis to the SRI.

The Organic Law for Productive Development, published on 21 August 2018, re-established the rate of 25 per cent for corporate income tax, but this rate was increased to 28 per cent for companies having stockholders, partners, participants, incorporators, beneficiaries or similar physical persons regarding whom the companies have not informed to the regulator authority and to the SRI or if within the channel of ownership there are residents linked with a tax haven.

Such law also provided for a progressive capital gain tax of 2 per cent to 10 per cent on the sale of shares or other participation titles on companies.

As a consequence of the complete reorganisation of the judicial system during 2012, constantly ongoing, the judges appointed for the majority of the tax courts are former officers of the SRI, which has led to suspicion regarding their impartiality.9

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9 In Juan Quevedo v. Servicio de Rentas Internas, the tax court of first instance ruled that even companies not having net worth and that only represent individuals are subject to anticipate income tax, which applied to double tax individuals. The National Tax Court refused to hear the case.
The surcharges on imports were eliminated as a consequence of a formal proceeding initiated by the Secretary General of the Andean Community.

The organic Law to avoid the evasion of taxation on inheritances is still in force. Thereunder, beneficiaries of trusts are subject to progressive taxation of between 5 per cent and 35 per cent.

A Public and Private Alliance Act establishing tax exemptions or benefits for energy and mining investment projects, supported by government planning, entered in force on 18 December 2015. Such law aims to encourage public projects in association with private investors by avoiding the rules for public contracting for specific projects.

VAT returned to 12 per cent from mid-2017. A special law on capital gains derived from sale of real property was enacted on 31 December 2016 establishing a rate of 75 per cent on the difference of the price at the time of acquisition after 1 January 2017 and the price of the first sale thereafter. Under the plebiscite called by president Moreno such law was abrogated.

The Organic Law on Reactivation of the Economy, in force since 1 January 2018, exempted microenterprises from income tax for three years, eliminated the exemption of income tax on reinvestment of corporate profits, increased personal income tax for professionals, granted the SRI authority to establish presumptive profits, returned to the old income tax rate of 25 per cent for corporate income, except for microenterprises and exporting companies, established special tax reductions of value added tax if payment is made electronically, increased the term for the expiry of customs duties and other taxes based on statute of limitations, created a special gazette destined to inform taxpayers of audits and observations, and increased the powers of the Superintendence of Banks.

The Organic Law for Productive Development, in force since 21 August 2018, created special tax incentives exempting from income tax for 12 years new companies devoted to listed activities and businesses, granted a tax amnesty for payment of taxes owed condoning fines and interest, permitted the submission to international arbitration under specific rules controversies between the state and foreign investors investing tens of millions of dollars or more under investment contracts, and established additional tax incentives and benefits to private parties entering into alliances with public entities for conducting joint projects in specific areas. The Law also eliminated the subsidy to high-octane fuel, but maintained the subsidies for low-octane fuel and diesel.

XI OUTLOOK AND CONCLUSIONS

A new trend to develop private investment, including foreign investment, has been implemented since 24 May 2017, when President Lenin Moreno was sworn in. Certain actions against corruption have been taken mainly through the Council of Citizenship Participation and Social Control, which dismissed all the members of the Council of the Judiciary to try to support the independence of the judicial system. The Council also dismissed, as said above, all the judges of the Constitutional Court because of allegations of corruption. It is expected that the new constitutional judges to be appointed will not be linked with the Executive Branch.

The former government had appropriated and confiscated the revenues of private pension funds, and had used funds destined to cover the social security benefits of retired persons in the public healthcare sector. The retirement pensions of members of the armed
forces and of members of the national were also reduced. The net worth and the cash flow of companies devoted to prepaid medical care has been affected by a law ordering that such companies should reimburse the amounts covered by the Social Security Institute.

A new Criminal Code, in force since 10 August 2014, considers as criminal offences subject to imprisonment several acts connected with accounting books and supporting documents triggering a reduction in taxes. Criminal liability is also established for juristic persons and corporations subject to the sanction of extinguishing their legal existence. Criminal cases under these new provisions may be brought even without sufficient evidence.

A new Organic Monetary and Financial Code, in force since 12 September 2014, contains provisions that may ease the elimination of the dollar as the country’s legal currency and the introduction of a new local currency, but the Organic Law for Productive Development, in force since 1 January 2018, has strengthened the dollarisation in force in Ecuador since January 2000.

On 31 December 2019, a law designed to simplify and bring progress to the taxation system was promulgated, containing new ways of taxing specific industries and microenterprises. However, it also imposed special contributions destined to finance the high state expenses and eventual deficit, payable during 2020, 2021 and 2022 by corporations that had earnings above US$1 million dollars during 2018, with tariffs from 0.10 per cent to 0.20 per cent, with a cap equivalent to 25 per cent of the income tax paid during 2018.
Chapter 10

HONG KONG

Steven Sieker and Wenwen Chai

I INTRODUCTION

With a maximum corporate tax rate of 16.5 per cent, and no tax on sales, dividends or capital gains, Hong Kong is one of the most tax-friendly economies in the world. Foreign investments are not subject to any specific approval process, and the Hong Kong tax regime does not differentiate between foreign and domestic investors, except in relation to the acquisition of residential property. Hong Kong also promotes shariah investment, with the Hong Kong Monetary Authority indicating its aspiration for Hong Kong to be an Islamic finance hub. Since 2014, a number of banks have begun offering shariah-compliant funds. Coupled with its close proximity to and connection with Mainland China, Hong Kong is a popular gateway for inward investment into Mainland China by multinational corporations.

Although not an Organisation for Economic Co-operation and Development (OECD) member, Hong Kong is committed to supporting international efforts on base erosion and profit shifting (BEPS) and the Common Reporting Standard (CRS). Hong Kong joined the inclusive framework for implementation of the package of measures against BEPS (BEPS Package) on 20 June 2016 as a BEPS Associate. Following public consultation on the proposed measures, legislative amendments to implement CRS and automatic exchange of information were passed back in 2016 and amendments to implement the four minimum standards of the BEPS Package on 13 July 2018.

The principal tax legislation in Hong Kong is the Inland Revenue Ordinance (IRO).

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The most common business entities used in Hong Kong are companies, partnerships and trusts.

i Companies

A company incorporated under Hong Kong law may be limited by shares, limited by guarantee or unlimited, with a company limited by shares being the most common corporate form. If a company is limited by shares, the liability of the shareholders is limited to the amount unpaid on their shares. A company limited by shares may either be a public or a private

1 Steven Sieker is a partner and Wenwen Chai is an associate at Baker McKenzie.
3 Inland Revenue Ordinance (Chapter 112 of the laws of Hong Kong).
company. Public and private companies mainly differ in their ability to offer their shares to the public for subscription. Private companies must also cap the number of shareholders at 50. Both types of company are required to appoint a company secretary who is a Hong Kong resident individual, or a company with a registered office or place of business in Hong Kong. However, a private company only needs to have one director, and at least one director must be an individual. Public companies, on the other hand, need at least two directors.

**Taxation**

Profits tax is charged on every person carrying on a trade, profession or business in Hong Kong. A ‘person’ under the IRO is defined to include individuals, corporations, partnerships and bodies of persons. Profits tax would be charged on the assessable profits that arose in or were derived from Hong Kong during the basis period.

Corporations were previously taxed at a flat rate of 16.5 per cent on their profits arising in or derived from Hong Kong. Beginning from the year of assessment 2018/19, a two-tiered profits tax system will apply to corporations as well as other entities chargeable to profits tax in Hong Kong. Under the two-tiered system, the first HK$2 million of profits will be chargeable to a reduced profits tax rate of 8.25 per cent and any profits in excess of HK$2 million will be chargeable at the previous rate of 16.5 per cent.  

As the two-tiered system was introduced primarily for the benefit of small and medium-sized businesses, if an entity has one or more connected entities at the end of the basis period for a relevant year of assessment, then the two-tiered profits tax rate would only apply to one entity nominated by the group. An entity is connected to another entity if: (1) one of them has control over the other; (2) both of them are under the control of the same entity; or (3) in the case of the first entity being a natural person carrying on a sole proprietorship business, the other entity is the same person carrying on another sole proprietorship business.  

In this context, control means directly or indirectly owning more than 50 per cent in aggregate of the issued capital of another entity, or an entitlement to exercise or control the exercise of more than 50 per cent of the voting rights in another entity, or an entitlement to more than 50 per cent in aggregate the capital or profits of another entity.

The two-tiered system applies to a natural person, a body of persons, as well as corporations, partnerships and trusts. Persons other than corporations were previously taxed at a flat rate of 15 per cent on their assessable profits. Under the two-tiered system, the first HK$2 million of profits would be taxed at the reduced rate of 7.5 per cent and the remaining at 15 per cent.

**ii Partnerships**

Under the Partnership Ordinance a partnership is established when a group of persons carry on a business in common with a view to profit. Generally, no formalities are required to establish a partnership. However, a written partnership agreement is usually used to govern the relationships between the partners.

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4 Section 14(2), IRO.
5 Section 14AAB, IRO.
6 Partnership Ordinance (Chapter 38 of the laws of Hong Kong).
Limited liability partnerships are permitted under Hong Kong law. They must be registered with the Companies Registrar under the Limited Partnership Ordinance.\textsuperscript{7}

**Taxation**

The assessable profits of a partnership are charged as though the partnership is a single entity.\textsuperscript{8} A partner’s individual tax liability is calculated by apportioning the partnership’s assessable profits between each of the partners in the ratio in which the profits or losses of the basis period were divided. Thereafter, losses carried forward from previous years are deducted before applying the tax rate applicable to the individual partner to that partner’s share of the assessable profits.

iii **Trusts**

Trusts are commonly used in Hong Kong as an investment vehicle. A trust comes into existence when one person transfers a specific property to the trustee with the intention that it will be applied for the benefit of another person (i.e., the beneficiary).

**Taxation**

A trustee is subject to profits tax on its own profits arising from the provision of trustee services. Due to the separation of legal and beneficial ownership, a trustee will not be personally liable for tax charged on profits of the underlying entities of the trust. To the extent that the trustee itself carries on business, those profits will be subject to tax. A corporate trustee will, therefore, be subject to tax at a rate of 8.25 per cent on the first HK$2 million of profits (subject to the connected-entity rules) and at 16.5 per cent on the remaining profits.

### III DIRECT TAXATION OF BUSINESSES

i **Tax on profits**

**Determination of taxable profit**

Hong Kong has a territorial system of taxation. Three conditions must be satisfied before a charge to profits tax can arise:

\begin{itemize}
  \item[a] the taxpayer must carry on a trade, profession or business in Hong Kong;
  \item[b] profits to be charged must be from the trade, profession or business carried on by the taxpayer in Hong Kong; and
  \item[c] the profits must be profits arising in or derived from Hong Kong.
\end{itemize}

Whether a person is carrying on a trade, profession or business in Hong Kong is a question of fact.

Six factors have emerged from case law in determining whether a taxpayer has engaged in trade, which collectively are referred to as the ‘badges of trade’, namely:

\begin{itemize}
  \item[a] the subject matter of the transactions;
  \item[b] the length of ownership;
  \item[c] whether there have been successive or frequent similar transactions;
\end{itemize}

\textsuperscript{7} Limited Partnership Ordinance (Chapter 37 of the laws of Hong Kong).

\textsuperscript{8} Section 22(1), IRO.
whether supplementary activities have been performed to make the assets marketable or to attract purchasers;

e the reason for the disposal or realisation of the subject matter; and

f the taxpayer’s motives.

In addition, the taxpayer’s intention to trade and the existence of a commercial purpose for the transaction are also relevant to such a determination. It is not necessary for all badges of trade to be present before a taxpayer will be found to be trading.

The definition of ‘business’ is much wider than ‘trade’. A company incorporated for the purpose of making profits for its shareholders that puts any of its assets to any gainful use is presumed to be carrying on a business. Business can be more passive than trade, with the receipt of share profits and fixed annuities having been held to be business. Similarly, the receipt of income by a holding company and the mere activity of depositing have been held to be carrying on a business as well. One-off transactions may also fall under the definition of ‘business’ under the IRO. Having a registered office in Hong Kong of itself will not necessarily amount to carrying on a business in Hong Kong.

A ‘profession’ is not defined in the IRO. Case law indicates that it refers to work requiring either purely intellectual skill or manual labour dependent upon purely intellectual skill. If a person practices a profession but is an employee, he or she is not considered to be carrying on a profession for the purpose of profits tax.

On the source of profits, the IRO defines ‘profits arising in or derived from Hong Kong’ to include ‘all profits from business transacted in Hong Kong, whether directly or indirectly through an agent’. According to Commissioner of Inland Revenue v. Hang Seng Bank Limited, the process of determining the source of profit involves examining the gross profit of the transaction and what the taxpayer has done to earn the profit in question. However, the test outlined in this case is not consistently followed in subsequent case law, many of which revert back to an operations test (i.e., an examination of the operations of the taxpayer that contributed to the generation of net profits).

To provide some guidance and clarity in this area, the Hong Kong Inland Revenue Department (IRD) issued Departmental Interpretation and Practice Note (DIPN) No. 21. DIPNs are not legally binding, but are indicative of the IRD’s views on various legal issues. According to DIPN No. 21, transactions must be looked at separately and the profits of each transaction considered on their own. Where the gross profit from an individual transaction arises in different places, they can be apportioned as arising partly in and partly outside Hong Kong. Further, the place where day-to-day investment decisions are undertaken does not generally determine the locality of profits. The absence of an overseas permanent establishment (PE) of a Hong Kong business does not of itself mean that all the profits of that business arise in or are derived from Hong Kong. However, practically, the IRD is less likely to accept an offshore profits claim in the absence of an offshore presence of the taxpayer.

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10 IRC v. Korean Syndicate Ltd (1921) 3 KB 258; South Behar Railway Co Ltd v. IRC (1925) AC 476.
11 D15/87 Inland Revenue Board of Review Decisions Vol 2, 373.
12 IRC v. Maese (1919) 1 KB 647.
13 Section 2, IRO.
14 Commissioner of Inland Revenue v. Hang Seng Bank Limited (1990) 1 HKRC.
All outgoings and business expenses incurred in the production of profits are deductible in the basis year in which they are incurred. Such expenses include:

- **interest on borrowings for the purpose of producing profits, and other sums payable in connection with such borrowings, subject to the limitations outlined in Section VII.ii;**
- **rent paid by tenants for buildings or lands occupied for the purpose of producing profits;**
- **foreign tax paid by a Hong Kong taxpayer where they were incurred in the production of profits;**
- **bad debts;**
- **expenditure incurred in the repair of premises, plant, machinery, implements, utensils or articles in the production of profits;**
- **expenditure incurred on the replacement of any implement, utensil or article, provided that no depreciation allowances are made;**
- **expenditure for the registration of trademarks, designs or patents used in the trade, profession or business that produced the assessable profits; and**
- **contributions made by individual taxpayers to mandatory provident funds in Hong Kong.**

As a general rule, capital expenditures are not deductible. However, there are certain exceptions. For example, expenditure on research and development related to a taxpayer’s trade, profession or business is deductible provided that the expenditure is not on land or buildings, and that the payment is to an approved research institute for research and development related to that trade, profession or business or that the payment is to an approved research institute, the object of which is the undertaking of research and development relating to that particular class of trade, profession or business. To promote technological progress in local industries, the purchase of patent rights and rights to know-how are also deductible. In addition, payments for technical education and approved charitable donations may also be deducted from the assessable profits.

Depreciation is allowed for qualifying industrial and commercial buildings, and plant and machinery. For industrial buildings, a taxpayer who has incurred capital expenditure on the construction of an industrial building or structure is allowed a 20 per cent initial deduction of the capital expenditure. Thereafter, a 4 per cent deduction of the original capital expenditure is allowed annually.

A taxpayer with an interest in a commercial building or structure who has incurred construction costs can claim a deduction of 4 per cent annually. No depreciation deduction is available for commercial buildings that are more than 25 years old.

Capital expenditure on plant and machinery is allowed an initial deduction of 60 per cent in the year in which the expenditure is incurred. Thereafter, depending on the type of asset, depreciation is allowed on a reducing-value basis at 10, 20 or 30 per cent.

A super tax deduction scheme for research and development (R&D) expenditure was introduced on 2 November 2018 and applies to expenditures incurred by enterprises on R&D activities conducted after 1 April 2018. Under this new scheme, a 300 per cent tax deduction will be offered for the first HK$2 million of qualifying R&D expenditure and, for expenditure in excess of HK$2 million, HK$6 million plus a 200 per cent tax deduction. In April 2019, the IRD issued DIPN No. 55 to provide guidance on the application of the new super tax deduction scheme. It also emphasises the need to maintain adequate documentation of R&D activities and expenditure to support any deduction claims.
**Capital and income**

Hong Kong does not impose tax on capital gains. However, the issue as to whether income constitutes trading profits or non-taxable capital gains arises frequently in relation to the disposal of real property. Relevant factors include the frequency of the transactions, the accounting treatment adopted by the taxpayer, how long the property was held, how the property was financed and developed, and the reason for its sale. Profits obtained from properties acquired, developed and then sold are generally regarded as trading profits.

**Losses**

Hong Kong allows losses to be carried forward indefinitely.

**Rates**

The profits tax rate for companies is 8.25 per cent for the first HK$2 million of profits and 16.5 per cent for profits in excess of HK$2 million, subject to restrictions on connected entities discussed in Section II.i. If a company is a partner in a partnership, profits tax for its share of assessable profits is also charged according to the same two-tiered system of 8.25 per cent and 16.5 per cent. The rate for unincorporated businesses is 7.5 per cent for the first HK$2 million of profits and 15 per cent for profits in excess of that amount, subject to restrictions on connected entities as well.

**Administration**

A single tax authority – the IRD – exists in Hong Kong, and is responsible for administering the IRO.

Tax is charged on the assessable profits for the year of assessment. The assessable profits for a business that makes up annual accounts are calculated on the profits of the year of account ending in the year of assessment. Generally, profits tax returns should be filed within one month of the date of issue. However, under the IRD’s Block Extension Scheme, this may be extended depending on the accounting date of the company. If a business objects to a tax assessment issued by the IRD, it has the right to file an objection within one month of the issuance of the assessment with the IRD, which will then render a determination that is subject to appeal to the IRD Board of Review as well as the Hong Kong courts.

**Tax grouping**

No group loss relief is available to companies that are members of a group in Hong Kong.

**ii Other relevant taxes**

**Stamp duty**

Hong Kong imposes stamp duty on instruments of transfer rather than the transaction itself. Instruments relating to the sale and lease of real property are subject to stamp duty, as are instruments relating to the sale of Hong Kong stock. Hong Kong stock is defined to include equity and debt instruments registered on a Hong Kong register. Therefore, if an offshore company maintains its share register in Hong Kong, any transfer of shares will be subject to stamp duty. Stock also includes units in unit trusts that maintain their registers in Hong Kong.
Hong Kong bearer instruments such as promissory notes and bills of exchange are also subject to stamp duty. However, owing to the range of exemptions applicable to these instruments, they are rarely subject to stamp duty in practice.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Owing to the territorial tax system of Hong Kong, whether profits tax is chargeable under domestic law depends on whether the source of profits is in Hong Kong. As part of the amendments of the IRO to introduce comprehensive transfer pricing rules passed on 13 July 2018, there are further provisions to clarify what constitutes a permanent establishment in Hong Kong, especially with regard to entities resident in jurisdictions with which Hong Kong has not concluded a double taxation agreement (DTA). However, it is important to bear in mind that the territorial principle continues to apply despite the introduction of detailed rules on the definition of permanent establishment.

Whether a person resident in a territory with which Hong Kong has concluded a DTA has a permanent establishment in Hong Kong is to be determined in accordance with the relevant provisions of the DTA concerned.

For a non-DTA territory resident person, it has a permanent establishment in Hong Kong if it has a fixed place of business in Hong Kong through which the business of the enterprise is wholly or partly carried on. Carrying out certain preparatory or auxiliary activities would not constitute having a permanent establishment in Hong Kong. However, the fact the activities carried on do not reach the threshold of a permanent establishment does not necessarily mean that it would not be chargeable to tax in Hong Kong. If the activities carried out constitute carrying on a trade, profession or business within the definition of Section 14 of the IRO, any profits derived from such activities sourced from Hong Kong would nevertheless be taxable profits.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

In general, and as a matter of policy, Hong Kong does not offer tax incentives. However, this principle has been relaxed in recent years with the result that four industries currently enjoy lower statutory tax rates.

i General

Corporate treasury centres (CTCs)

In addition to the general allowance for deductions discussed in Section III.i, the IRO allows the deduction of interest payable on money borrowed by a corporation carrying on an intra-group financing business in Hong Kong as long as the following conditions are satisfied:

a the deduction claimed is in respect of interest payable by a corporation (i.e., the borrower) on money borrowed from a non-Hong Kong associated corporation (i.e., the lender) in the ordinary course of an intra-group financing business;

b the lender is, in respect of the interest, subject to a similar tax (i.e., such tax has been paid or will be paid) in a territory outside Hong Kong at a rate that is not lower than the Hong Kong's profits tax rate (i.e., 16.5 per cent); and
the lender’s right to use and enjoy that interest is not constrained by a contractual or legal obligation to pass that interest to any other person, unless the obligation arises as a result of a transaction between the lender and a person other than the borrower dealing with each other at arm’s length.

In addition, there is a reduction in the profits tax rate to 8.25 per cent for qualifying CTCs, which are dedicated CTCs, multifunction CTCs and CTCs by determination. A dedicated CTC is one that carries out one or more corporate treasury activities that stands alone. It would generally be prohibited from carrying out other activities. Multifunction CTCs can engage in a certain level of income-generating activities but still qualify for the profits tax concession on qualifying profits. A CTC by determination is a CTC that does not meet the conditions of either a dedicated CTC or a multifunction CTC, but may obtain a determination from the IRD stating that it is a qualifying CTC. Qualifying profits include lending transactions, corporate treasury services and corporate treasury transactions with non-Hong Kong associated corporations.

These CTC incentives became effective from 1 April 2016.

Captive insurers

Captive insurers enjoy a 50 per cent reduction in profits tax on their business of insuring offshore risks, thereby also reducing the effective corporate tax rate to 8.25 per cent.

Funds

Over the years, Hong Kong has rolled out numerous exemptions for different types of funds, starting with profits tax exemptions for offshore funds in 2006, for offshore private equity funds in 2015 and most recently for open-ended fund companies incorporated in Hong Kong in 2018.

However, starting from 1 April 2019, a new comprehensive regime was introduced that grants exemption to all privately offered onshore and offshore funds operating in Hong Kong, regardless of their size, structure or purpose, for transactions in specified assets, subject to meeting certain conditions. The exemption also applies to special purpose entities established by a qualifying fund.

The existing exemptions for offshore funds will continue to apply for any entity that does not satisfy the criteria under the new regime but the previous regime for open-ended fund companies will be repealed.

Aircraft lessors and managers

Through legislative amendments passed in July 2017, Hong Kong now offers a tax concession to qualifying aircraft lessors and aircraft leasing managers.

Qualifying aircraft lessors enjoy an 8.25 per cent tax rate on their assessable profits. In addition, the assessable amount of leasing income of a qualifying aircraft lessor is deemed to be 20 per cent of the gross leasing income less deductible expenditure. Effectively, the profits tax payable on the assessable profits of a qualifying aircraft lessor is reduced to 1.65 per cent of its net profit (ignoring depreciation). An 8.25 per cent profits tax rate also applies to the assessable profits of aircraft leasing managers providing management services (which also include aircraft financing activities) to qualifying aircraft lessors. These tax concessions apply to all profits derived on or after 1 April 2017.
Any aircraft lessor or manager who wishes to take advantage of the regime must make a written election with the IRD. The election is irrevocable.

To qualify for the reduced profits tax rate, the aircraft lessor or manager must satisfy the following conditions:

a. the lessor or manager must have its central management and control in Hong Kong;

b. the entity must not carry on any aircraft leasing or management activities from a permanent establishment outside Hong Kong;

c. the aircraft lessor must not carry on any activities other than aircraft leasing activities; and

d. an aircraft leasing manager must ensure that at least 75 per cent of its profits are derived from the aircraft leasing management business, and at least 75 per cent of its assets are deployed for such business.

If an aircraft lessor or manager fails to satisfy any of the conditions above, it will automatically be disqualified and cannot opt back into the regime. No grace period is allowed.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Hong Kong has no withholding tax. However, sums paid as royalties to non-residents for the right to use intellectual property are subject to a tax similar to withholding tax. The withholding tax rate is 4.95 per cent if the recipient is a corporation and 16.5 per cent if the two parties are associates. However, even if the recipient is an associate, as long as no person carrying on a trade, profession or business in Hong Kong has at any time held an interest in the ownership of such intellectual property, the normal 4.95 per cent rate would apply. For payments to unincorporated businesses, the rates are 4.5 and 15 per cent respectively.

There is no withholding tax on interest or dividends.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

There are no exclusions or exemptions applicable.

iii Double tax treaties

Traditionally, as Hong Kong adopts a territorial basis for taxation, Hong Kong residents generally do not suffer from double taxation. However, in recent years, Hong Kong has negotiated and entered into numerous DTAs with its trading partners, recognising that DTAs provide certainty to investors on the taxing rights of the contracting parties, helping investors to better assess their potential tax liabilities and providing an added incentive to do business in Hong Kong.15

Jurisdictions with which Hong Kong has concluded comprehensive DTAs include Austria, Belarus, Belgium, Brunei, Cambodia, Canada, the Czech Republic, Estonia, Finland, France, Guernsey, Hungary, India, Indonesia, Ireland, Italy, Japan, Jersey, Korea, Kuwait, Latvia, Liechtenstein, Luxembourg, Mainland China, Macau, Malaysia, Malta, Mexico, the

Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, South
Africa, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and
Vietnam.

iv Taxation on receipt
Dividends from a company subject to Hong Kong profits tax are not included in profits. No
part of the profits or losses of a trade, profession or business carried on by a person subject to
profits tax is included in ascertaining profits on which any other person is subject to profits
tax.

VII TAXATION OF FUNDING STRUCTURES
i Thin capitalisation
There are no thin capitalisation rules in Hong Kong.

ii Deduction of finance costs
Interest payable upon money borrowed by a person for the purpose of producing assessable
profits is deductible, subject to certain restrictions. In general, interest will be deductible
if borrowed from a foreign or domestic financial institution or if borrowed from a person
subject to tax in Hong Kong on the interest received. Generally (aside from the CTC rules
discussed in Section V.i), interest paid to a corporation outside of Hong Kong will not be
deductible.

In addition, legal fees, procuration fees, stamp duties and other expenses in connection
with the borrowed money are also deductible.

Borrowing expenses that are of a capital nature are not deductible. In making this
determination, the relevant consideration is the purpose of the loan, namely whether money
was borrowed for capital expenditure purposes. For example, where interest was paid on
money borrowed for the purpose of acquiring a redevelopment site, intended ultimately to
generate rental income, the interest expenses was of a capital nature and deduction should
not be allowed. 16

iii Restrictions on payments
A company must not make a distribution except out of profits available for the purpose,
where ‘distribution’ is defined to include every form of distribution of a company’s assets to
its members. 17 Profits available for distribution are the company’s accumulated realised profits
less accumulated realised losses.

iv Return of capital
Return of capital is permitted under the CO for a company limited by shares through a
reduction of share capital. 18 This is generally used when changes in a company’s business
result in excessive capital in the company. A reduction of capital is tax-neutral in Hong Kong.

17 Sections 297(1) and 290, Companies Ordinance (CO) (Chapter 622).
18 Section 210, Companies Ordinance (Chapter 622).
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
As Hong Kong does not impose tax on the sale of capital assets, capital gains on the sale of shares are not taxable. It is a question of fact as to whether shares are capital or trading assets. As discussed previously in Section III.ii, instruments of transfer of Hong Kong stock are subject to stamp duty.

ii Reorganisation
The CO introduced a court-free amalgamation scheme on 3 March 2014 for intra-group mergers. Under this scheme, two or more Hong Kong-incorporated, wholly owned companies within the same group could amalgamate and continue as one. However, neither the CO nor the IRO itself currently contain provisions on the tax consequences of such amalgamation. These rules are under development.

iii Exit
There is no exit tax for Hong Kong.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Anti-avoidance measures under the IRO include the following:

a Use of artificial or fictitious transactions under Section 61 of the IRO. A fictitious transaction is one that was never intended to be carried out by those who were ostensibly parties to it. An artificial transaction includes transactions that have been carried out but are commercially unrealistic. Commercially realistic transactions with incidental tax benefits could not be struck down under this provision.

b Implementation of transactions with the sole or dominant purpose of producing a tax benefit under Section 61A of the IRO. This section aims to strike down blatant or contrived tax-avoidance schemes. If a transaction is found to have the sole or dominant purpose of obtaining a tax benefit, then the transaction as a whole or a part of it will be disregarded.

c Sale of loss companies under Section 61B of the IRO. If a change in the shareholding of a company has been effected, and the sole or dominant purpose of the change in shareholding was to use a tax loss to obtain a tax benefit, then the set-off of a loss may be disallowed.

ii Controlled foreign corporations
Hong Kong has no controlled foreign corporation legislation.

19 Section 61, IRO.
21 Cheung Wah Keung v. Commissioner of Inland Revenue (2003) HKRC.
iii Transfer pricing

Hong Kong introduced its first ever transfer pricing legislation in July 2018 through substantial amendments to the IRO. These amendments codify the arm’s-length principle, which, prior to July 2018, had been applied in Hong Kong through informal practice rules rather than legislative provisions. This means that all transactions with associated parties must be conducted on arm’s-length terms. In addition, the amendments introduce transfer pricing documentation requirements, namely local and master files, and country-by-country reporting. The IRD’s recently-issued DIPNs, namely No. 58 on transfer pricing documentation and country-by-country reports, No. 59 on transfer pricing between associated persons and No. 60 on attribution of profits to permanent establishments in Hong Kong, further clarify provisions in the IRO relating to transfer pricing.

A Hong Kong entity entering into transactions with associated persons is required to prepare and keep on record a local file and a master file, unless such entity meets any of the two conditions below: (1) the total revenue of the entity does not exceed HK$400 million; (2) the total value of the entity’s assets does not exceed HK$300 million; and (3) the average number of the entity’s employees does not exceed 100. While the Hong Kong entity is not required to submit the master file and local file when filing its profits tax return, it must declare in the return whether it is required to prepare the master file and local file. Whether the Hong Kong entity has prepared the master file and local file in a timely and adequate manner may be subject to compliance checks by the IRD.

The master file should contain information on the group’s structure, the location of all the group entities, high-level information about the group’s global business operations, the group’s transfer pricing policies and consolidated financial statements. The local file should describe the business of the relevant entity, record information and transfer pricing documentation on each material category of related-party transactions (even where the relevant income or profits are sourced outside of Hong Kong) and contain the entity’s financial statements. However, if a certain transaction falls below the relevant monetary thresholds, then it would not be necessary to cover the transaction in the local file. Nonetheless, according to DIPN No. 58, all entities are encouraged to keep documentation on file even if they are not subject to transfer pricing documentation rules, as proper maintenance of transfer pricing documentation helps to mitigate audit and penalty exposure.

Multinational corporations are also subject to country-by-country reporting requirements that generally follow the OECD’s requirements on the same. If a multinational corporation’s ultimate parent entity is a tax resident in Hong Kong for each accounting period beginning on or after 1 January 2018, then the parent entity should prepare a country-by-country return in a form specified by the IRD. A Hong Kong entity that is not the ultimate parent entity may also be required to file a return if, for example, the ultimate parent company is not required to file a return in its tax residence jurisdiction, where there is no exchange arrangement in place between Hong Kong and the other jurisdiction, or where there has been a systemic failure to exchange a country-by-country report by the other jurisdiction.

22 Section 50AAF, IRO.
23 Section 58C, IRO.
24 Section 58E, IRO.
25 Section 58F, IRO.
Advance pricing arrangements are now available in Hong Kong, allowing entities to reach prior agreement with the IRD on the application of transfer pricing rules to material transactions during specified years of assessment.  

### iv Tax clearances and rulings

Under Section 88A of the IRO, the IRD is empowered to make advance rulings upon an application made by a person. An advance ruling may relate to how any provision of the IRO applies to the applicant or to the arrangement described in the application. However, it must not relate to the imposition or remission of a penalty, the correctness of a return supplied by a person, the prosecution of a person or the recovery of any debt owing by any person. The IRD will not entertain applications for arrangements that are hypothetical or speculative, and a ruling will only be given for a seriously contemplated arrangement.

Where a ruling has been made, that ruling applies to the arrangement for the period specified in the ruling. Each ruling is confined to its specific terms and cannot be relied on as a precedent for similar arrangements in the future.

Advance ruling applications are subject to a charge calculated on the basis of cost recovery.

### X YEAR IN REVIEW

Following Hong Kong’s significant enactment of its first transfer pricing legislation last year, Hong Kong has continued to demonstrate its commitment to support international efforts on BEPS in 2019 by issuing three corresponding DIPNs that streamline application of the transfer pricing legislation and promote consistency of that application with OECD principles.

Throughout 2019, Hong Kong also continued to expand and strengthen its automatic exchange of information network. Whereas Hong Kong first adopted the OECD CRS by way of an amendment to the IRO back in 2016, by 1 January 2017, all Hong Kong financial institutions were required to comply with the due diligence and reporting obligations under the legislation. In March 2019, the Hong Kong government announced that, with effect from 1 January 2020, not only would such due diligence and reporting obligations be extended to certain fund arrangements such as registered mandatory provident fund schemes and occupational retirement schemes, the IRO would also be amended to add another 51 jurisdictions to the information exchange network, increasing the number of reportable jurisdictions from the current 75 to 126.

On the profits tax front, as discussed in Section VI, Hong Kong has amended its tax regime to widen the scope of profits tax exemption available for privately offered funds. This offers greater flexibility for both inbound and outbound investments in Hong Kong, further strengthening Hong Kong’s position as an attractive market for investment purposes.

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26 Section 50AAP, IRO.
27 Section 1, Part 1 of Schedule 10, Inland Revenue Ordinance.
XI OUTLOOK AND CONCLUSIONS

Hong Kong prides itself on maintaining a simple tax system with a low effective tax rate, a principle that was enshrined in the Basic Law, the quasi-constitutional document governing the operation of the Hong Kong Special Administrative Region. In general, the government continues to satisfy this objective, but the system’s complexity has increased significantly in recent years, largely as a result of international pressure. Tax treaties, once unknown to Hong Kong, have become part of the tax landscape and, while providing some taxpayers with additional certainty, have introduced additional complications. Similarly, concepts such as transfer pricing and exchange of information were once unknown, but have now become part of domestic law.

Notwithstanding such development, Hong Kong retains an enviable competitive position with respect to taxes, as complexity has increased in most other jurisdictions at an even faster pace. Moreover, the absence of any sales taxes, significant duties, withholding taxes on dividends and interest, or tax on capital gains makes it an attractive investment location, particularly as a gateway to Mainland China, with which Hong Kong enjoys a privileged relationship.

28 Article 108, Basic Law.
I INTRODUCTION

Hungary, as an open economy, seeks to attract inbound investments by, inter alia, operating a favourable corporate income tax (CIT) regime; for example, the CIT has a flat rate of 9 per cent, no withholding tax is imposed on payments made to companies, reported shares can be relied on to exempt capital gains arising on the sale of shares from taxation, preferential tax rules may apply to intangible assets and to the income derived therefrom etc. In addition, the payroll taxes have been steadily decreasing and this tendency, in conjunction with Hungary having a skilled and cheap labour force, may result in relatively low wage expenses.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

The most commonly used types of business associations for inbound investments are the limited liability company (Kft), the company limited by share (Rt) and the limited partnership (Bt). Both entities are subject to Hungarian corporate income tax on their income. Shareholders are taxed separately on dividends received from these corporations. There is no difference between the Hungarian taxation of such entities; however, other aspects (e.g., liability of the members, the costs of the foundation and other regulatory requirements) makes the Kft form the most popular in Hungary.

ii Non-corporate

Classical fiscally transparent entities do not exist in Hungary (i.e., general partnerships and limited partnerships are tax residents and taxable entities as it is the trust registered in Hungary).

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1 János Pásztor is a senior associate, Alexandra Töth is an associate and Bence Kálmán a member of the tax team at Wolf Theiss Faludi Erős Attorneys-at-Law.
III DIRECT TAXATION OF BUSINESSES

i Tax on profits

**Determination of taxable profit**

The Hungarian rules applicable to CIT are set out in the Act LXXXI of 1996 on the Corporate Income Tax and Dividend Tax (the Act on CIT).

Taxpayers with Hungarian residence are taxable on their worldwide income (unlimited tax liability), while non-resident businesses only need to pay tax on the income derived from their Hungarian activities (limited tax liability).

The CIT base should be established on the basis of the total revenues less costs and expenses (‘pre-tax profit’) as determined in the financial statements prepared in accordance with the Hungarian accounting standards, or in certain cases in line with international financial reporting standards.

For the purpose of determining the CIT base, the pre-tax profit has to be modified by certain tax base increasing items and also certain tax base decreasing items may be applied as set forth by the Act on CIT.

The most common pre-tax profit modifying items are the losses carried forward, provisions, depreciation, declared share, declared intangible goods, dividends, received royalties, research and development, costs incurred that are not in relation with the business’ interests, imposed penalties, thin capitalization rules, controlled foreign company rules (CFC).

Business expenses are generally deductible for CIT purposes. This means that, in general, travel, accommodation, renting expenses should be deductible for tax purposes. Furthermore, the Act on CIT provides a non-exhaustive list of expenses that should qualify as business expenses, such as: wages, the costs of training provided by the taxpayer, certain membership fees, certain insurance fees, business entertainment expenses, business gifts, etc.

Depreciation is deductible for tax purposes in accordance with the Annexes to the Act on CIT. The annexes specify, among others, the following straight-line tax depreciation rates for main assets:

\[ \begin{align*}
   a & \quad \text{buildings used in hotel or catering businesses: 3 per cent;} \\
   b & \quad \text{commercial and industrial buildings: 2 to 6 per cent;} \\
   c & \quad \text{leased buildings: 5 per cent;} \\
   d & \quad \text{motor vehicles: 20 per cent;} \\
   e & \quad \text{computers: 50 per cent; and} \\
   f & \quad \text{intellectual property and film production equipment: 50 per cent.}
\end{align*} \]

Tax losses carried forward from previous years can be used to decrease the pretax profit only up to 50 per cent of the positive tax base.

There is no Hungarian withholding tax on dividend and interest paid by the Hungarian entity to foreign entities. Therefore, Hungary would not levy a withholding tax on the dividend or interest paid to foreign legal entity shareholders; however, related party transactions are subject to transfer pricing rules and should be carried out at an arm’s length basis.

Hungary grants tax credits related to funding film making and performance acts, certain spectacle team sports, for business growth, for energy efficient investments and for small and medium-sized businesses.

There is a reduced effective tax on certain types of income. Companies may reduce their corporate tax base by 50 per cent of royalty income, which includes, in certain cases,
income from the disposal of intangible property. In effect, only half of the royalty income is taxable. In light of the recent developments regarding the Base Erosion and Profit Shifting (BEPS) Project of the Organisation for Economic Co-operation and Development (OECD), the definition of royalties eligible for these incentives was narrowed, and the conditions for applying these allowances were tightened as of 1 July 2016.

If the higher of the pre-tax profit and the CIT base of the taxpayer does not reach 2 per cent of the revenues less the costs of goods sold and less the costs of mediated services (‘minimum income’), the taxpayer has to either complete a declaration form supplementary to the tax return, or it has to consider the minimum income as its CIT base. The declaration should provide details of revenues and expenses based on which the tax authority may later initiate an audit at the company. This provision is not applicable during the tax year and the following tax year when the taxpayer is functioning as a pre-company.

**Capital and income**

As a general rule, Hungarian CIT legislation does not distinguish between the taxation of ordinary income and capital gains (i.e., these latter are included in the CIT base as well and are consequently taxed at a flat rate of 9 per cent). However, preferential rules may apply to capital gains derived in respect of certain assets as set out below.

Under the reported share regime, gains realised on the sale of reported shares or on the disposal thereof by providing them as in-kind contribution to another entity are exempt from CIT, provided that the reported shares concerned have been held for at least one year.

The reported intangibles scheme is basically modeled after the reported share regime, i.e., if the subject of any of the transactions set out above qualified as a reported intangible, the gains accruing to the taxpayer on the alienation thereof would be exempt from CIT, provided that the reported intangible concerned has been held by the taxpayer for at least a year.

Furthermore, the gains stemming from the sale of an intangible falling outside the ambit of the reported intangibles scheme may be exempt from CIT on condition that it is used to purchase royalty-generating intangibles within five years. A taxpayer may not enjoy the benefits arising from the reporting of a repurchased intangible if this asset was previously sold as an unreported intangible that benefited from this capital gains tax exemption.

**Losses**

Losses carried forward from previous tax years may be utilised to decrease the pre-tax profit by up to 50 per cent of the relevant tax year’s CIT base as calculated without the carried-forward losses. As of 1 January 2015, tax losses generated in 2014 or in the previous years can be used in the tax year starting in 2025 at the latest; however, tax losses generated in 2015 or later can be utilised within five years.

Corporate transformations (including mergers, demergers as well as changing the company form) and acquisitions, and change-of-control restrictions fall under a special regime.

**Rates**

The tax rate is 9 per cent of the positive amount of the tax base.
**Administration**

In addition to the National Tax and Customs Authority (referred to herein as the ‘tax authority’), which is responsible for administering state taxes, local taxes (e.g., local business tax, building tax, land tax etc.) are administered by the local tax authority of the municipality on the territory of which a given local tax liability has been incurred.

The tax year is the calendar year in which the tax liability was incurred, or, in case of taxes to be assessed on the basis of the financial statements, it is aligned with the financial year of the taxpayer (which latter, in turn, corresponds by default to the calendar year as well).

The CIT return should be filed until the last day of the fifth month following the end of the tax year (i.e., the deadline is 31 May of the year following the tax year concerned by default) and should also be paid within this deadline (advance tax payments that have already been paid until this date may be credited against the CIT payable). In this tax return, taxpayers also have to declare advance tax payments that they will pay for the 12-month period beginning in the second month after the filing deadline (i.e., such period commences by default on 1 July). The total amount of the advance payments equals the CIT payable for the year covered in the CIT return.

The taxpayer may seek to justify any delay in submitting the CIT return by settling the CIT payable and submitting a letter setting out the reasons for the delay alongside the CIT return within 15 days once the reason for the delay have been remedied. Should the tax authority accept the taxpayer’s justification, the return would be regarded as if it had been submitted within the deadline. Otherwise, the taxpayer may be sanctioned by the tax authority for the delay (e.g., it could be obliged to pay default payment and late payment interest).

The tax authority shall conduct tax audits at companies with net sales revenue reaching 60 billion forints (approximately €180 million) in two consecutive financial years, if their after-tax profit is zero or negative in both financial years.

The taxpayer may lodge an appeal to the second instance tax authority against the assessments made by the tax authority in a tax audit. The decision of the second instance tax authority may, in turn, be contested by the taxpayer by initiating court proceedings in front of the competent administrative court.

To mitigate tax risks by gaining clarity on the correct tax treatment, it is possible to request on a no-name basis a non-binding guideline from the tax authority. Moreover, an advance tax ruling may be requested from the Ministry of Finance.

**Tax grouping**

According to the new rules entered into force in 2019, group taxation can be opted for by at least two entities subject to CIT in Hungary, provided that (1) one of the entities directly or indirectly holds at least 75 per cent of the voting rights in the other entity; or (2) the same person directly or indirectly holds at least 75 per cent of the voting rights in each entity.

The tax base of the group consists of the positive tax bases of its members. Each group member has to determine its tax base in accordance with the corporate income tax rules. In contrast to the current Hungarian tax legislation, which does not allow a taxpayer to utilise losses carried forward by another taxpayer, the negative tax bases of group members may, subject to certain limitations, be utilised to decrease the tax base of the tax group in the tax year and the subsequent five years. Special rules apply to the tax allowances that can be used on a group level. The corporate income tax payable should be allocated to each group member in proportion to their positive tax bases.
In addition to the above, group taxation also substantially eases the transfer pricing obligations (e.g., preparing transfer pricing documentation and adjusting the tax bases) as the group members do not need to fulfil these obligations in respect of transactions effectuated between them.

ii Other relevant taxes

Local business tax

Under Hungarian legislation, the local municipalities can levy local business tax (LBT) and they are also entitled to determine the rates within their territories; however, the maximum rate of LBT is 2 per cent. The LBT base is, in essence, calculated as the net sales revenue less the cost of goods sold, value of intermediated services, value of subcontractors’ performance, R&D expenses and material cost.

Transfer tax

Transfer tax may arise (regardless of the personal characteristics of the owner) when acquiring:

- real estate located in Hungary;
- shares in a real estate holding company (Hungary legislation defines this latter distinctly from the definition given to it for CIT and personal income tax (PIT) purposes);
- rights of a pecuniary value connected to real estate;
- movable tangible property within the frame of a public auction; and
- structures not qualifying as real estate located in public areas or rights connected thereto with a pecuniary value.

The general rate of the transfer tax is 4 per cent of the market value of the asset. If the market value of the real estate exceeds 1 billion forints (approximately €3 million), the rate of the transfer tax on the exceeding part is 2 per cent, but this liability is capped at 200 million forints (approximately €600,000) per real estate property.

Payroll taxes

The employee and also the employer should pay taxes and social security contributions. The employee pays 15 per cent personal income tax, 17 per cent health insurance and pension contribution and 1.5 per cent labour force contribution. These amounts would be withheld by the employer from the gross salary of the employee and monthly payroll tax returns filed thereon and those amounts remitted to the tax authority by the employer. According to a legislative proposal, the contributions payable by the employee will be merged together from 1 July 2020 as social security contribution to be withheld from the gross salary at 18.5 per cent.

On the other side, 17.5 per cent social contribution tax and 1.5 per cent training fund contribution is payable by the employer, which should be assessed on the basis of the gross salary of the employee.

Value added tax

The standard rate of the value added tax chargeable in Hungary is 27 per cent with certain supplies qualifying for a preferential rate of 5 per cent or 18 per cent and some supplies being exempt (e.g., financial services, the sale of shares in companies).
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Entities (i.e., legal persons established under Hungarian law, partnerships, other organisations) that are considered as resident taxpayers in Hungary are determined by the Act on CIT. Above these resident entities, any non-resident person whose effective place of business management is in Hungary shall be treated as resident taxpayer for Hungarian tax purposes. Furthermore, a trust fund managed under a fiduciary asset management contract shall also be treated as resident taxpayer.

ii Branch or permanent establishment

Corporations having neither their registered seat nor their place of effective management in Hungary are taxable only on specific types of income in Hungary. This, inter alia, includes income from a Hungarian permanent establishment. A permanent establishment for Hungarian tax purposes is very similar to the OECD approach.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

The Hungarian CIT legislation aims to incentivise making capital investments in entities by making the reported share regime available to taxpayers. This latter may be relied on so that gains realised on the sale of reported shares or on the disposal thereof by providing them as in-kind contribution to another entity may be treated as exempt from CIT, provided that the reported shares concerned have been held for at least one year. However, the capital losses resulting from the alienation of the shares may not be deducted from the CIT base.

Shares would be regarded as a ‘reported’ if the taxpayer has reported the acquisition thereof or an increase in the shareholding (so that such increase may also qualify for the reported share regime) to the tax authority within 75 days following the date of the acquisition to the Hungarian tax authorities. In any case, shares in a controlled foreign company ‘CFC’ cannot be treated as reported shares.

ii IP regimes

The Hungarian CIT legislation offers double deduction from the CIT base for qualifying R&D expenses (i.e., the qualifying R&D expenses decrease the pre-tax profit and then they can be deducted from the tax base again). Therefore, direct costs of own base research, applied research, experimental development (except for the value of R&D services provided directly or indirectly by a resident taxpayer, by the domestic permanent establishment of a non-resident entrepreneur or by a private entrepreneur) can be deducted or if the taxpayer opted for capitalising R&D expenses then the amount of the depreciation can be deducted.

Furthermore, based on the Hungarian patent box regime, taxpayers may benefit from a 50 per cent deduction for licensing activities (i.e., 50 per cent of royalty income is exempt up to 50 per cent of the pre-tax profit). If the royalty-generating IP asset is acquired from a related party or R&D services to create the asset concerned are provided by a related party, the nexus approach would limit such benefit: the amount eligible for it should be calculated as the ratio of 130 per cent of the qualifying expenditures (i.e., direct costs at the
taxpayer) incurred to develop the asset to the overall expenditures (including the qualifying expenditures, purchase price of the asset and the direct costs at affiliated companies) incurred multiplied by the overall royalty income.

In addition, the reported intangibles scheme – which is basically modeled after the reported share regime – can be utilised to exempt capital gains accruing on certain disposals of the intangibles concerned by reporting the intangible asset to the tax authority within 60 days after the date of its acquisition or creation and holding it for at least one year. However, this scheme would not be available to a taxpayer in respect of reacquiring an asset that was previously alienated as an unreported intangible by the taxpayer in respect of which the taxpayer has availed of the below exemption from CIT on capital gains.

The gains stemming from the sale of an intangible asset falling outside the ambit of the reported intangibles scheme may be exempt from CIT as well on condition that such gains are used to purchase royalty-generating intangibles within five years.

### ii. State aid

Hungary is vested in supporting the improvement of corporate productivity, the creation of high-added value jobs as well as keeping existing jobs. Therefore, the Hungarian government offers non-refundable VIP cash incentive, which is accorded to investors upon their request on the basis of a governmental decision provided that the contemplated investment meets the prescribed criteria with a view to subsidizing:

- **a** asset investments;
- **b** R&D projects;
- **c** the creation or expansion of shared service centers;
- **d** the establishment and development of workshops; and
- **e** the training of employees.

In addition to the above, eligible investments may benefit from a wide range of tender calls financed from European Union (EU) funds (e.g., acquisition of assets, job creation, etc.).

### iv. General

Hungary incentivises certain investments through the tax system by providing for the possibility to apply development tax allowance (i.e., an opportunity for taxpayers to credit the eligible costs incurred in connection with a given investment against the CIT). This tax allowance may, in essence, be claimed up to 80 per cent of the CIT payable within the 12 tax years following the tax year in which the investment was completed.

### VI. WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

#### i. Withholding outward-bound payments (domestic law)

Hungary does not levy withholding tax on payments (e.g., interest payments, dividends, royalties etc.) made to entities, e.g., repatriating profits would not trigger taxes in Hungary.

#### ii. Domestic law exclusions or exemptions from withholding on outward-bound payments

See Section VI.i.
iii Double tax treaties

Hungary has a quite extensive double tax treaty network: currently there 86 double tax treaties (DTTs) in force that take precedence over the domestic legislation. Hungary has, inter alia, concluded DTTs with countries that include the member states of the EU, the countries of the Balkans, Iceland, Liechtenstein, Norway, San Marino and Switzerland, Belarus, Moldova, Russia, Ukraine, the countries of the Caucasus, Kazakhstan and Uzbekistan, Canada, the United States, Mexico, Brazil and Uruguay. There are DTTs in place with India, Pakistan, Vietnam, Thailand, Taipei, Hong Kong, China, Mongolia, South Korea, Japan, the Philippines, Indonesia, Malaysia, Singapore and Australia. Hungary also has DTTs with African countries, namely, South Africa, Morocco, Tunisia and Egypt. In recent years, Hungary ratified DTTs with several countries of the Middle East (i.e., with Bahrain, Iran, Israel, Kuwait, Qatar, Saudi Arabia, Turkey, the United Arab Emirates and Oman).

iv Taxation on receipt

The DTTs concluded by Hungary usually provide for the credit method to grant tax relief to Hungarian tax resident entities in regard of passive income. In case no DTT would be applicable, a credit would be granted under the domestic legislation.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

See Section VII.ii.

ii Deduction of finance costs

As a general rule, finance costs (including those connected to acquisition finance) that have been incurred within the frame of the business operations of the taxpayer may be deducted from the CIT base.

However, Hungary has implemented the interest deduction limitation rule set out in the Anti-Tax Avoidance Directive (ATAD). Consequently, excess financing costs (i.e., the amount of the net financing costs exceeding the higher of the following) increases the pre-tax profit: (1) 30 per cent of the earnings before interest, tax, depreciation and amortisation (EBITDA) or (2) the statutory threshold of 939,810,000 forints (approximately €3 million).

Inter alia, the following items should be taken into account as financing costs: interest expenses, also, any costs and expenses equivalent to interest in economic terms, as well as costs and expenses incurred in connection with the raising of finance etc. The amount of the net financing costs is equal to the positive difference of the aforementioned financing costs less interest income and other economically equivalent taxable income.

The unused interest deduction capacity can be carried forward (i.e., the amount can be used to reduce the excess financing costs in the subsequent tax year or years) but this reduction cannot exceed the amount of the excess financing costs. The interest deduction capacity of a given tax year is 30 per cent of the pertaining EBITDA less the net financing costs incurred for that tax year.

If the CIT base was increased in accordance with the above, the CIT base can be reduced by up to the amount of such increase in the subsequent tax year or years; however, the amount may not exceed the interest deduction capacity calculated for the tax year in which such reduction is applied.
iii Restrictions on payments
Certain rules constrain the payment of dividends (e.g., dividends cannot be paid if (1) the company’s adjusted capital (equity less the fixed reserve and evaluation reserve) does not, or would, as a consequence of the dividend payment, not reach the company’s registered capital, or, (2) would otherwise prejudice the solvency of the company).

iv Return of capital
In principle, it is feasible to repay capital subsequent to a reduction of capital, but the registered capital of the company may not, as a consequence, fall under the statutory minimum threshold set out by the legislation for the given company form. As a general rule, this would be tax-neutral. However, if a non-resident shareholder realises capital gains on the reduction of capital in a real estate holding company, this shareholder may incur CIT at 9 per cent on such capital gains.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES
i Acquisition
Hungarian businesses are typically acquired by way of a share deal (rather than by way of an asset deal), with the shares in the Hungarian company being purchased by an entity located in a country with a favourable participation exemption.

ii Reorganisation
Hungarian corporate legislation stipulates many types of reorganisations, including upstream and downstream mergers and demergers. Generally, such transactions would trigger Hungarian tax liability (making them prohibitively expensive); however, the Hungarian tax legislation allows such restructurings to be carried out in a tax-neutral manner under certain circumstances being met.

iii Exit
As from 1 January 2020, the Hungarian CIT regime introduces exit taxation provisions. The implementation of such rules serves the purpose to be in compliance with the harmonisation requirements of the EU’s ATAD I.

Accordingly, a Hungarian taxpayer is subjected to 9 per cent CIT, at the time of the exit of its assets and at the amount equal to the positive difference between the fair market value of such assets (to be determined in line with the general transfer pricing guidelines) and the tax book value of those assets, in certain cases (e.g., in the case of transferring the effective place of management to a foreign jurisdiction, etc.).

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION
i General anti-avoidance
The Hungarian general anti-avoidance rule (GAAR) contains an explicit reclassification provision allowing for the tax authority to re-characterise the transaction based on the actual content and assess the tax implications as if the tax avoidance transaction had not taken place. In addition, the Hungarian legislation has been supplemented by the main purposes test to
further limit the tax planning opportunities. The legislation is silent on whether the GAAR can apply to a transaction covered by a tax treaty, although some recent treaties include anti-avoidance rules.

ii  Controlled foreign corporations

Under the new CFC rules, effective from 1 January 2019, a Hungarian taxpayer shall treat a foreign entity as a CFC where the following conditions are met.

A Hungarian taxpayer entity alone or together with its related parties (throughout most of the Hungarian entity’s financial year) holds a direct or indirect interest therein, which entitles it to: (1) more than 50 per cent of the voting rights; (2) more than 50 per cent of the registered capital; or (3) more than 50 per cent of the after tax profits.

In the foreign entity’s given financial year, the actual CIT paid by the foreign entity is less than 50 per cent of the CIT that would have been charged on the entity under the applicable CIT rules in Hungary (i.e., less than 50 per cent of the Hungarian CIT rate of 9 per cent that is 4.5 per cent, unless the foreign entity earns income that would not be subject to tax in Hungary either, such as, dividend or capital gain).

According to the recent changes, an entity will no longer be automatically exempt from being deemed as a CFC solely on the basis that one of its related parties is listed on a recognised stock exchange.

To avoid the qualification as a CFC, the foreign entity must meet the following conditions:

a  its income arises purely from genuine arrangements or series of such arrangements, which the Hungarian taxpayer will need to evidence; or

b  its accounting profit does not exceed 243,952,500 forints and its non-trading income does not exceed 23,395,250 forints; or its accounting profits amount to no more than 10 per cent of its operating costs for the tax period.

An arrangement or a series thereof shall be regarded as non-genuine to the extent that its primary purpose is to obtain tax benefit and the foreign entity would not own the assets or would not have undertaken the risks that generate all, or part of, its income if it were not controlled by a Hungarian tax resident company where the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the controlled company’s income.

iii  Transfer pricing

Hungary’s transfer pricing rules widely comply with the OECD transfer pricing guidelines. The rules allow the tax authorities to adjust taxable profits where transactions between related parties are not at arm’s-length level. For agreements between related parties, the tax base of the related parties must be adjusted by the difference between the market price and the contract price if the application of the market price would have resulted in higher income for the companies. Tax base reduction can be only applied based on the declaration of the related party stating that it will take (or has taken) into account the same amount when calculating its CIT (or other equivalent tax) base. The tax base reduction does not apply if the transaction involves companies deemed to be CFCs.

The current legislation prescribes the methods applicable for determining a fair market price and also the way in which these should be applied. The taxpayer is entitled to calculate the fair market value using any method, provided it can prove that the market price cannot
be determined by the methods included in the Act on CIT and that the alternative method suits the purpose. Transfer pricing legislation should also be applied to transactions where registered capital or capital reserve is provided in the form of non-cash items, reduction of registered capital, or in-kind withdrawal in the case of termination without successor, if this is provided by or to a shareholder that holds majority ownership in the company.

A Ministry of Finance decree describes the requirements for the transfer pricing documentation, which should be prepared for all related party agreements that are in effect, regardless of the date on which the agreement was concluded. A wide range of taxpayers is obliged to prepare detailed transfer pricing documentation until the deadline for the submission of the annual CIT return of the company. These documentations must be available at the time of the tax audits.

Unilateral, bilateral and multilateral Advance Pricing Agreements (APA) are available in Hungary. In this procedure, the taxpayer and the tax office can agree in advance concerning the appropriate approach to determine the ‘arm’s length’ price in related party transactions. APAs can be requested for future transactions and such agreements could be effective for three to five years.

iv  Tax clearances and rulings
Binding tax rulings issued by the Ministry of Finance (Ministry) are also available in Hungary. The taxpayer may request a binding opinion from the Ministry relating to future business transactions. The opinion is binding on the tax office in the course of a future audit if the facts and circumstances of the business transaction have been fully disclosed in the request and remained the same, and the applicable tax law had not changed. In addition, for large taxpayers satisfying certain conditions, a special type of CIT ruling is available that remains binding for two years irrespective of future changes in the corporate tax law.

X YEAR IN REVIEW
As a consequence of the implementation of the ATAD, the general anti-avoidance rule, the rules on controlled foreign companies and the interest deduction limitations underwent a major overhaul in 2019.

XI OUTLOOK AND CONCLUSIONS
The summer tax package promulgated in 2019 transposed into Hungarian law the provisions of the ATAD on exit taxation and the hybrid mismatch rules with such rules being applicable from 1 January 2020. By levying an exit tax, Hungary will be able to tax the economic value of capital gains yet unrealised at the time of exit created in its territory. The implementation of the rules on hybrid mismatches will enable Hungary to tackle double deduction or deduction without inclusion outcomes that result from the differences in the legal characterisation of payments, financial instruments and entities, or in the allocation of payments under the laws of two or more jurisdictions.

Besides adopting the EU mandatory rules, the Hungarian tax system aims to provide a favourable environment for foreign investments by a low CIT burden, relatively low (continuously decreasing) payroll taxes combined with skilled labour forces and by granting several tax incentives and allowances for foreign investments.
I  INTRODUCTION

A host of reforms have made it easier for entities to start, operate and exit businesses in India. Some of the initiatives, including ‘Make in India’, improving the ease of doing business in India, ‘Start up India’ and ‘Digital India’ will further pave the way for growth. Over the past few years, the government has delivered landmark structural reforms (including the Insolvency and Bankruptcy Code, Indian Accounting Standards and the Goods and Service Tax), which are expected to foster economic growth in India. A testament to this is India having jumped 65 places under four years of the current government to be ranked 77th on the World Bank’s Ease of Doing Business Index for 2019.

II  COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

There are several types of business vehicles that operate in India. Broadly, these include sole proprietorships, partnership firms or limited liability partnerships (LLPs), private limited companies and public limited companies. However, the options available to a non-resident intending to set up a business in India are more specific.

i  Corporate

One of the more preferred business vehicles in India is a private company limited by shares, which is incorporated under the Companies Act 2013 (the Companies Act).

The key differences between a private company and a public company are set out below:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Private company</th>
<th>Public company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basic characteristics</td>
<td>Preferred by small to mid-sized companies</td>
<td>Preferred by large companies</td>
</tr>
<tr>
<td></td>
<td>Cannot invite the public to subscribe to its shares or make deposits</td>
<td>Can invite the public to subscribe to its shares or make deposits</td>
</tr>
<tr>
<td>Corporate governance and disclosure requirements</td>
<td>Less compared to public companies</td>
<td>More compared to private companies</td>
</tr>
<tr>
<td>Potential listing on stock exchanges</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Transferability of shares</td>
<td>Not freely transferable</td>
<td>Freely transferable</td>
</tr>
<tr>
<td>Shareholders</td>
<td>Minimum two, and not exceeding 200</td>
<td>Minimum seven, with no upper limit</td>
</tr>
</tbody>
</table>

1 Bijal Ajinkya is a partner at Khaitan & Co. She would like to acknowledge the contribution of Kruthika Prakash to the chapter.
### Non-corporate

A non-resident may contribute to the capital of a general partnership firm, or a proprietorship concern in India, only with the prior approval of Reserve Bank of India (RBI).

Foreign investment in LLPs is permitted under the automatic route in sectors that are open to 100 per cent foreign direct investment under the automatic route. Unlike partnership firms, LLPs are body corporates and have a legal existence that is separate from their partners. An LLP can be incorporated with a minimum of two partners, and unlike partnerships, there is no restriction on the maximum number of partners. The liability of partners in LLPs is limited to the provision of their capital contribution and any other contribution as agreed in the partnership agreement. As a result, a significant benefit that an LLP has over the partnership structure is that a partner of an LLP is not personally liable for an obligation of the LLP or the wrongful act or omission of other partners of the LLP.

Under the Income Tax Act, 1961, neither Indian general partnerships nor LLPs are accorded a tax pass-through status, and both qualify as a separate taxpayer category.

### III DIRECT TAXATION OF BUSINESSES

#### i Tax on profits

**Determination of taxable profit**

Taxable income from business is required to be computed in accordance with either the cash or mercantile system of accounting regularly employed by the taxpayer. Taxable profits are based on accounting profits but are adjusted for specific allowances and disallowances. All revenue expenditure expended ‘wholly and exclusively’ for the purposes of the taxpayer’s business is generally allowed as a deductible expense.

Further, while computing its taxable income, a taxpayer is entitled to claim certain deductions and industry-specific tax concessions, subject to the fulfilment of specific conditions. Adjustments on account of depreciation are available to all categories of taxpayers on an annual basis, where depreciation is to be reduced from the written down value of each ‘block of assets’, namely buildings, furniture and fittings, machinery and plant, intangible assets, etc. It is important to note that depreciation for the purposes of the IT Act is different from depreciation as computed under accounting principles.

Residents are subject to income tax on their worldwide income, whereas non-residents are subject to tax in India only on income that is sourced in India, namely income that: (1) is received or is deemed to be received in India; or (2) accrues or arises or is deemed to accrue or arise in India.
Capital and income

The IT Act is schedular in nature and provides for different heads of taxable income. The general rule under Indian domestic law is that all revenue receipts are taxable unless a receipt is specifically exempt and all capital receipts are exempt from taxation unless there is a specific provision to tax it. While calculating taxable business income, only revenue receipts after deducting revenue expenses are considered. The IT Act provides a separate head of ‘income from capital gains’ for levying tax on certain capital receipts. Income from these capital gains is usually taxed at special rates, depending on the nature of the capital asset, and the period of holding. The IT Act also provides a residual category of income, namely ‘income from other sources’, which also taxes certain capital receipts as ordinary income of the taxpayer.

Taxpayers that use the mercantile system of accounting are required to follow the Income Computation and Disclosure Standards for computation of income chargeable under the headings ‘profits and gains of business or profession’ and ‘income from other sources’.

Losses

The IT Act provides for intra-head and inter-head adjustment of losses. If in any year, a taxpayer incurs a loss from any source under a particular head of income, then that taxpayer is allowed to adjust such loss against income from any other source falling under the same head (intra-head adjustments). Only after such intra-head adjustments are made can a taxpayer adjust losses from one head against income from another head (inter-head adjustments). However, there are certain rules for these adjustments. For instance, losses from speculative business can only be set off against income from speculative business, although non-speculative business losses can be set off against income from speculative business; long-term capital losses cannot be set off against any income other than income from long-term capital gains, although short-term capital losses can be set off against short or long-term capital gains, etc.

Losses are usually permitted to be carried forward for a period of eight years immediately succeeding the year in which such loss is incurred.

A taxpayer that operates as a private limited company is not permitted to carry forward any tax losses of the years prior to the relevant financial year, unless shareholders beneficially holding 51 per cent of the voting power as on the last day of the year in which the loss was incurred, and the year in which the loss is desired to be set off, remain the same. However, such losses are allowed to be carried forward in case of certain eligible start-ups and companies under insolvency proceedings.

Rates

Rates as prescribed under the IT Act and as mentioned hereinafter are required to be increased by applicable surcharge and education cess (unless otherwise stated). Surcharge is payable as a percentage of the income tax payable. For domestic companies, the rate of surcharge is 7 per cent (if income >10 million rupees but ≤100 million rupees) and 12 per cent (if income >100 million rupees). For foreign companies, the rate of surcharge is 2 per cent (if income >10 million rupees but ≤100 million rupees) and 5 per cent (if income of >100 million rupees). For general partnerships and LLPs, the rate of surcharge is 12 per cent (if income >10 million rupees) and nil (if income ≤10 million rupees). Further, a health and education cess of 4 per cent is also payable on the aggregate of income tax and surcharge.
Corporates

Domestic companies are liable to tax on their business income at the rate of 30 per cent. Certain domestic companies can choose to avail of a concessional tax rate of 25 per cent, subject to certain conditions. A new regime has been introduced under the Taxation Laws (Amendment) Ordinance, 2019 for domestic companies. Under the new regime, companies can claim the tax rate of 22 per cent when the total income of the company is computed without claiming specified deductions, incentives and additional depreciation. Another provision provides for reduced tax rate of 15 per cent for certain manufacturing companies incorporated in India on or after 1 October 2019. Non-resident companies having a permanent establishment in India are subject to tax on their business income at the rate of 40 per cent.

Domestic companies declaring, distributing, or paying dividends are required to pay an additional dividend distribution tax (DDT) at an effective rate of 20.56 per cent (including applicable surcharge and education cess of 4 per cent) on the dividends distributed. These dividends are tax exempt in the hands of all non-resident shareholders and resident corporate shareholders. However, a holding company does not have to pay DDT on dividends paid to its shareholders to the extent that it has received dividends from its Indian and foreign subsidiary company on which DDT has been paid by the subsidiary, subject to fulfilment of conditions.

If the income tax payable by a domestic company is less than 15 per cent of its adjusted book-profits, then that company would be required to pay a minimum amount of tax, known as minimum alternate tax (MAT) at the rate of 15 per cent. MAT credit can be utilised over a period of 15 years.

Non-corporates

General partnerships and LLPs are taxed at the rate of 30 per cent. No additional tax is required to be paid by a partnership firm or an LLP at the time of distribution to the partners. Shares of profits received by partners of a general partnership or an LLP are tax exempt in their hands.

An LLP is not subject to MAT. It is subject to an alternate minimum tax (AMT) at the rate of 18.5 per cent, when income tax on its total income is less than 18.5 per cent on its adjusted total income. However, this is applicable only if the LLP claims specified tax holidays or deductions under the IT Act.

Administration

Unlike some other nations, income tax in India is a central (federal) levy, and not a state-specific levy.

The Ministry of Finance governs and administers the IT Act through the Central Board of Indirect Taxes and Customs, which from time to time issues notifications, circulars and instructions, etc., to clarify or interpret the provisions of the IT Act. In addition to this, every year, the Finance Minister of India proposes amendments to the IT Act and revises the applicable rates of taxation annually through the Finance Bill for that year. Once the Indian Parliament approves the proposed amendments, the Finance Bill is enacted and the relevant changes or amendments get incorporated into the law.

The Indian tax year runs from 1 April to 31 March. Certain taxpayers having business income are required to get their account books audited for tax purposes. All companies
are required to electronically file income tax returns on or before 30 September of the year following the tax year. In the event transfer pricing provisions are applicable, the due date for filing tax returns is extended to 30 November.

Further, quarterly returns have to be filed for withholding taxes in the prescribed form and manner.

On filing of tax returns, details furnished by the taxpayer are assessed by the tax authorities, and accordingly, an ‘assessment order’ is passed by the ‘assessing officer’ after giving an opportunity of being heard to the taxpayer. A detailed appeal process is provided in the IT Act, which allows taxpayers to challenge an order passed by the tax authorities. The Supreme Court of India (i.e., the apex court of India), and the various High Courts provide a ruling on the law and do not engage in a fact-finding exercise.

Further, an advance ruling may be obtained from the Authority for Advance Rulings (AAR) on any question of law or fact in respect of a transaction undertaken or proposed to be undertaken by a non-resident or with a non-resident. Such a ruling obtained from the AAR is then binding on the revenue authority and the applicant in respect of the concerned transaction.

**Tax grouping**

India does not recognise group taxation, and each company in a group (or otherwise) is taxed as a separate company.

**ii Other relevant taxes**

**Indirect taxes**

The goods and services tax (GST) legislation has been enacted by the Indian government with effect from 1 July 2017. GST overhauls much of the indirect taxation framework in India, and has subsumed most of the erstwhile indirect taxes such as sales tax or VAT, service tax, excise duty, entertainment tax (unless levied by local bodies), entry tax, additional customs duty (countervailing duty), special additional duty of customs, surcharges and cesses. Basic customs duty on import of goods into India remains outside the GST ambit. Further, certain tobacco, petroleum and alcohol products remain outside GST, and will continue to be taxed as per the earlier system. As opposed to the multiple taxable events under the erstwhile indirect tax regime, such as manufacture, sale, provision of service, etc., the GST law imposes tax on a single taxable event, ‘supply’ which covers all kinds of transactions such as sale, transfer, barter, lease, provision of service, etc., unless specifically exempted. Both the centre and the states simultaneously levy GST across the value chain.

While problems of immediate migration costs are posed by it, the overall economy is expected to benefit from a more seamless movement of goods and service, and a less burdensome indirect tax credit and compliance regime. GST allows for seamless credit flow throughout the value chain with fewer restrictions to mitigate the cascading effect of taxes.

**Stamp duty/registration fees**

Separately, all legal documents are required to be stamped in India, and documents that have the effect of transferring immovable property are mandatorily required to be registered. Documents that have not been duly stamped cannot be introduced as evidence in any court. Stamp duty rates differ from state to state across the country, as stamp duty is a state subject. However, central government fixes the stamp duty rates for certain instruments.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

A company is said to be resident in India in a financial year, if (1) it is an Indian company (i.e., incorporated in India), or (2) its place of effective management (POEM) is in India. The phrase ‘place of effective management’ has been explained to mean ‘a place where key management and commercial decisions that are necessary for the conduct of business of an entity as a whole are, in substance made’. With effect from 1 April 2018 the concept of ‘significant economic presence’ (as defined) has been introduced into the definition of ‘business connection’. Also, transactions or activities (yet to be prescribed) undertaken by the non-resident shall constitute ‘significant economic presence’ in India, irrespective of whether the non-resident has a residence or place of business in India or renders services in India. The Central Board of Direct Taxes (CBDT) has issued guidelines for the determination of POEM of a company. POEM is, however, not applicable to companies having turnover or gross receipts of 500 million rupees or less in a financial year. If a foreign company’s POEM is considered to be in India, its global income shall be chargeable to tax in India at the rate of 40 per cent.

As per the Guidelines (based on the average data of the relevant year and two years prior to such relevant year) in case of a company that is engaged in ‘active business outside India’, its POEM shall be presumed to be outside India if the majority of meetings of the board of directors of the company are held outside India and the board of directors of the company exercise their powers of management and do not stand aside enabling either their holding company or such other person resident in India to exercise the said power. However, if the company is not ‘engaged in active business outside India’, then the determination of POEM for such company shall be to:

a identify or ascertain the person or persons who actually make the key management and commercial decisions for conduct of the company’s business as a whole; and

b identify the place where these decisions are in fact being made.

ii Branch or permanent establishment

A non-resident entity may set up branch, liaison or project offices in India. While a liaison office acts as a representative office of its parent company in India, a branch office is an establishment of the parent entity and can carry out the same or substantially the same activities as its parent company. A project office is permitted for specific projects to be undertaken in India, by the person resident outside India. Although these vehicles may be used by a non-resident, their use is not particularly popular given that the activities that these offices may undertake are heavily regulated and restricted by the RBI.

A branch of a foreign company is taxed as a foreign company in India at the rate of 40 per cent.

2 Section 6(3) of the (Indian) Income Tax Act 1961.
3 The Guidelines define a company to be engaged in ‘active business outside India’ if: (1) the company’s passive income is not more than 50 per cent of its total income; (2) less than 50 per cent of its total assets are situated in India; (3) less than 50 per cent of total number of employees are situated in India or are resident in India; and (4) the payroll expenses incurred on such employees is less than 50 per cent of its total payroll expenditure. The Guidelines define ‘passive income’ of a company shall be the aggregate of: (1) income from the transactions where both the purchase and sale of goods is from or to its associated enterprises; and (2) income by way of royalty, dividend, capital gains, interest or rental income.
Activities carried out by foreign companies should be carefully examined to determine the existence of a permanent establishment (PE) of the foreign company in India. In the case of a PE, income of the foreign company that is attributable to the activities of the PE in India will be subject to tax at the rate of rate of 40 per cent.

Typically, the kinds of PEs common to India’s tax treaties are fixed place PE, service PE and dependent agent PE.

For the purpose of attribution of profits, the Indian PE is considered as a fictional entity separate from the foreign enterprise dealing with the latter on an arm’s-length basis. No specific rules for attribution of profits are provided under Indian laws, and such attribution is a complex determination.

Further, in keeping with Action Plan 1 on tax challenges of the digital economy, India introduced an equalisation levy of 6 per cent in respect of certain specified digital services in the online marketing and advertising space rendered by non-residents who do not have a PE in India. However, such income shall not be taxable in the hands of the recipient.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
India does not have any participation exemption or qualifying dividend regime.

ii IP regimes
By way of the Finance Act 2016, the government put in place a concessional taxation regime for income from patents. Following Action Plan 5 of the Organisation for Economic Co-operation and Development (OECD)’s Base Erosion and Profit Shifting (BEPS) project, the government has adopted the nexus approach, which prescribes that income arising from the exploitation of IP should be attributed and taxed in the jurisdiction where substantial R&D activities are undertaken, rather than the jurisdiction of legal ownership only.

Accordingly, the IT Act was amended to provide that, where the total income of an ‘eligible taxpayer’ includes any income by way of royalty in respect of a patent developed and registered in India, then such royalty shall be taxable at the rate of 10 per cent on the gross amount of royalty.

iii State aid
As a welfare economy, the Indian government offers subsidies in various sectors, such as agriculture, small and medium enterprise industry, railways and infrastructure.

Separately, under the Special Economic Zones Act 2005, the government has identified certain zones in the country, where through favourable economic policies, business incentives and tax breaks, a conducive environment has been sought to be created for export-oriented businesses. In addition to the deductions otherwise available, the IT Act also provides for profit-linked deductions to certain taxpayers, such as units established for export in special economic zones.
VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Tax is to be withheld by the payer on all payments to non-residents that are chargeable to tax in India. The witholding rate is prescribed and depends on the nature of payment, and is subject to any relief under the relevant tax treaty between India and the country of residence of the payee. Set out below are the withholding tax rates in terms of India’s domestic laws:

<table>
<thead>
<tr>
<th>Income stream</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>Nil</td>
</tr>
<tr>
<td>Interest</td>
<td>5 per cent to 40 per cent (depending on currency of loan, etc.)</td>
</tr>
<tr>
<td>Royalty</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Fees for technical services</td>
<td>10 per cent</td>
</tr>
</tbody>
</table>

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

India does not have a parent–subsidiary or participation exemption regime.

However, capital gains arising from the transfer of certain instruments may be subject to a reduced rate of withholding in terms of India’s domestic law. For instance, long-term capital gains arising on transfer of listed equity shares (including units of an equity-oriented fund) executed on a recognised stock exchange in India, where securities transaction tax (STT) has been paid, was exempt from tax in India subject to certain conditions. From financial year 2018–2019, long-term capital gains above 100,000 rupees, made on or after 1 April 2018, will be taxed at 10 per cent.

Section 90(2) of the IT Act provides that where India has entered into a double taxation avoidance agreement with any country, the provisions of the IT Act or the double taxation avoidance agreement, whichever are more beneficial to the taxpayer, shall apply. Accordingly, the withholding tax rates under India’s domestic law are subject to the provisions of the applicable tax treaty.

iii Double tax treaties

India has a vast tax treaty network and has signed Double Taxation Avoidance Agreements with over 80 countries across the globe. While the rates may vary from treaty to treaty, set out below are some of the common reduced withholding rates across most treaties:

<table>
<thead>
<tr>
<th>Income stream</th>
<th>Tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>7.5 per cent to 15 per cent</td>
</tr>
<tr>
<td>Capital gains</td>
<td>Generally, sale of shares is taxable in India at domestic tax rates</td>
</tr>
<tr>
<td>Fees for technical services or royalty</td>
<td>10 per cent</td>
</tr>
</tbody>
</table>

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4 STT is payable on certain on-market transactions (sale and purchase) ranging from 0.001 per cent to 0.2 per cent on the value of the transaction.
iv  Taxation on receipt
Foreign dividends received by an Indian resident are taxed as ordinary income, namely at the rate of 30 per cent in the case of an Indian company, and at the applicable slab rate in the case of an individual. However, credit for foreign taxes paid (on dividends or otherwise) should be available to the Indian resident. Foreign dividends may be subject to a reduced rate of 15 per cent in the hands of an Indian company, if the Indian company holds 26 per cent of shares in the foreign company.

However, DDT, being an additional corporate tax on the Indian distributing company, is generally not affected by tax treaties. As a result, the availability of credit for DDT in the home country of the non-resident shareholder is doubtful.

VII  TAXATION OF FUNDING STRUCTURES
i  Thin capitalisation
Following the BEPS Action Plan 4, the Finance Act 2017 introduced limited thin capitalisation norms in India's extant transfer pricing regime, according to which, the Indian 'associated enterprise' would not be permitted a deduction of interest (payable to its non-resident 'associated enterprise') exceeding 30 per cent of the earnings, before interest, taxes, depreciation and amortisation, if the total amount of such interest exceeds 10 million rupees per year. If the interest is not eligible for deduction in a particular year, the same can be carried forward for eight years, and the same shall be allowed to the extent of maximum allowable interest expenditure for the relevant year.

ii  Deduction of finance costs
Interest payments by an Indian company to a non-resident shall be eligible to be deducted as an expense by the Indian company, if the loan is for its business purpose. However, if the Indian company and the non-resident are regarded as 'associated enterprise' in terms of the (Indian) transfer pricing regulations, such interest payments shall be subject to the arm's-length requirement, and also thin capitalisation norms as set out above.

iii  Restrictions on payments
In terms of the Companies Act, dividends can be declared by a company out of profits of the current financial year or any previous year, only after providing for depreciation in accordance with the provisions of the said Act. In the case of inadequacy of profits in any financial year, a company may declare dividends out of the accumulated profits earned by it in previous years, and transferred to the reserves in accordance with the prescribed rules. However, these dividends can only be declared from the free reserves of the company.

iv  Return of capital
A company may undertake a scheme of buy-back to purchase its own shares from its free reserves, securities premium account, or the proceeds of the issue of any shares. For a company to be able to undertake a buy-back, the same should be authorised by its charter documents. Further, generally, buy-back requires shareholder approval by way of a special resolution.

There are certain other restrictions on a company undertaking a scheme of buy-back, including, inter alia, that a company cannot issue fresh shares (of the same kind as those
bought back) for a period of six months since the date of buy-back, there has to be a cooling off period of at least one year between two consecutive buy-backs, and only fully paid-up shares can be bought back.

Buy-back of unlisted shares is subject to tax at the rate of 20 per cent in the hands of the company on the amount of buy-back price that is in excess of the amount received by it for the issue of such shares. There are specific rules prescribed to determine the amount received for the purpose of computing this tax. Once such tax is paid by the company, no further tax shall be payable on such amount by the shareholders.

In capital reduction, to the extent of accumulated profits, the company is required to pay DDT on the amount returned to the shareholder. Although the rate of buy-back tax is slightly higher than the rate of DDT, in case of a buy-back, the company is allowed to reduce the amount that it had received at the time of share issuance from the buy-back consideration to arrive at the buy-back tax. This is not permitted in case of DDT, as DDT is payable on the gross amount of dividend.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Acquisitions may be structured at: (1) the entity level, by acquisition of shares in a fresh issue or share buyout or merger/amalgamation; or (2) the business level, by acquisition of the entire business (referred to as slump sale in the Indian context), cherry-picking certain assets or demerger. A foreign investor looking to acquire certain Indian assets or businesses would need to have an Indian entity that acquires the business or assets.

The preferred mode of acquisition would depend on various considerations, such as the commercial objective sought to be achieved, tax efficiency, ability of the target to carry forward past tax losses, regulatory aspects, etc.

Other structuring considerations include the choice of intermediate holding jurisdiction to acquire or set up the Indian target, and choice of instrument for investing into the Indian target. Further, with ‘substance’-driven taxation and evolving tax laws aimed at protecting the source country’s tax base, aspects such as valuations and transaction documentation assume significance and tend to become major negotiation points.

Furthermore, India’s tax treaties with Mauritius and Singapore have been revised, in terms of which, capital gains arising to tax residents of these jurisdictions from the sale of shares of Indian companies acquired on or after 1 April 2017 shall be taxable in India. The amendments do not impact the beneficial capital gains tax treatment in relation to investment in instruments other than shares (regardless of the time of investment), and in relation to shares acquired prior to 1 April 2017 (regardless of when the exit occurs).

The choice of instrument for investment, that is, shares (equity or preference shares) or debt, would primarily depend on the commercial objectives, regulatory considerations and rights sought to be acquired by the investor, and would entail different tax implications for the investor as well as the investee.

Further, it is important to ensure that appropriate valuations are undertaken at the time of the investment, failure of which can lead to adverse tax consequences for both the seller as well as the acquirer. The IT Act has prescribed certain minimum fair market value norms, which are applicable at the time of transfer of unquoted shares, and acquisition or subscription of shares and securities. According to these provisions, transfer of unquoted shares, or receipt of shares or securities, at a price that is less than the fair market value (to
be computed in line with the prescribed guidelines) could attract adverse implications in the hands of the transferor and recipient. Note that similar fair market value requirements are also applicable in the case of a transfer of property.

Where Indian assets are indirectly acquired at an offshore level through the acquisition of shares in a foreign entity, an Indian tax charge will be triggered if the foreign target derives ‘substantial value’ (as defined) from India. Thus, prescribed valuations should be carried out to assess the Indian tax impact in such a case.

ii Reorganisation
Amalgamations and demergers are tax neutral in India, provided certain specified conditions are satisfied.

The Indian government in April 2017 enacted certain provisions of the Companies Act that permit cross border mergers. However, there has been no corresponding amendment to the IT Act. Accordingly, only inbound mergers are tax neutral, subject to conditions.

iii Exit
The sale of equity and debt instruments, specific assets or the entire business on a going-concern basis by a non-resident investor will entail capital gains tax in India that could vary from nil to 40 per cent (depending on the nature of the instrument and the period of holding), subject to relief under the applicable tax treaty.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
The General Anti-Avoidance Rules (GAAR) included in the IT Act came into effect on 1 April 2017. GAAR may be invoked where the main purpose of an arrangement is to obtain a tax benefit. GAAR provisions empower the tax authorities to investigate any such arrangement as an ‘impermissible avoidance arrangement’, and consequently disregard entities in a structure, reallocate income and expenditure between parties to the arrangement, alter the tax residence of these entities and the legal situs of assets involved, treat debt as equity and vice versa, and the like. By doing so, the tax authorities may even deny tax benefits conferred under a tax treaty. Accordingly, it must be ensured that there is justifiable commercial substance in the structure to avail of any beneficial taxation under the IT Act or a tax treaty.

ii Controlled foreign corporations (CFCs)
India does not have any rules for CFCs.

iii Transfer pricing
Transfer pricing regulations are applicable to ‘international transactions’ carried on between two or more ‘associated enterprises’ (AEs), where either both or at least one party to the transaction is a non-resident. The term ‘AE’ has been defined in the IT Act to include,
inter alia, any enterprise that participates, directly or indirectly, or through one or more
intermediaries, in the management or control or capital of another enterprise. The transfer
pricing regulations provide that any income arising from such an international transaction
would be computed having regard to the principle of an arm’s-length price (ALP). The transfer
pricing regulations also prescribe the methods that a taxpayer can adopt to arrive at an ALP,
and the documentation that is required to be maintained by the taxpayer to demonstrate that
the ALP adopted by it is in accordance with the transfer pricing regulations.

The transfer pricing regulations also provide for ‘secondary adjustments’, which
essentially mean that an AE (being a non-local entity) will have to make a secondary
adjustment in its books as a consequence of a primary adjustment to the taxpayer in India.

Safe harbour rules that prescribe conditions and circumstances under which the transfer
price adopted by parties to a transaction would be immune from questioning by the Indian
tax authorities have been prescribed.

The government has introduced an advance pricing agreement scheme and transfer
pricing documentation requirements that are in line with the standards outlined in BEPS
Action Plan 13. Taxpayers are required to maintain a master file, local file and country-by-
country report. The CBDT has notified the final rules for maintaining and furnishing of
transfer pricing documents in the master file and country-by-country report.

iv Tax clearances and rulings
As set out earlier, an applicant may approach the AAR for an advance ruling for transactions
with a non-resident.

Further, if during pendency of any tax proceedings, a taxpayer transfers certain
specified assets (such as land, building, plant, machinery, shares, securities, etc.), then the tax
authorities are empowered to treat such transfer of assets as void against taxes for recovery of
any tax claims arising pursuant to conclusion of such proceedings. However, such transfer
will not be treated as void, if: (1) a no objection certificate had been obtained by the seller
from the tax authorities prior to such transaction; or (2) the transfer is done for adequate
consideration and without notice of the pendency of any proceedings or tax payable by the
transferor. Therefore, such a tax clearance is important as it protects the buyer with respect
to outstanding tax demands of the seller, or tax proceedings that are pending at the time of
transfer of assets.

X YEAR IN REVIEW
Over the past couple of years, the government has re-negotiated tax treaties with countries
such as Singapore, Cyprus and Mauritius to ensure that the right to tax capital gains
comes to country of source (i.e., India and not to the country of residence, i.e., Singapore
or Mauritius). The government had also simultaneously reduced the rate of tax on sale of
unlisted securities (held for more than 24 months) to 10 per cent to ensure that foreign
investors were not burdened with a high tax liability. An exemption was, however, provided in
respect of transactions undertaken on the stock exchange for long-term capital gains (LTCG)
and the transactions are only subject to a nominal STT. This was to encourage portfolio

6 Further, two or more enterprises would be deemed to be AEs under specific circumstances by virtue of
shareholding, borrowing, guarantees, licensing of trademarks, purchase, sales or where enterprises have any
relationship of ‘mutual interest’ as may be prescribed by the government.
investors to access the Indian securities market. With significant movement of stock prices, the government has realised that it has brought a significant opportunity to bring a wider set of investors into the tax net. Therefore, with effect from 1 April 2018, the existing exemption on LTCG arising out of sale of listed equity shares of an Indian company on a stock exchange is withdrawn and a new provision is introduced to levy a 10 per cent tax on LTCG arising from the transfer listed equity shares, units of an equity-oriented mutual fund, or units of a business trust. However, gains accrued until 31 January 2018 are grandfathered.

As a part of India’s commitment to the OECD’s BEPS initiative, the scope of the definition of ‘business connection’ has been expanded to harmonise it with the changes to the tax treaties because of the multi-lateral instrument and include situations where a person plays a principal role in the conclusion of contracts in India.

Further, in the market of job seekers, India needed job creators and start-ups appeared to be ray of hope. With the intention to promote these job creators and to facilitate their growth in the initial phase of business, a deduction of 100 per cent of the profits of the start-up engaged in innovation, development, deployment or improvement of products or processes or services or a scalable business model with a high potential for employment generation or wealth creation would be available for a period of three consecutive years out of seven years, starting from the year the start-up was incorporated.

XI OUTLOOK AND CONCLUSIONS

While in recent times the Indian economy has been facing challenges such as the depreciating rupee, increasing current account deficit, rising inflation and so on, the government has attempted a set of reforms. India’s endeavour is to become one of the most attractive investment destinations in the world, and it understands very well that the need of the hour is to simplify its tax regime and reduce corporate tax rates in the country.
Chapter 13

INDONESIA

Mulyana, Sumanti Disca Ferli, Bobby Christiano Manurung, Ratna Mariana and Astrid Emmeline Kohar

I INTRODUCTION

Indonesia is a unitary state consisting of 34 provinces and 514 regencies and municipalities. In addition to national taxes such as income tax and value added tax, others are taxes imposed by the regional governments, such as taxes on land and buildings (except for areas used for plantation, forestry and mining, which are still maintained as national taxes), motor vehicles, restaurants, entertainment and advertising.

Under Article 23A of the Indonesian Constitution, every tax and other impositions that are compelling in nature for the needs of the state must be regulated by law. In many cases, the tax laws delegate to lower regulations, such as government regulations or even ministerial regulations, as implementing regulations to further regulate the subject matter. The Director General of Tax also issues many circular letters on certain subjects to subordinates as internal direction or guidelines. While these circular letters are not regulations and are technically non-binding on taxpayers, the tax offices very often follow these. However, problems arise when the provisions in lower regulations or these circular letters of the tax authority conflict with those provided in the tax laws. As a general principle of Indonesian law, a regulation higher in hierarchy will take precedence over a regulation lower in hierarchy (lex superior derogat legi inferiori). It has been more than three decades since Indonesia adopted a self-assessment system to replace the official assessment system in its tax legal system (except for tax on land and buildings, which still uses the official assessment system). Under the self-assessment system, taxpayers must themselves calculate, pay and report their own tax obligations in accordance with the prevailing laws and regulations.

In 2002, Indonesia enacted Law No. 14 of 2002 on the Tax Court (Tax Court Law), and also established a Tax Court (replacing the Board of Tax Dispute Settlement) to examine and decide tax disputes between taxpayers and the tax authorities. Under the Tax Court

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1 Mulyana is a partner and Sumanti Disca Ferli, Bobby Christiano Manurung, Ratna Mariana and Astrid Emmeline Kohar are associates at Mochtar Karuwin Komar.


4 Set out in Law No. 28 of 2009 on Regional Taxes and Dues. Note also the decision of the Constitutional Court No. 46/PUU-XII/2014, dated 26 May 2015, which annuls the elucidation of Article 124 of this Law with respect to the regional dues for telecommunication tower control and the decision of the Constitutional Court No. 15/PUU-XV/2017 dated 10 October 2017, which annuls a number of articles in Law No. 28 of 2009 with respect to taxation of heavy equipment treated as motor vehicles.
Law, based on limited grounds, taxpayers and the tax authorities, if not satisfied with a Tax Court decision, also have the right to request a civil review application to the Supreme Court against that Tax Court decision. Many tax disputes have been brought by taxpayers before the Tax Court regarding transfer pricing issues as a result of the price adjustment of or non-recognition by the tax authorities of the expenses in transactions between taxpayers and their foreign shareholders or affiliated companies. Tax disputes can also arise owing to different interpretations of laws and regulations between taxpayers and the tax authorities, or a conflict between laws and regulations affecting the rights and obligations of taxpayers.

To increase business activities in Indonesia, the government has also maintained certain tax incentives and facilities for companies doing business in Indonesia in specific business sectors and regions. There is also a tax incentive for publicly listed companies meeting certain requirements as regards the rate of income tax.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The types of business entity commonly used in Indonesia take the form of sole proprietorship, general partnership, firm partnership, limited partnership (CV), limited liability company (PT) or cooperative.

A sole proprietorship is carried out by a natural person in his or her personal capacity. This form is typical for small to medium-sized businesses such as stores, restaurants and small repair shops.

A general partnership is the most basic form of partnership under Indonesian law. The general partnership is an association of persons for the carrying out of a joint enterprise. The members of the general partnership are not personally liable for the liabilities of the general partnership, and each member cannot bind the other member unless specifically authorised by the other member or unless the transaction is of benefit to the general partnership. A general partnership is the form of organisation that is typically used by professional experts, such as law firms or accounting firms.

A firm partnership is the form used by commercial partnerships, such as trading or commercial services firms. Each partner in the firm partnership has the right to act in the name of the partnership within the scope of its business. Liability of the partners in the firm partnership with third parties is on a joint and several basis.

A CV differs from a firm partnership; while all partners are active partners in a firm partnership, in a CV there is also a non-active or 'sleeping' partner (limited partner). The liability of the limited partner is only to the extent of the sum he or she has pledged to contribute to the CV.

Major companies in Indonesia mostly take the form of a PT. The main characteristic of a PT is that it owns its assets and holds liabilities separately from its shareholders. Generally speaking, the shareholders of a PT have no liability for acts carried out for and on behalf of the PT. Their liability is limited to the shares they have subscribed. However, under certain circumstances, the court may ‘pierce the veil’ or disregard the corporate entity, and hold that the shareholders are personally liable for acts carried out in the name of the PT. Those circumstances are:

a where the requirements for the PT to be established as a legal entity have not been made or are not met (e.g., approval of the Minister of Law and Human Rights has not been obtained);
the shareholders in question, directly or indirectly, in bad faith exploit the PT for their personal interest;

c the shareholders in question are involved in an unlawful act committed by the PT; or

d the shareholders in question, directly or indirectly in an unlawful act, make use of the assets of the PT in such a way that the PT assets become insufficient to settle the PT’s debts.

The Indonesian Company Law (Law No. 40 of 2007) also provides that if there is only one shareholder in the PT for a period of not more than six months, the shareholder must transfer a part of its shares to another party. Otherwise, the sole shareholder becomes personally liable for all of the obligations and losses suffered by the PT.

A cooperative is an association of persons, and its objective is the enhancement of the welfare of its members through engagement in a specific business as authorised in its charter. A cooperative has the status of legal entity after it is legalised by the relevant minister.

Generally, the basic tax treatment for all forms of businesses, except for the sole proprietorship, is the same (i.e., a flat tax rate of 25 per cent of the net income). In the sole proprietorship, the person’s tax rates are calculated on a progressive basis ranging from 5 per cent up to 30 per cent. To calculate the tax obligation, in addition to the permissible deductible expenses, the natural person must also deduct a non-taxable income threshold for himself or herself, his or her spouse and up to three dependants.

i Corporate

Most large companies adopt a corporate form. Like its predecessor, the 1967 Foreign Investment Law, the Indonesian Investment Law of 2007 requires business entities engaged in almost all business sectors (including manufacturing and trading of goods and services) to take the form of a PT if there is a foreign ownership participation in that entity in the framework of foreign direct investment (a PMA company). The same requirement also applies to the financial sector (except for banking). For the oil and gas sector, a foreign corporation can be used. Banking business can take the form of a branch office of the foreign bank, but the banking authority no longer issues new business licences to a branch office of a foreign bank. Based on the foregoing, the discussion below focuses on the PT corporate form.

ii Non-corporate

Non-corporate entities such as a general partnership, firm partnership and limited partnership are not permissible for foreign-owned equity. Generally, the Indonesian Income Tax Law treats all entities, regardless of whether they are incorporated, in the same manner.

III DIRECT TAXATION OF BUSINESSES

Generally, the flat tax rate of 25 per cent of net income applies for all businesses that take the form of an entity (regardless of whether they are incorporated). There are some exceptions, including:

a a public company that satisfies a minimum listing requirement of 40 per cent and other requirements can obtain a 5 per cent reduction from the standard rate;

b corporate taxpayers with gross revenue up to 50 billion rupiah are entitled to a 50 per cent reduction of the standard tax rate imposed on the taxable income for gross revenue up to 4.8 billion rupiah;
companies engaged in upstream oil and gas and geothermal industries must calculate their corporate income tax pursuant to the terms of their production-sharing contracts; and

companies engaged in mining activities that are parties to the contract of work with the government must calculate their corporate income tax pursuant to the terms of the contract of work.

There are also businesses that have deemed profit margins for tax purposes. For such businesses, their respective deemed profit on gross revenue and effective income tax rate are, inter alia, domestic shipping operations (4 per cent; 1.2 per cent) and foreign shipping and airline operations (acting through a permanent establishment (PE) in Indonesia) (6 per cent; 2.64 per cent).

**i Tax on profits**

*Determination of taxable profit*

Indonesian tax residents are taxed on their worldwide income, and foreign tax credits are available for the foreign income of tax residents subject to certain criteria. The taxable profit is calculated based on the gross income deducted with allowed expenses. Pursuant to the Income Tax Law, deductible expenses are expenses for the purposes of earning, collecting or maintaining income, including:

- expenses that are directly or indirectly related to the business activities, such as material expenses, salaries, wages, allowances, interest, royalties, travelling expenses, waste management expenses, insurance premiums, promotion and selling expenses, administration expenses and taxes (except income tax);
- depreciation and amortisation expenses;
- contributions to the pension fund;
- losses; and
- expenses for research and development conducted in Indonesia.

Non-deductible expenses include:

- distributions of profit in any form, such as dividends;
- expenses for personal interests of shareholders, partners or members;
- establishment of reserves or provisions, with some exceptions, such as provisions for doubtful accounts for banking and financing companies, reclamation provisions for mining companies, forestation provisions for forestry companies, and provisions for closure and maintenance for industrial waste processing businesses;
- benefits in kind; however, meals and drinks provided to all employees, or benefits in kind in certain remote areas, are deductible as regulated by a Minister of Finance regulation;
- income tax payments; and
- tax penalties.

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5 There have been reports that in an effort to further encourage the movement of capital into Indonesia, the government is planning to change the taxation regime for individual (non-corporate) taxpayers from the (currently) worldwide system to the territorial basis. When applied, this proposed change would result in the taxation of income deriving only from Indonesia.
Pursuant to Article 11 of the Income Tax Law, expenditure incurred in relation to tangible assets with a useful life of more than one year (except for land titles) can be depreciated. Depreciation is commenced from the month of the acquisition of the assets by using the straight-line method or the declining method consistently. Buildings can be depreciated by using the straight-line method only.

Pursuant to Article 11A of the Income Tax Law, amortisation for expenditure to acquire intangible assets, including expenses for extension of land titles and goodwill having a useful life of more than one year, can be carried out by the straight-line method or declining method during the useful life by way of applying an amortisation tariff for such expenditure or on the remainder of the book value; provided this is done consistently, it is all amortised at the same time at the end of the useful life. The amortisation is commenced in the month in which the expenditure is incurred, except for in certain business sectors that are regulated further by a Minister of Finance regulation.

Basically, taxable profits are based on accounting profits. However, for the calculation of the tax obligation, some adjustments may be required, since certain expenses are not tax-deductible. Profits are taxed on an accruals or receipts basis, depending upon which book method the taxpayer has adopted. The book method must be conducted consistently by the taxpayer. A change of the book method must obtain the approval of the Director General of Tax.

**Capital and income**

In practice, there is still a distinction between the taxation of income and capital gain (profit). Currently, the income tax on income arises from the sale of shares in the stock exchange, and is a final tax of 0.1 per cent of the gross amount of the sale of shares. In the case of the sale of shares by founding shareholders in publicly listed companies, there is an additional tax of 0.5 per cent of the sale transaction value.

Tax on capital gains from the sale of shares in closely held companies by a foreign shareholder is 5 per cent of the value of the sale transaction, unless provided otherwise by a relevant tax treaty if the taxing authority is not Indonesia.

**Losses**

Pursuant to Article 6(2) of the Income Tax Law, losses may be carried forward for a maximum of five years. For a limited category of businesses in certain regions, or businesses subject to certain concessions, however, the period can extend up to 10 years. The carry-back of losses is not allowed. Losses can survive a change in shareholders of the PT.

**Rates**

Pursuant to Article 17 of the Income Tax Law, the flat tax rate for tax-resident entities (whether corporate or non-corporate) is generally 25 per cent. For individual tax residents, the tax rates are as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 50 million rupiah</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Over 50 million rupiah but not exceeding 250 million rupiah</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Over 250 million rupiah but not exceeding 500 million rupiah</td>
<td>25 per cent</td>
</tr>
<tr>
<td>Over 500 million rupiah</td>
<td>30 per cent</td>
</tr>
</tbody>
</table>
**Administration**

Businesses must pay tax and file tax returns for particular taxes either monthly or annually, depending on the tax obligation in question. For example, for many withholding taxes, the tax payment deadline is the 10th day of the following month, and the tax return filing deadline is the 20th day of the following month. For corporate income tax, the tax payment deadline is at the end of the fourth month after the book year-end before filing the tax return, and the deadline for filing the tax return is the fourth month after the book year-end.

There are two kinds of tax authorities: at the national level (i.e., the Directorate General of Tax and the Directorate General of Customs and Excise, both under the Ministry of Finance: this chapter focuses on the authority of the Directorate General of Tax only) and at the local (regional) level.

The tax authorities may audit businesses from time to time at random to check the compliance of taxpayers. If a business requests a tax refund, this will always trigger a tax audit. In practice, it is possible to obtain guidance or clearance from the tax authorities where there is uncertainty as to the correct tax treatment or if the tax treatment could apply in a way that would not seem to be intended. Normally, the tax authorities follow the written guidance or clearance they have issued to the taxpayer in treating such taxpayer. Since some of this written guidance and clearance has been made publicly available, taxpayers who believe that such guidance or clearance may also be beneficial to them usually attempt to rely on such documents in convincing the tax authorities that they are eligible for the same tax treatment.

In cases where a taxpayer does not agree with a tax position taken by the tax office as stipulated in the tax assessment letter, the taxpayer has the right to submit an objection application to the Director General of Tax to annul the tax assessment letter within three months as of the sending date of the tax assessment letter. If the taxpayer is not satisfied with the objection decree of the Director General of Tax, the taxpayer can ask for an appeal against such an objection decree to the Tax Court within three months as from the receipt of the objection decree.

Under the Tax Court Law of 2002, Tax Court decisions are final and binding, but are still subject to an extraordinary legal remedy for civil review to the Supreme Court based on limited grounds as provided for in the Tax Court Law. 6 Under Article 91 of the Tax Court Law, those grounds are:

- **a** if the Tax Court decision is based on a lie or fraud by the counterparty that is known after the rendering of the decision, or based on evidence that later is declared forged by the criminal judge;
- **b** if there is new written evidence that is important and decisive that, if it is known in the proceedings at the Tax Court, will result in a different decision;
- **c** if something is granted that was not claimed, or that is more than what was claimed by a party;
- **d** if it concerns a part of the claim that has not been decided without considering the causes; or
- **e** if there is a decision that is clearly not in accordance with the provision of the prevailing laws and regulations.

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6 This extraordinary legal remedy is available for both taxpayers and the tax authorities, such as the Director General of Tax.
Looking at the Supreme Court level, and from decisions of the Supreme Court on tax disputes on the Supreme Court website,\(^7\) the ground in (e) above is always used in civil review applications. Other grounds are very rarely used, and if they are, they are used only as an additional ground.

Pursuant to Article 93 of the Tax Court Law, the Supreme Court examines and renders a decision within six months as from the date the dossier is received by the Supreme Court in the event that the Tax Court has rendered its decision through an ordinary procedure examination; or within one month if the Tax Court has rendered its decision through an expediting procedure examination.

In recent practice, it is often that the Supreme Court renders its decisions within those timelines. However, there are still delays that are caused particularly by the administrative processing and sending of case dossiers by the Tax Court to the Supreme Court.

**Tax grouping**

There are no group tax relief provisions available in Indonesia. As a result, members of a group of companies are taxed individually.

**Other relevant taxes**

Other taxes relevant for businesses are, inter alia, VAT and luxury goods sales tax, land and building tax, income tax on land and building transfers, duty on the acquisition of land and building rights\(^8\) and stamp duty.

VAT is imposed on the transfer of taxable goods or the provision of taxable services in the Indonesian customs area. The current VAT rate is 10 per cent, as provided for in the VAT Law. Pursuant to the VAT Law, a government regulation can provide for a VAT rate ranging from 5 to 15 per cent.

In addition to VAT, certain goods regarded as luxury goods are subject to an additional luxury goods sales tax ranging from 10 to 75 per cent. Pursuant to the VAT Law, the rate of the luxury goods sales tax may be increased by the government up to 200 per cent.

Land and building tax (PBB) is divided into two categories,\(^9\) as follows:

\(a\) PBB on general area: this PBB is imposed annually on property in the form of land or a building based on an official assessment issued by the head of the region. The rate of this PBB is to be determined by the regional regulation, but it should not be more than 0.3 per cent. The tax due is calculated by applying the tax rate on the tax object sale value (NJOP) deducted with non-taxable NJOP, which is set at a minimum of 10 million rupiah. Any change to the non-taxable NJOP must be stipulated in a regional regulation.

\(b\) PBB on plantation, forestry and mining areas: this PBB is imposed annually on property in the form of land or a building based on an official assessment issued by

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7 www.mahkamahagung.go.id.
8 By Law No. 28 of 2009 on Regional Taxes and Dues, the duty on the acquisition of land and building rights became a local (regional) tax.
9 PBB was historically governed by Law No. 12 of 1985 on Tax on Land and Buildings, as amended by Law No. 12 of 1994 (PBB Law) and was part of the national taxes. Starting from 1 January 2010, by virtue of Law No. 28 of 2009 on Regional Taxes and Dues (Regional Tax Law), PBB became part of the local taxes governed thereunder with the exception of areas used for plantation, forestry and mining, where PBB remains part of the national taxes.
the Director General of Tax. The rate of this tax is 0.5 per cent, and the tax due is calculated by applying the tax rate on the taxable sale value (NJKP). The NJKP is a predetermined portion of the NJOP. Currently, the NJKP is 40 per cent of the NJOP. The government can increase the NJKP rate by up to 100 per cent of the NJOP. The NJOP rates are determined by the Director General of Tax on behalf of the Minister of Finance. They may be adjusted every year or every three years, depending on the economic development of the region.

Income tax on land and building transfers is imposed on the seller for the transfer of land and buildings. The rate of this tax is 5 per cent of the gross transfer value unless such value is lower than the NJOP of the object. In the latter case, the tax base is the NJOP. The tax paid is a final tax.

Duty on the acquisition of land and buildings is imposed on the buyer to acquire land and buildings. The rate of this duty is 5 per cent of the acquisition value of the object, unless such value is lower than the NJOP of the object. In the latter case, the tax base is the NJOP.

Stamp duty of 6,000 rupiah is imposed for each of the documents prepared with the purposes of being used as an evidence instrument concerning an act, fact or situation that is civil in nature, such as agreements, notarial deeds and their copies, and every document to be presented as evidence before the courts.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
A company is treated as an Indonesian tax resident if it is established or has its place of management in Indonesia. A foreign corporation can become a tax resident of Indonesia if it has a presence in Indonesia through a PE. Generally, a PE assumes the same tax obligations as a resident taxpayer.

ii Branch or permanent establishment
A foreign company can have a fiscal presence in Indonesia in the form of PE if it has or performs any of the following in Indonesia:

- a place of management;
- a branch office;
- a representative office;
- an office building;
- a factory, workshop or warehouse;
- a site for promotion and sales;
- a mining site;
- a working area of oil and gas;
- fishery, husbandry, agriculture, plantation or forestry activities;
- construction, installation or assembly projects;
- provides services through employees or others for more than 60 days in any 12-month period;
- a dependent agent;
- an insurance company agent or employee receiving premiums or taking risks in Indonesia; or
computer, electronic or internet devices used in Indonesia for internet (e-commerce) transactions.

The above, however, are subject to the provisions of a relevant tax treaty.

In addition to the standard corporate income tax, a PE is also subject to 20 per cent branch profit tax, which is applied to the net profit after tax of the PE unless the profit is reinvested in Indonesia.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
Pursuant to Article 23(4)(c) in conjunction with Article 4(3)(f) of the Income Tax Law, withholding tax on the dividend is not applied if that dividend is received by a PT tax resident, provided the dividend derives from the retained earnings and the PT has at least 25 per cent of the paid-up capital in that company.

ii IP regimes
Currently, there are no IP regimes that are subject to special tax treatment in Indonesia.

iii State aid
There may be special tax treatment for the income tax of government projects funded by foreign loans or grants. For such projects, the income tax liability of the main contractors, consultants and suppliers may be borne by the government.

iv General
The fiscal incentives of import duty, or import-related tax relief or exemption, are generally applicable to foreign direct investment in manufacturing or processing for imports of capital equipment, spare parts and basic materials during the initial start-up period. The government has also provided income tax incentives and tax holidays.

Income tax incentives
For investments in certain industries and certain regions, income tax incentives are available under Government Regulation No. 18 of 2015 on Income Tax Facilities for Investment in Specific Businesses and/or Regions as amended by Government Regulation No. 9 of 2016 (taking effect from 7 May 2016). These incentives cover the following:

a an investment allowance of 30 per cent, spread over six years at a rate of 5 per cent annually;

b accelerated depreciation and amortisation;

c a reduction in the withholding tax tariff on dividends payable to the foreign investors of up to 10 per cent (subject to a lower rate being made applicable by a tax treaty); and

d a longer tax loss carry-forward period of up to 10 years meeting certain requirements.

The industries to which these incentives are available are listed in the governing Government Regulation. Industries eligible to obtain the incentives as listed in the Government Regulation include geothermal energy (exploration, drilling and conversion to electricity), oil refining,
iron steel making, nickel ore mining and non-ferrous metal manufacture and various other industries such as food, textile, chemical substances, pharmacy, computers and electronic and optical goods, electricity equipment, motor vehicles and spare parts and electricity power. Government Regulation No. 18 of 2015 as amended by Government Regulation No. 9 of 2016 is implemented further by Regulation of the Minister of Finance No. 89/PMK.010/2015 (taking effect since 6 May 2015).

Further, in 2019, the Government issued Government Regulation No. 45 of 2019 on Amendment to Government Regulation No. 94 of 2010 on the Calculation of Taxable Income and Settlement of Income Tax in the Current Year (taking effect since 26 June 2019), which provides the following tax incentives:

\[a\] allowing corporate taxpayers who open a new business or expand their existing businesses in labour-intensive sectors to offset 60 per cent of their investment against their taxable net income;

\[b\] allowing corporate taxpayers that conduct work practices, internships or training for human resources development purposes to offset up to 200 per cent of the cost of their activities against their taxable gross income; and

\[c\] allowing corporate taxpayers that conduct research and development (R&D) activities in Indonesia to offset up to 300 per cent of the cost of their activities against their taxable gross income.

The Government also issued another regulation at the end of 2019: Government Regulation No. 78 of 2019 on Income Tax Facilities for Investments in Particular Business Sectors and/or Particular Regions (taking effect since 13 December 2019). Under this Regulation, 183 business sectors are eligible for income tax facilities, which comprise 166 particular business sectors and 17 business sectors located in particular regions. These include certain businesses in a number of industries (e.g., agriculture and forestry industries, the chemical industry, the mining industry and the electronics industry). As a general rule, the income tax facilities available under Government Regulation No. 78 of 2019 are namely: (1) net income deductions; (2) accelerated depreciation of fixed tangible assets and accelerated amortization of intangible assets; (3) 10 per cent income tax (or lower) on dividends paid to foreign taxpayers not operating as permanent establishments within Indonesia; and (4) compensations for losses.

**Tax holiday**

On 27 November 2018, the Minister of Finance issued Regulation No. 150/PMK.010/2018 on Facility on Income Tax Exemptions and Reduction for Business Entities. This Regulation replaced the previous Minister of Finance Regulation No. 35/PMK/010/2018 on the same. Under this Regulation, income tax exemptions can be granted to business entities for a maximum of 20 fiscal years or a minimum of five fiscal years.

The criteria established for business entities that qualify for income tax exemptions and reductions are as follows:

\[a\] the business is categorised as a pioneering industry, such as:

- integrated upstream basic metal industry;
- integrated petroleum refinery industry;
- integrated basic petrochemical industry;
- integrated pharmaceutical raw material industry;
- machinery industry;
• ship parts manufacturing industry;
• train parts manufacturing industry;
• agriculture, farming or forestry-based processing industries;
• economic infrastructure; or
• digital economy;

b the business is an Indonesian legal entity;
c the business is a new investment that has not yet been issued a decree on the giving or notice of rejection to corporate income tax reduction;
d the business has a new investment plan with a minimum value of 100 billion rupiah; and

e the business meets the debt-to-equity ratio requirement as referred to in a Minister of Finance regulation.

As an implementing rule of the above-mentioned Minister of Finance Regulation No. 150/PMK.010/2018, the Indonesian Investment Coordinating Board (BKPM) issued Regulation No. 1 of 2019 on Details of the Pioneering Industry Business Sectors and Production Types Eligible for Corporate Income Tax Deduction Facilities and Guidelines and Procedures for the Granting of Corporate Income Tax Deduction Facilities (taking effect since 23 January 2019). Notable changes that are introduced by BKPM Regulation No. 1 of 2019 are, among others: (1) changes to sectors classified as pioneering industries (e.g., the addition of the sectors of digital economy and agriculture, farming or forestry-based processing industries that produce pulp with or without derivatives); and (2) changes to the minimum value of the investment plan eligible to income tax deductions from previously, 500 billion rupiah (pursuant to the previous BKPM Regulation No. 5 of 2018 on the same) to currently, 100 billion rupiah. Later, BKPM Regulation No. 6 of 2019 was issued (taking effect since 13 September 2019) as an amendment to BKPM Regulation No. 1 of 2019. The amendment was only with respect to Letter R of Attachment I of BKPM Regulation No. 1 of 2019 regarding Details of the Pioneering Industry Business Sectors and Production Types Eligible for Corporate Income Tax Deduction Facilities and Guidelines and Procedures for the Granting of Corporate Income Tax Deduction Facilities.

Tax amnesty

On 1 July 2016, Law No. 11 of 2016 on Tax Amnesty took effect. Income tax, VAT and sales tax on luxury goods are covered by the Law. The objective of the Law is to increase tax revenues, make fairer tax reforms possible because of an expanded tax base and accelerate economic growth. There are several benefits for tax amnesty participants, including a waiver of any taxes due, and of administrative and tax criminal sanctions with respect to assets reported in declaration letters up to tax year 2015, as well as clearance levy rates that are significantly lower than the normal tax rates. Following the end of tax amnesty on 31 March 2017, the government issued several regulations to accelerate any unfinished asset repatriation, to strengthen tax-compliance supervision and to provide another opportunity for taxpayers to disclose or report their assets in the framework of tax amnesty. These regulations, applicable to both participants and non-participants of the tax amnesty, are, among others:

a Government Regulation No. 36 of 2017 on the Imposition of Income Tax upon Certain Income in the Form of Net Assets Treated as or Deemed to Be Earnings (taking effect from 11 September 2017), which regulates the applicable final income tax rates for net assets;
b Minister of Finance Regulation No. 141/PMK.08/2017 on Procedures for the Transfer of Taxpayer Assets to Indonesia and Their Placement in the Financial Market and Non-Financial Market through the Tax-Amnesty Framework (taking effect from 24 October 2017), which regulates asset repatriation; and

c Minister of Finance Regulation No. 165/PMK.03/2017 on the Second Amendment of the Minister of Finance Regulation No. 118/PMK.03/2016 regarding the Implementation of Law No. 11 of 2016 on Tax Amnesty (taking effect from 20 November 2017), which regulates the further implementation of tax amnesty.

The Director General of Tax also issued Circular Letter No. SE-14/PJ/2018 on the Supervision of Taxpayers after the Tax-Amnesty Period (replacing the previous Circular Letter No. SE-20/PJ/2017), which took effect from 19 July 2018 and serves as a set of guidelines for the supervision of taxpayer compliance in the future. Further, the Director General of Tax also issued Regulation No. PER-03/PJ/2017 on the Reporting and Supervision of Additional Assets under the Tax Amnesty Framework (as has also been amended by Regulation No. PER-07/PJ/2018, which amendment took effect on 6 March 2018).

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Withholding tax at a rate of 15 per cent of the gross amount applies to dividends, interest and royalties paid by a company in Indonesia to Indonesian taxpayers or PEs. As discussed above, there is no withholding tax on the dividends paid out of retained earnings in cases where the company earning dividends has at least 25 per cent of the paid-up capital in the company distributing the dividends.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

As discussed in Section V.iv, for investments in certain industries and certain regions there are income tax incentives that also cover a reduction in the withholding tax tariff on dividends payable to foreign investors to 10 per cent (subject to a lower rate under a relevant tax treaty). Contracts of work entered into by mining companies and the government prior to the 2009 Mining Law may provide such exclusions or exemptions from withholding.

iii Double tax treaties

Pursuant to Article 26 of the Income Tax Law, withholding tax at a rate of 20 per cent of the gross amount applies to distributions such as dividends, interest and royalties paid by resident taxpayers to non-residents, unless a relevant tax treaty provides otherwise. Currently, Indonesia has entered into tax treaties with more than 60 countries.

The tax treaties provide withholding tax exemptions for service fees, and reduced withholding tax rates on dividends, interest, royalties and branch profits received by residents of countries with which Indonesia is a party to such tax treaties. To claim the tax treaty benefits, the foreign taxpayer must present a certificate of domicile to the tax authority.
iv Taxation on receipt

Indonesian tax residents are taxed on their worldwide income. Pursuant to Article 24 of the Income Tax Law, the tax paid for income from foreign sources can be credited to the tax owed under the Income Tax Law in the same tax year. The amount of the tax credit is the amount of the foreign income tax paid abroad, but must not exceed the tax owed under the Indonesian Income Tax Law.

VII TAXATION OF FUNDING STRUCTURES

Indonesian PTs are usually funded by capital pay-ins and loans. The minimum authorised capital of PTs under the Indonesian Company Law of 2007 is 50 million rupiah. However, laws and regulations governing certain types of businesses may determine a minimum capital higher than this figure.

i Thin capitalisation

For foreign direct investment companies, there are requirements as to the debt-to-equity ratios depending on the type of the business in which they will be engaged. Pursuant to Minister of Finance Regulation No. 169/PMK.010/2015 on Determination of the Amount of Debt-to-Equity Ratio of Companies for the Purpose of the Calculation of the Income Tax (taking effect from tax year 2016), the maximum debt-to-equity ratio for companies is 4:1, except for certain taxpayers such as banking, finance and insurance companies, and taxpayers engaging in the business of oil and gas, mining and infrastructure. In cases where the debt-to-equity ratio of the taxpayers exceeds the maximum figure, the expense to service the loan that is tax deductible is only up to the expense to service the loan up to the maximum debt-to-equity ratio.

ii Deduction of finance costs

Finance costs, such as interest and bank arrangement fees, can be deducted if these are expenses for the purposes of earnings, or collecting or maintaining income.

iii Restrictions on payments

There are some rules on payments of dividends to shareholders of a PT under Indonesian company law. Pursuant to the Indonesian Company Law of 2007, a PT can only declare and distribute dividends out of its net profits to its shareholders provided that the requirement for setting aside sums to the reserve fund has been satisfied. The Company Law does not provide what particular percentage of the PT’s net profits in any one financial year must be set aside for the reserve fund. The setting aside of net profits for the reserve fund shall be carried out until the reserve fund reaches at least 20 per cent of the issued and paid-up capital of the PT. This does not mean that in one financial year a PT must set aside its net profits for the reserve funds to reach 20 per cent of its issued and paid-up capital. However, reserve funds that have not reached 20 per cent of the issued and paid-up capital can only be used by the PT to cover losses that cannot be covered by other reserves. The use of net profits, including determination of the amount for the reserve fund, must be decided by a general shareholders’ meeting.
Return of capital can be achieved by a company purchasing its own shares from shareholders. Pursuant to Article 37(1) of the Company Law, a PT can purchase its own shares based on a resolution of the general shareholders’ meeting provided that:

a) the repurchase of the shares does not cause the net assets of the PT to become smaller than the issued capital plus the mandatory reserve fund that has been set aside; and

b) the total amount of all shares repurchased by the PT, and the pledge of shares or the fiduciary encumbrance over the shares held by the PT or other companies, or both, whose shares, directly or indirectly owned by the PT, do not exceed 10 per cent of the issued capital of the PT, unless provided otherwise in capital market laws and regulations.

For tax purposes, the payment by a PT to a shareholder for purchasing the shares owned by such shareholder in the PT will be treated in the same manner as a distribution of dividends to a shareholder.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Foreign companies acquiring local businesses generally structure transactions by acquiring shares in the Indonesian target company (share deals) or by purchasing assets of the target company (asset deals).

Share deals

A foreign entity may acquire shares in an Indonesian target company directly or indirectly through another foreign entity provided that the business sector of the target company is open for foreign investment. For the transfer of shares in a closely held company, if the seller is another foreign entity, such seller will have a final income tax of 5 per cent of the share price (withholding tax of 20 per cent and net deemed profit of 25 per cent of the share price) imposed on it, unless, pursuant to the relevant tax treaty, the taxing authority is not Indonesia.

The PT should only record the transfer of the shares in the shareholders’ register if evidence is presented to it that the income tax has been completely settled. In cases where the purchaser of the shares is a foreign entity, the PT is deemed as the party who has the obligation to collect the income tax.

Pursuant to Article 18(3c) of the Income Tax Law, the sale of shares in an Indonesian (target) company by a conduit company or special purpose company established or domiciled in a tax haven country that has a special relationship with an entity established or domiciled in Indonesia or a PE in Indonesia can be deemed as the sale or transfer of shares by the Indonesian entity or PE in Indonesia.

Asset deals

A foreign entity is not allowed to acquire assets of an Indonesian entity directly to operate a business in Indonesia. As discussed above, except for certain limited business sectors, foreign entities are not eligible to obtain business licences in Indonesia. To acquire assets of the Indonesian (target) company and operate a business in Indonesia, a foreign entity must use
its Indonesian company, or must first establish a PMA company, to acquire such assets. If the acquired assets are land and buildings, the purchaser of the assets will have duty imposed on the acquisition of land and buildings at a rate of 5 per cent of the price of the assets imposed on it.

Pursuant to Article 18(3b) of the Income Tax Law, the indirect purchase of shares or assets of an Indonesian (target) company by an Indonesian entity through a special purpose company can be deemed as the purchase of shares or assets by the Indonesian entity if the special purpose company has a special relationship with the Indonesian entity or if there is unreasonable pricing.

ii Reorganisation

As a general rule, the transfer of assets in business mergers, consolidations or spin-offs is conducted at market value. This results in taxable gain or loss. This loss is basically tax-deductible. Upon approval of the Director General of Tax, the assets can be transferred at book value for a tax-neutral merger or consolidation provided that the business purpose tests are satisfied.

In Indonesia, there is no provision that can allow a merger of a local entity with a foreign entity.

iii Exit

If a business decides to relocate to another country, the Indonesian entity must be dissolved and must further be liquidated. As one of the exercises in the liquidation process, that entity must also resolve its tax liability, and for these purposes there will be a tax audit. Upon the settlement of the tax obligation, the tax authority will issue a tax clearance. Once the tax clearance has been obtained, the Indonesian entity can completely dissolve and cease to exist as a legal entity.

There is no tax penalty merely for relocation of a business to another country.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

As discussed in Section VIII.i, the Indonesian Income Tax Law provides avoidance rules for the sale of shares or assets meeting certain requirements.

Pursuant to Article 18(3b) of the Income Tax Law, the indirect purchase of shares or assets of an Indonesian (target) company by an Indonesian entity through a special purpose company can be deemed as the purchase of shares or assets by the Indonesian entity if the special purpose company has a special relationship with the Indonesian entity or if there is unreasonable pricing.

Pursuant to Article 18(3c) of the Income Tax Law, the sale of shares in an Indonesian (target) company by a conduit company or special purpose company established or domiciled in a tax-haven country that has a special relationship with an entity established or domiciled in Indonesia, or a PE in Indonesia, can be deemed as the sale or transfer of shares by the Indonesian entity or PE in Indonesia.

Indonesia no longer has a tax treaty with Mauritius, a low-tax jurisdiction.
ii **Controlled foreign corporations**

As discussed above, in most business sectors controlled foreign corporations must take the form of a PT. As such, the rules for the distribution of dividends to a shareholder that is a foreign entity are basically the same as those that apply to shareholders of a closely held PT.

iii **Transfer pricing**

Pursuant to Article 18(3) of the Income Tax Law, the Director General of Tax has the authority to adjust taxpayers’ income or costs in transactions with related parties not carried out under the arm’s-length principle by using the comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method and other methods. Currently, the transfer pricing documentation must also be attached to the corporate income tax return for any transaction with a related party that: (1) exceeds 20 billion rupiah for tangible goods transactions; or (2) exceeds 5 billion rupiah for service provision, interest payment, intangible goods utilisation or other affiliated transactions per entity per year. For such purpose, the taxpayer must conduct a comparable analysis or determine comparable data to show that the transaction with the related party conforms to the arm’s-length principle.

Pursuant to Article 18(3a) of the Income Tax Law, the Director General of Tax also has the authority to enter into advance pricing agreements with taxpayers or the tax authority of another country on the application of the arm’s-length principle to transactions between related parties.

iv **Tax clearances and rulings**

It is possible to obtain advance tax rulings from the tax authority to secure certainty. Tax rulings may also be required to acquire a local business.

To issue a tax clearance, the tax authority will need to conduct a tax audit. In the acquisition of a local business, the seller of the local business is usually reluctant if the tax clearance is required as a condition precedent for the conclusion of the transaction.

v **Mutual Agreement Procedures**

In an effort to more effectively prevent and settle international taxation disputes, the Minister of Finance has also recently issued Regulation No. 49/PMK.03/2019 on Procedures for the Implementation of Mutual Agreement Procedure (taking effect from 26 April 2019). The Mutual Agreement Procedure (MAP) refers to an administrative procedure provided for under a tax treaty for the settlement of disputes that arise during the implementation of a tax treaty. As a general rule, Minister of Finance Regulation No. 49/PMK.03/2019 provides opportunities for Indonesian domestic taxpayers to submit requests to the Director General of Tax for the implementation of MAP, in the event that a tax treatment by a tax treaty partner state is in contradiction to the relevant tax treaty. In addition to Indonesian domestic taxpayers, the request for the implementation of MAP can also be filed by: (1) Indonesian citizens who have become domestic taxpayers in a tax treaty partner state (which request is to be filed via the Director General of Tax); (2) the Director General of Tax; or (3) the tax authority of the tax treaty partner state (which request is to be filed via the authorised official in the tax treaty partner state in accordance with the tax treaty).

Pursuant to Minister of Finance Regulation No. 49/PMK.03/2019, following the application for MAP, the requests will be reviewed by the Director General of Tax. Subsequently, there will be a follow-up (e.g., notification to the authorised official in the tax
treaty partner state) and a negotiation conducted between the Director General of Tax and the tax treaty partner authority. The outcome of the negotiation will be set out in a mutual agreement that sets out the agreement or disagreement on the points requested for MAP. If an agreement is reached between the parties, a decree confirming the implementation of the mutual agreement is then delivered to the requesting parties.

X YEAR IN REVIEW

The transfer pricing issues involved in transactions between related parties have been scrutinised by the Indonesian tax authorities in recent years. Many taxpayers have challenged the adjustments made by the tax authority to the Tax Court for nullification. The Tax Court has rendered decisions on some of these, but others are still pending before it. Certain of these disputes are also pending with the Supreme Court, and some disputes have been decided by the Supreme Court. The typical reason for taxpayers to challenge the adjustments is that the tax authority did not provide the comparable data necessary to show that transactions between related parties that have been entered into are not in accordance with the arm’s-length principle.

There is only one Tax Court in Indonesia, which is situated in Jakarta. However, the Tax Court has also held sessions in Yogyakarta and Surabaya on 7 June 2012 and 14 March 2013, respectively.

XI OUTLOOK AND CONCLUSIONS

Similar to the previous year, it has been reported that there are plans to reform the current tax law regime, some of which are plans to amend the General Provisions and Procedures of Taxation Law, the Income Tax Law and the VAT Law, in the framework of tax reform. The reasons for the amendment of the General Provisions and Procedures of Taxation Law are, inter alia, to make it easier for taxpayers to fulfil their obligations, to ease the process of tax withholding, and to increase the state revenue from the tax sector. The revision of the articles in the Income Tax Law is expected to be in line with the paradigm and trend of global taxation, which emphasises equality of rights, transparency, and moderation of tax rates. Meanwhile, the VAT Law revision is expected to make the VAT Law clearer, simpler and more certain. Further, the government is also looking to address the taxation issues of the digital economy/e-commerce industry and to expand the coverage of tax exemptions and reduction.

Recent reports also suggest that the government is planning to introduce sweeping regulatory reforms in the forms of omnibus laws, which are hoped to boost the country’s economic growth and address employment scarcity issues. One of the omnibus laws being proposed is the omnibus law on taxation. The omnibus taxation bill is expected to reduce income tax for individuals and corporations and also eliminate dividend tax for shares ownership of less than 25 per cent. Specifically regarding the proposed reduction of corporate income tax, it has been reported that the government plans to gradually cut the corporate income tax from the current 25 per cent up to 20 per cent in 2023 (this plan is reported to also include an additional 3 per cent reduction for go-public companies).
I INTRODUCTION

Ireland has for many years attracted a disproportionately large amount of inward investment. This trend did not change during the recent economic downturn. In fact, paradoxically, the economic crisis enhanced Ireland’s attractiveness as an investment location. IBM’s 2019 Global Location Trends Report (the most recent version available) states that ‘Ireland . . . recorded [its] highest level of inward investment in the last 10 years’. The Report has ranked Ireland as the second-best destination globally for jobs by quality and value of investment ahead of other leading locations including Lithuania, Switzerland and Hong Kong. Significant gains in inbound investment have been achieved in recent years. The 2019 Report shows that only Singapore ranks ahead of Ireland in this regard.

Ireland has boasted significant growth in job creation from foreign direct investment in Europe. When looking at jobs created from foreign direct investment relative to population size, Ireland ranks second, with growth of more than 25 per cent compared to the previous year. In terms of manufacturing and services, Ireland is the top ranking Western European country.

The government and opposition parties have consistently reaffirmed their commitment to maintaining the corporation tax rate of 12.5 per cent amidst the changing international tax environment (most recently in the 2020 Budget announcement on 8 October 2019), which is a cornerstone of Ireland’s inward investment strategy.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

There are various forms of business organisation to choose from in Ireland. Some involve the creation of a separate legal person, while others do not.

Only bodies corporate are subject to Irish corporation tax. This would include all limited or unlimited companies and registered societies. All income of an Irish-resident company or other body corporate, wherever it arises, will normally be liable to Irish corporation tax.

Entities without identities separate from those of their members are not subject to corporation tax, and include sole traders, partnerships and unincorporated associations. In general, income tax is charged on the profits of a person carrying on a trade or profession. There are special tax rules for partnerships under which each partner is taxed separately on his or her share of partnership profits.

1 Peter Maher is a partner at A&L Goodbody.
i Corporate

The private limited company is the most common form of Irish company. Its principal attraction is that shareholders’ liability for the company’s debts is limited to the amount they agreed to pay for their shares. Under the Companies Act 2014, there are two types of private limited company – the company limited by shares (ltd) and the designated activity company. Public limited companies are generally used where there is a larger dispersed ownership of the company or where shares will be traded on a stock exchange. There are more onerous disclosure requirements (particularly in relation to financial disclosures) on public companies than on private companies, and they are subject to a minimum capitalisation requirement.

In an unlimited company, the liability of the members for the company’s debts is not restricted. These types of company are not particularly common. Unlimited companies previously had certain advantages over limited companies as they enjoyed fewer disclosure requirements and greater flexibility in terms of returning share capital. However, the Companies (Accounting) Act 2017 amended the position somewhat with the effect that the majority of unlimited companies are now obliged to file financial statements in the Companies Registration Office.

ii Non-corporate

Non-corporate forms of business organisation are often used in Ireland either by sole traders or by groups of individuals who do not wish to, or are prohibited from, forming a body corporate. Partnerships are used by persons carrying on a business together with a view to profit, and are not registered or incorporated entities. Limited partnerships, where some of the members have limited liability for the debts of the partnership, can be created, but these do not constitute a legal entity separate to their members.

III DIRECT TAXATION OF BUSINESSES

The Irish tax system is based on the classical model, meaning that tax is generally payable at each level of the chain, without credit being given at a higher level in that chain for tax suffered lower down. Therefore, when profits are distributed by an Irish-resident company, Irish-resident shareholders are not given credit for underlying corporation tax already suffered by the company.

The tax system is a schedular system, in that income from different sources is allocated to different ‘schedules’ and ‘cases’ and may be taxed in different ways. Corporation tax rates, and the deductions available against income sources, vary depending on the source of the income.

i Tax on profits

Determination of taxable profit

A company’s income is generally computed in accordance with income tax principles. The aggregate net income as calculated under each of the schedules and cases gives the company’s taxable income, and when this in turn is aggregated with taxable capital gains, the company’s total profits are arrived at.

The profits of a trade carried on by a company are computed in accordance with generally accepted accounting practice, but subject to any adjustment required or authorised by law in computing such profits or gains for those purposes. Consequently, any deductions
that are given in the accounts but are statutorily disallowed for Irish tax purposes need to be added back. As a general rule, no tax deduction is allowed against trading income for capital expenditure or for revenue payments that are not incurred wholly and exclusively for the purposes of the trade. By way of example, client entertainment expenditure is not allowed for tax purposes and motoring revenue expenses are generally restricted. In addition, accounting depreciation is disallowed for tax purposes, but instead a deduction may be granted for allowances as provided for by Irish tax legislation – known as ‘capital allowances’ – in respect of capital expenditure incurred on various types of assets (e.g., plant and machinery, industrial buildings and intellectual property rights) for the purpose of the trade.

The general capital allowance regime for plant and machinery grants a capital allowance on a straight-line basis over eight years (12.5 per cent per annum) for the capital expenditure incurred on the asset. Generally, the rate of capital allowances for industrial buildings is 4 per cent per annum. In the case of capital expenditure on intellectual property rights, the allowances are generally granted in accordance with the amortisation of those assets in the accounts or, at the company’s election, over a period of 15 years (see also Section V.ii). Disposals of the assets for amounts greater than or less than the tax written-down value may result in balancing charges or balancing allowances for the company.

**Capital and income**

A fundamental feature of the Irish tax system is the separate treatment for Irish tax purposes of income and capital. Income is subject to income tax (or, in the case of companies within the charge to corporation tax, to corporation tax computed by reference to income tax principles), whereas capital receipts generally are subject to capital gains tax (CGT) (or, in the case of companies with a charge to corporation tax, to corporation tax by reference to CGT rules) and generally computed by reference to separate rules for capital gains. The rates of tax applicable to income and gains differ. Companies are taxed on income at a rate of either 12.5 or 25 per cent, whereas capital gains are generally taxed at 33 per cent.

**Losses**

When, after the deduction of trading expenses, a company incurs a current-year trading loss, it can normally use that loss to shelter other trading income in the current year and also trading income (from the same trade) in a preceding accounting period of corresponding length. When the company has excess trading losses, these losses can be used on a value basis to shelter other income of the same accounting period or preceding accounting period of corresponding length, reflecting that different corporation tax rates apply to trading and non-trading income. Unused losses can then be carried forward by the company for offsetting against income from the same trade in future accounting periods.

An anti-avoidance provision operates to deny the carry-forward of unused trading losses (and certain capital allowances) where, within a period of three years, there is both a change in ownership of the company, and a major change in the nature and conduct of the trade carried on by the company. The provision also denies the carry-forward where the activities in a trade have become small and negligible and there is a change in ownership of the company before any considerable revival of the trade.

In general, non-trading revenue losses can only be used for offset against non-trading income taxed in the same manner. For example, Irish rental losses can only be offset against
Irish rental income in the same accounting period, or an earlier accounting period of corresponding length or subsequent accounting periods. Excess capital losses can shelter future capital gains, except gains on disposal of Irish development land.

Certain investment companies are allowed to claim expenses of management against their profits. If there is an excess of management expenses, such excess can be carried forward to future accounting periods.

**Rates**

The rate of tax applicable to most trading profits (other than profits derived from trading activities involving mining, petroleum activities and dealing in land) is 12.5 per cent. For profits generated from these excluded trades and all other non-trading income, the applicable rate is 25 per cent. In addition to the 25 per cent tax on trading profits from petroleum activities, a petroleum production tax (PPT) applies to oil and gas licences and options granted on or after 18 June 2014. The rate of PPT ranges from 5 to 40 per cent, but is tax deductible against profits or gains chargeable to corporation tax resulting in a maximum marginal rate of 55 per cent. The rate for capital gains has traditionally been different to these rates, and the current rate stands at 33 per cent. A 10 per cent rate applies to certain gains realised by entrepreneurs on the disposal of certain business assets.

**Administration**

The Revenue Commissioners are the sole taxation authority in Ireland.

A system of self-assessment applies for the payment of corporation tax, and a system of mandatory electronic payment and filing of returns (e-filing) is now largely in place. Companies are required to make a payment of preliminary tax that must, in general, be a minimum of 90 per cent of the corporation tax for that period. The dates and amounts for payment of preliminary tax differ depending on whether the company is a small or large company. For a small company, the payment of preliminary tax is due in the 11th month of the company’s accounting period. For a large company, one with a tax liability of more than €200,000 in the previous accounting period, payment of preliminary tax is made in two instalments, in the sixth and 11th months of the accounting period.

A corporation tax return must be filed with the Revenue Commissioners before the nine months after the end of the accounting period (but no later than the 23rd day of that month), together with the balance of tax due.

Where a doubt exists about the tax treatment of a specific item, a company may take a view on the issue and express doubt on its tax return filing. A formal genuine expression of doubt protects a taxpayer from interest (provided any additional tax arising is paid when due) and penalties should the Revenue Commissioners take a different position to the company on the tax treatment.

An audit may be conducted by the Revenue Commissioners if, upon a review of a company’s tax returns, queries are raised that are not answered satisfactorily. A revenue audit may also be conducted on a random basis, and in some cases randomly within a particular business or profession.
**Tax grouping**

Ireland does not permit the filing of consolidated tax returns. Affiliated companies may, however, be able to avail of corporate tax ‘group relief’ provisions. Where a direct or indirect 75 per cent relationship exists, and all the companies are resident in a European Union (EU) Member State or a European Economic Area (EEA) country with which Ireland has a double taxation agreement (DTA), each of the companies will be deemed a member of the group.

Group relief can be claimed on a current year basis in respect of trading losses, excess management expenses and excess charges on income within a group. Irish legislation now provides that an Irish resident parent company may offset against its profits any losses of a foreign subsidiary resident for tax purposes in an EU Member State or an EEA country with which Ireland has a DTA. This is provided that the losses cannot be used in the country in which the subsidiary is tax resident.

Capital losses cannot be surrendered within a group. Capital assets can, however, be transferred between members of a CGT group on a tax-neutral basis. Any gain referable to the group’s ownership will be precipitated when the asset is disposed of outside the group, or when a company that acquired the asset intra-group ceases to be a member of the group within 10 years of the acquisition.

A group for CGT purposes is a principal company and all its effective 75 per cent subsidiaries. For the purposes of identifying the relevant indirect ownership interest in a company, holdings by any EU Member State company, EEA resident company, company resident in a tax treaty partner country, or certain companies that are substantially and regularly traded on a recognised stock exchange, may be taken into consideration.

**ii Other relevant taxes**

VAT is payable on goods and services supplied in Ireland by taxable persons in the course of business. VAT is also payable on goods imported into Ireland from outside the EU. The rates of VAT currently range from zero to 23 per cent. An Irish established taxable person is required to register for VAT purposes when its annual turnover exceeds €37,500 if its business supplies services and where its annual turnover exceeds €75,000 if the business is supplying goods. A non-Irish established taxable person supplying taxable goods or services in Ireland is obliged to register and account for VAT irrespective of the level of turnover.

Stamp duty applies to documents that implement certain transactions and is payable within 30 days of execution. Transfers of Irish stocks and marketable securities are chargeable to stamp duty at 1 per cent.

Transfers of other non-residential property attract a flat rate of 6 per cent stamp duty currently. It is proposed pursuant to Finance Bill 2019 to increase that rate to 7.5 per cent. The 7.5 per cent rate is to apply to instruments executed on or after 9 October 2019. The Finance Bill 2019 provides for transitional arrangements. Where there is a binding contract in place before 9 October 2019 and the instrument of transfer is executed before 1 January 2020 and the instrument contains a certificate, stamp duty applies at the pre-budget rate of 6 per cent. Where non-residential land is purchased for residential development and stamp duty is paid at the new rate of 7.5 per cent, a refund of up to 11/15ths of the stamp duty paid may be available where certain qualifying conditions are met.

Exemptions exist in the case of intellectual property and certain financial instruments. In addition, various types of relief apply in the case of company reconstructions, amalgamations,
intra-group asset transfers, cross-border mergers and domestic mergers by absorption. An exemption from stamp duty also exists for the transfer of stocks and marketable securities of companies listed on the Enterprise Securities Market of the Irish Stock Exchange.

Stamp duty at the rate of 1 per cent is to be introduced pursuant to Finance Bill 2019 as an anti-avoidance measure for certain schemes of arrangement involving the cancellation of shares.

Employers have an obligation to register with the Revenue Commissioners and follow the procedures for the deduction at source of employee’s income tax, known as pay-as-you-earn (PAYE), and social insurance contributions, known as pay-related social insurance (PRSI) and the universal social charge (USC). Employers have primary responsibility for the collection of the tax, and must ensure PAYE, USC and PRSI are operated on any additional taxable benefits, such as benefits in kind, provided to employees. In addition to the PRSI deduction from an employee’s income, the employer must make a PRSI contribution for each employee, generally at a rate of 10.75 per cent of the gross salary of the employee.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Companies incorporated in Ireland on or after 1 January 2015 are automatically regarded as Irish tax resident unless treated as tax resident elsewhere under a tax treaty with Ireland. For companies incorporated before that date, this ‘incorporation rule’ applies from the earlier of 1 January 2021 or the date where there is a change in the ownership of the company and within a specified period there is also a major change in the nature or conduct of the business of the company. Otherwise, until either of those events occurs, the tax residence of a company incorporated in Ireland prior to 1 January 2015 is broadly determined by virtue of the common law rule that a company is Irish tax resident if it is ‘centrally managed and controlled’ in Ireland. This is subject to a ‘stateless’ company rule where an Irish-incorporated company is managed and controlled in another EU Member State or jurisdiction with which Ireland has a DTA and is not regarded as tax resident in any territory. In such a case, the company is regarded as resident in Ireland for tax purposes. The provision does not, however, affect structures that involve Irish-incorporated companies that are in fact managed and controlled in a non-EU or non-DTA jurisdiction (e.g., Bermuda).

A non-Irish-incorporated company (whether incorporated before or after 1 January 2015) can become resident in Ireland if its ‘central management and control’ is exercised in Ireland. Generally speaking, this case law concept is taken to denote control at the highest strategic level of a company’s business rather than at the level of day-to-day activities. Many factors need to be looked at when considering where a company is to be regarded as having its place of central management and control; for example, the place where company board meetings are held and the place where the directors of the relevant company are themselves resident.

ii Branch or permanent establishment
A company not resident in Ireland is subject to corporation tax if it carries on a trade in Ireland through a branch or agency, and it will be chargeable on all profits arising therefrom. However, an exemption exists in the case of an authorised investment manager who acts as an agent on behalf of a non-resident in carrying on a financial trade and is independent of the non-resident. In addition, an Irish management company appointed to manage a non-Irish undertaking for the collective investment in transferable securities (UCITS) fund should not
as a result bring the non-Irish UCITS into the Irish tax net. Nor should an Irish management company appointed to manage a non-Irish alternative investment fund bring the latter into the Irish tax net.

The concept of branch or agency is not defined in Irish statutory tax law; although similar to the Organisation for Economic Co-operation and Development (OECD) Model Treaty concept of the permanent establishment, it is likely wider in its scope. For example, the emphasis on a fixed presence, and on a degree of permanence, is probably not necessary for a branch or agency to exist for the purposes of Irish law. Liability to Irish tax will normally depend on whether the operation of the non-resident company constitutes trading in Ireland. The major consideration in this determination is whether there is power to conclude contracts and whether contracts are in fact concluded in Ireland.

In cases where the company is resident in a country with which Ireland has a tax treaty, liability to Irish corporation tax will depend on whether the company carries on a trade in Ireland through a permanent establishment. The treaty may displace an Irish corporation tax charge that would apply in the absence of the treaty.

There are many views as to how profits should be allocated to a permanent establishment, but given the wording of the business profits article in the majority of Ireland’s tax treaties, an approach that treats the permanent establishment as being a fictitious separate legal entity to which income and expenses are allocated as if it were an independent company is likely to be acceptable to the Irish Revenue Commissioners. There is no statutory basis for the calculation of profits to be allocated to a branch, but an approach that treats the Irish branch as a fictitious separate legal entity, similar to the approach taken for a permanent establishment, may be considered to be reasonable.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i 12.5 per cent tax rate for trading income
The cornerstone of Ireland’s attraction for foreign companies is undoubtedly the 12.5 per cent corporate tax rate. This applies to the income of a trade at least partly carried on in Ireland. There is no precise statutory definition of ‘trading’ or a ‘trade’, and it is therefore necessary to refer to relevant case law to determine whether a trade exists. A UK Royal Commission reported in the 1950s on a similar definition in the UK tax legislation and identified the relevant principles that are indicative of trading activity, known as the ‘badges of trade’. These include the length of the period of ownership of the relevant subject matter and the frequency of transactions that the relevant company enters into. It is important to note that the Irish Revenue Commissioners will also seek a minimum level of ‘substance’ or physical presence in Ireland.

ii IP regimes
Irish tax legislation provides relief in relation to the acquisition of specified intangible assets, which include patents, copyright, registered designs, design rights or inventions, trademarks, trade names, brands, brand names, domain names, service marks or publishing titles, know-how and certain software. The definition of ‘specified intangible assets’ also includes the acquisition of ‘customer lists’ except where the lists are acquired directly or indirectly in connection with the transfer of a going concern. The relief is given by means of a capital allowance deduction available against trading income that is derived from activities that
consistent of the managing, developing or exploiting of the IP, including activities that comprise the sale of goods or services that derive the greater part of their value from the IP. An 80 per cent cap applies on the annual deductibility of capital allowances and related interest expense in relation to expenditure incurred on intangible assets on or after 11 October 2017.

A reward mechanism for key employees involved in R&D activities allows (where appropriate) a company to surrender part of its R&D tax credits to a qualifying employee to effectively enable him or her to receive part of his or her remuneration free from tax.

A number of improvements to the R&D tax credit regime as it applies to small and micro companies are detailed in Finance Bill 2019. It envisages an increase in the R&D credit from 25 to 30 per cent; a provision to allow such companies to claim the credit with respect to pre-trading R&D expenditure for off-set against VAT and payroll taxes; and amendments to the method for calculating the refundable credit amount.

### iii Knowledge Development Box (KDB)

The KDB provides for an effective 6.25 per cent rate of corporation tax on profits arising from qualifying assets, including certain patents and copyrighted software that are the result of qualifying R&D carried out by the company availing of the relief (i.e., the tax relief provides for an allowance of 50 per cent of the qualifying profits to be treated as a trading expense of the company, resulting in an effective 6.25 per cent tax rate on such profits). The definition of R&D is the same as that applying to the R&D tax credit, but only allows R&D expenditure incurred in another EU Member State to the extent it is tax deductible in Ireland. The KDB has been promoted by the government as the first OECD-compliant preferential tax regime in the world.

### iv Holding company regimes

Ireland has a holding company regime that provides for an exemption from Irish tax on capital gains arising on a disposal of substantial shareholdings held by companies in subsidiaries. The exemption applies when the shares disposed of are in a company that is resident for tax purposes in the EU or in a country with which Ireland has signed a tax treaty. The Irish company must have held at least 5 per cent of the company whose shares are being sold for a period of at least 12 months ending in the previous 24 months; and the company whose shares are being sold, or the disposing company and all its 5 per cent affiliates taken as a whole, must be wholly or mainly involved in trading activities.

A parallel exemption applies with respect to options over shares and convertible securities, provided the disposing company is one that would be entitled to exemption on a disposal of shares.

### v Irish finance companies — recent extensions

Specific tax legislation was introduced a number of years ago to encourage the use of Ireland as a jurisdiction for locating finance vehicles. The asset classes that these companies are permitted to hold and manage include plant and machinery (e.g., aircraft), commodities and carbon credits as well as most forms of financial assets. A company coming within the relevant provision of the Irish tax legislation, Section 110, may be used advantageously in securitisations and in a wide range of finance transactions. The legislation effectively provides that where a relevant company falls within its ambit, its profits will be calculated as if it were carrying on a trade. As a result, expenses such as funding costs, payments made under hedging swaps and payments to services providers are generally deductible. The deductibility
position is bolstered by two further specific statutory provisions. First, the normal distribution rules are modified to the extent that, broadly, the provision that recharacterises interest as a distribution (see below) does not apply to interest payable in respect of a debt obligation of a qualifying company where the interest is profit-dependent or excessive. Second, the statutory provision deals with the deductibility of bad or doubtful debts, and allows for a specific deduction in respect of such amounts to the extent they are not otherwise deductible under general principles. Some limited restrictions on deductibility were introduced in 2011; however, these would not affect the majority of structures.

Notwithstanding the fact that profits are calculated on the assumption that the qualifying company is carrying on a trade for tax purposes, the taxable profit of that company is subject to tax at the higher corporation tax rate of 25 per cent. That higher rate of tax generally has little consequence, as most transactions entered into by a qualifying company are generally structured so that the deductions available to the company result in minimal taxable profit arising in the company.

Generally, to come within the provisions of Section 110 of the Irish tax legislation, a company must be resident for tax purposes in Ireland, and must acquire and manage or hold qualifying assets the market value of which, on the day it first acquires assets, is not less than €10 million. The definition of qualifying asset includes most types of financial assets, commodities, plant and machinery (including aircraft) and carbon offsets. A notification must be made by the company within eight weeks of the first acquisition of ‘qualifying assets’ to the Revenue Commissioners in relation to the company’s intention to be a qualifying company.

vi Tax-exempt regulated funds

Ireland is the largest hedge fund administration centre in the world, with the Irish funds industry servicing assets worth over €3 trillion held in over 13,000 funds. One of the principal factors in enabling Ireland to establish its position as a leading global fund jurisdiction is the tax neutrality of Irish-regulated funds.

There is a specific tax regime that applies to Irish-regulated funds, which is applicable to all types of funds that are established in Ireland and are authorised by the Central Bank of Ireland. These can include variable capital companies, Irish collective asset-management vehicles (ICAVs), unit trusts, investment limited partnerships and common contractual funds. From a tax perspective, an important feature of the ICAV is that it is able to elect its classification under US ‘check the box’ taxation rules.

This tax regime treats all such funds (other than investment limited partnerships and common contractual funds) as resident in Ireland for Irish taxation purposes, but provides that the funds do not pay tax on their income or gains as they arise. Instead, it imposes an exit tax regime whereby an exit tax arises on the occasion of certain chargeable events arising in respect of investors. For the vast majority of investors, there is no actual Irish tax liability suffered through the investment in an Irish fund, as these chargeable events do not give rise to tax if the relevant investor is neither resident nor ordinarily resident in Ireland for Irish tax purposes.

Irish-resident or ordinarily resident investors (other than certain exempt residents’ investors, e.g., charities, pensions schemes) suffer an exit tax on the occasion of certain chargeable events. Such chargeable events are broadly:

a income and other distributions;

b redemptions and repurchases of units by the fund;
disposals of units by investors; and
d deemed disposals occurring on each eight-year anniversary of an investor’s acquisition of units.

On these chargeable events, generally the fund is required to operate an exit tax. Where the chargeable event is an income or other distribution by the fund, tax will be deducted at a rate of 41 per cent or, where the investor is a company and the relevant declaration has been made to the fund, at a rate of 25 per cent. In relation to all other forms of chargeable events, tax will be deducted at a rate of 25 per cent for corporate investors where the relevant declaration has been made to the fund, and 41 per cent for all other types of investors. There are certain exemptions for fund reorganisations.

Exemptions applicable to Irish funds have also been introduced for indirect taxes. There is no stamp duty payable on the issue or transfer of units in a fund. There is an exemption from Irish inheritance tax and gift tax for gifts on inheritances between non-Irish residents of units in an Irish fund.

In general, no Irish VAT is suffered or payable by a fund in respect of investment management services, administration services or custodial services provided to it. There is a practice that can enable funds to recover any VAT paid by the fund in respect of supplies received by it by applying a specific formula either on the basis of the proportion of the assets of the fund that are outside the EU, or the proportion of investors that are outside the EU.

A real estate investment trust (REIT) regime was introduced a number of years ago to complement the existing regulated fund regime. The REIT regime provides investors with greater access to investments in regulated listed property vehicles. Broadly speaking, a publicly quoted REIT that meets certain conditions is exempt from tax at a corporate level. The profits of the REIT are instead subject to tax at shareholder level only.

The Finance Bill 2019 proposes a number of changes to the REIT regime. For example, there is a requirement that any expenses deducted when calculating REIT profits available for distribution must be incurred wholly and exclusively for the purposes of the REIT business. Any excessive amounts are charged to tax in the hands of the REIT. Also, any distributions comprising the proceeds of property disposals are to be subject to dividend withholding tax.

A 20 per cent withholding tax applies on certain payments by a non-UCITS fund that constitutes an Irish real estate fund (IREF) to certain investors. Broadly, an IREF refers to a non-UCITS fund where at least 25 per cent of the value of the fund (or sub fund in the case of an umbrella fund) derives from Irish real estate or assets that derive their value from Irish real estate.

The Finance Bill 2019 proposes to introduce a number of anti-avoidance measures broadly to ensure that the level of IREF tax on the profits of an IREF when these are distributed or otherwise released to investors is not reduced through certain tax structuring techniques.

vii State aid

IDA Ireland (IDA), one of Ireland’s principal inward investment promotion agencies, offers a range of services and incentives, including funding and grants, to companies considering an inward investment in Ireland.

The IDA will in certain cases offer capital grants that are available towards the cost of fixed assets including site development. Rent remissions and rent allowances may also be available. Grants may also be available to meet the cost of training workers in new projects,
and there are a number of additional incentives available for companies undertaking R&D programmes in Ireland. The IDA owns several industrial parks with purpose-built factories and can also offer greenfield sites where promoters can erect custom-built facilities.

Employment grants may be available to a company where permanent full-time positions are created, and these are a commonly used IDA grant. The unique characteristics of any proposed project will determine the incentive package available, in particular its location. Employment grants are now mostly available for employment in the western and midlands regions of Ireland, and also in the areas that border Northern Ireland. The IDA evaluates potential projects through a process of negotiation. Aside from location, amounts paid tend to depend on the level of investment involved, the activities undertaken and the skill level of the employee.

viii General
The ease of doing business in Ireland is an important factor for investors. It is to Ireland’s advantage that it is an English-speaking EU Member State (and will be the only English-speaking Member State apart from Malta after Brexit) and one with a common law legal regime. As a location, Ireland bridges the time zone gap between the East and West. In the World Bank ‘Doing Business 2019’ report, Ireland is ranked 11th in Europe and 23rd in the world in terms of ease of doing business. Ireland’s ranking fell from eighth in Europe and 17th in the world from the previous year.

A PwC ‘Paying Taxes 2019’ report has ranked Ireland first in Europe for ease of paying taxes and the fourth most effective worldwide. The Irish workforce is among the best educated in the world; the share of population aged 25 to 34 with a third-level qualification is higher than in the United States or the United Kingdom, and is above the OECD average. Fifty-six per cent of Irish 25- to 34-year-olds have received higher or further education. The average for the OECD is 44 per cent. This Irish score is the highest in Europe and the fourth highest in the world. The findings are contained in the OECD’s Education at a Glance 2019 Report.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS
i Withholding on outward-bound payments (domestic law)
Annual interest, patent royalties (however, see exemptions below), dividends and other distributions paid by an Irish-resident company are generally subject to withholding tax, currently at a rate of 20 per cent, absent an exemption. The Finance Bill 2019 proposes to increase the withholding tax rate on dividends and other distributions to 25 per cent from 1 January 2020. Withholding obligations are not generally imposed on non-patent IP royalties or on payments for the use of equipment, such as aircraft lease rentals.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
There are various exemptions under Irish domestic law applicable to interest and dividend payments. In particular, in the case of cross-border interest payments, interest will be exempt if it is paid:

a on quoted Eurobonds;

b by a company in the ordinary course of business to a company resident in an EU Member State (other than Ireland) or in a tax treaty country, provided that either the
country generally imposes a tax on such interest receivable by the company or the interest is exempted under the relevant tax treaty. This exemption will not apply where it is paid in connection with a trade or business carried on in Ireland by the payee;

c by a securitisation qualifying company to a person resident in an EU Member State (other than Ireland) or in a tax treaty country, except where it is paid in connection with a trade or business carried on in Ireland by the payee; and

d on certain wholesale debt instruments for which the term is less than two years.

In the case of cross-border dividend or distribution payments, they will be exempt if paid by an Irish-resident company to:

a a non-resident individual resident in an EU Member State (other than Ireland) or in a tax treaty country;

b an EU company holding at least 5 per cent of the Irish company (Irish enactment of the Parent–Subsidiary Directive);

c a non-resident company that resides in an EU Member State (other than Ireland) or in a tax treaty country, provided that the company is not controlled by a person or persons resident in Ireland;

d a non-resident company that is ultimately controlled by a person or persons resident in an EU Member State (other than Ireland) or in a tax treaty country;

e a non-resident company whose principal class of shares is substantially and regularly traded on a stock exchange in Ireland or in an EU Member State (other than Ireland) or in a tax treaty country; or

f a non-resident company that is either a 75 per cent subsidiary of a company the principal class of shares of which is quoted and regularly traded on such a stock exchange, or that is wholly owned by two or more such companies.

The obligation to withhold tax and pay it to the Revenue Commissioners is placed on the company paying the dividend. With the exception of the application of the EU Parent–Subsidiary Directive, a shareholder who seeks to avail of an exemption must lodge an appropriate declaration with the paying company certifying that a particular exemption applies.

Patent royalties are also eligible for a domestic withholding exemption where the payments are made by a company in the course of a trade or business to a company resident in an EU Member State (other than Ireland) or in a tax treaty country. The payments must be made for bona fide commercial reasons to a company in a territory that generally imposes a tax on royalty payments receivable from outside that territory. The exemption does not apply where the royalties are paid in connection with a trade carried out in Ireland through a branch or agency by the receiving company.

In addition to the statutory exemptions from withholding on patent royalties, a further category of exemption can be obtained under an administrative statement of practice issued by the Revenue Commissioners. Permission for payment of patent royalties gross can be applied for where the recipient is not resident in the EU or in a tax treaty country once a number of conditions are satisfied. The royalty must be paid in respect of a non-Irish patent by a company in the course of its trade, and under a licence agreement executed and subject to law outside Ireland. There are restrictions on the recipient company, which must be the
beneficial owner of the payment, and must be neither resident in Ireland nor carrying on a trade in Ireland through a branch or agency (even if that branch or agency is unconnected with the royalty payment).

iii Double tax treaties

Ireland has signed comprehensive double taxation treaties with 74 countries; 73 of those treaties are currently in effect. On 13 June 2019, Ireland and the Netherlands signed a new DTA. Procedures are under way to ratify the new DTA, which will replace the existing DTA between Ireland and the Netherlands. Negotiations have concluded for new DTAs with Kenya, Kosovo, Oman and Uruguay. A new double taxation convention with Ghana was signed on 7 February 2018 and procedures to ratify the convention are under way.

In relation to outbound payments, generally the generous domestic withholding exemptions outlined above are relied upon rather than exemption under an applicable treaty, which often requires the authorisation of the Revenue Commissioners. In relation to inbound payments, the rates of withholding currently applicable under the Irish tax treaty network are set out in Appendix I.

iv Taxation on receipt

Ireland generally operates a credit system rather than an exemption system, although, in the case of dividends, dividends received by an Irish-resident company are exempt if received from another Irish-resident company, or where the particular shareholding in the foreign company is less than 5 per cent and the dividends form part of the trading income of the Irish company. To the extent that dividends are received from companies resident in the EU, in a tax treaty country or in a territory that has ratified the Convention on Mutual Administrative Assistance in Tax Matters, and are payable out of the trading profits of such subsidiaries, those dividends are taxed in the hands of an Irish holding company at the lower 12.5 per cent rate. The lower rate may also apply to dividends paid out of the trading profits of companies resident in non-treaty countries where the company is owned by a publicly quoted company. In any other scenario, the 25 per cent rate should apply.

An Irish tax liability for dividends received from a foreign subsidiary may be reduced by any foreign withholding tax on the dividend and by an appropriate part of the foreign tax on the income underlying the dividend. This unilateral credit provision applies equally to countries that do not have a tax treaty with Ireland. The credit is not limited to first-tier tax, but to lower-tier companies having certain qualifying connections. The credit is available with respect to dividends from a 5 per cent shareholding in a foreign company. In such a case, the credit is available at a lower subsidiary level where the immediate relationship is at least 5 per cent and the Irish company itself also controls at least 5 per cent of the lower level company. Pooling of foreign tax credits is available to reduce the overall Irish tax bill when a company is in receipt of several foreign dividends, and excess foreign tax credits can be carried forward indefinitely.

A unilateral credit is also available to companies receiving royalties or interest as part of the income of a trade in respect of foreign tax suffered on the royalties or interest. This applies where no double tax treaty is in place to provide relief, or where the unilateral relief is greater than the provisions of an applicable double tax agreement.
VII TAXATION OF FUNDING STRUCTURES

Irish companies are generally funded through a combination of debt and equity (and, by way of extension, ‘capital contributions’).

i Thin capitalisation

Ireland does not have any general thin capitalisation rules. However, see below in relation to the reclassification of certain interest payments as non-deductible distributions. There are also some restrictions where related-party borrowings are used to purchase assets from another related party.

ii Deduction of finance costs

A deduction is generally available for interest incurred by a company for the purposes of its trading operations, even where it may be suggested that the interest was incurred on capital account in the financing of a capital asset, rather than in the financing of current assets or general operations.

Interest incurred on borrowings of a company for the acquisition of shares of a trading company or of a company that holds shares in trading companies, or for lending to such companies, may also be deductible, subject to certain conditions being satisfied. Several conditions are required to be satisfied, including that the borrowing company must beneficially own, directly or indirectly, more than 5 per cent of the relevant company, and must share at least one director with the company or a connected company. Restrictions apply to the recovery of capital by the borrower from the company, and anti-avoidance measures deny the interest relief in certain circumstances, such as certain wholly intra-group transactions and transactions where the purpose or one of the purposes of which is the avoidance of tax.

However, in certain circumstances an interest payment made by a company may be reclassified as a distribution for tax purposes, and no tax deduction will be available to the company in that instance. This can apply to interest paid on securities:

a that are convertible into shares when they are neither quoted nor comparable to quoted convertible securities;

b when the interest is profit-dependent or excessive;

c that are held by a 75 per cent foreign parent company or affiliate that is not resident in an EU Member State (although, where the interest is paid in the ordinary course of a trade and the paying company makes an election, ‘interest’ treatment will apply to a company resident in a country with which Ireland has a treaty); or

d ‘connected’ with shares.

Anti-Tax Avoidance Directive (ATAD) 1 must generally be implemented by each Member State by 2019 subject to certain derogations for Member States that have equivalent measures in their domestic law. Ireland previously notified the EU Commission of its intention to derogate from the interest limitation rule, potentially until 1 January 2024. Notwithstanding this it was suggested the interest limitation rule could be introduced in Ireland as early as 1 January 2020. However, the Finance Bill 2019 makes no mention of this. As such it is unlikely that interest limitation measures will be introduced until 1 January 2021 at the earliest.
ATAD 2 must be implemented by all EU Member States by 1 January 2020. The Finance Bill 2019 contains measures which if enacted will provide for hybrid mismatch rules as mandated by ATAD 2.

iii Restrictions on payments

Under Irish company law, dividends can generally only be paid out of a company’s distributable reserves. These are its accumulated realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated realised losses, so far as not previously written off in a reduction or reorganisation of capital.

iv Return of capital

Irish company law permits a limited liability company to return share capital and acquire its own shares, provided this is from the company’s distributable reserves.

A court-approved reduction or repayment of share capital is possible when a number of statutory procedures are followed, the creditors of the company are adequately protected and the constitutional documents of the company allow for such a reduction. The court may refuse its consent in certain circumstances; for example, where there is an infringement of class rights or where the reduction is not in the public interest.

In addition, the Companies Act 2014 includes a provision for a ‘summary approval procedure’ to validate reduction in a company’s capital. This amended process offers an alternative to seeking court approval and is considered to be beneficial from a cost perspective.

Any payment made out of the assets of the company that represents a repayment of capital on shares is not treated as a distribution, whereas any payment in excess of the original capital subscription will be so treated. In certain circumstances, payments that would otherwise fall to be treated as a distribution can be treated instead as a capital payment and taxed under CGT rules.

In general, a payment made on the redemption, repayment or purchase of shares by a quoted company shall not be treated as a distribution unless made for tax-avoidance purposes. In the case of an unquoted trading company or unquoted holding company of a trading group, such a payment shall not be treated as a distribution subject to certain conditions. These include that the redemption, etc., must be for the purpose of benefiting a trade carried on by the company or by any of its 51 per cent subsidiaries, and must not be for tax-avoidance purposes. The vendor must also satisfy a number of conditions, which include that it must be Irish resident, have owned the shares for a period of five years and satisfy a test of a ‘substantial reduction’ in shareholding where only part of its shares have been redeemed. The vendor must not be connected with the redeeming company after the redemption.

In addition, a reduction or reorganisation of share capital in exchange for a new holding may be treated as involving neither a disposal nor an acquisition of shares for capital gains purposes subject to certain restrictions.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

An Irish acquisition may be structured as an asset purchase or as a share purchase. Stamp duty is assessed on the transfer of Irish-registered shares at 1 per cent of the consideration, whereas the sale of business assets, subject to certain exemptions, may attract stamp duty at a rate of
6 per cent of the consideration due. Share sales are exempt from VAT. Irish asset sales are subject to VAT at rates of up to 23 per cent, although full VAT relief can be obtained where, broadly, the assets are being transferred as part of a transfer of a business.

In the case of a share purchase, Irish stamp duty will be charged on the acquisition of shares in an Irish company regardless of whether the acquisition company is established in or outside Ireland. It may be advantageous to use an Irish company as the acquisition company, given that dividends received by it from another Irish tax-resident company are generally tax-exempt in Ireland. The use of such an acquisition vehicle may also allow for the Irish substantial shareholdings capital gains exemption to be availed of. In addition, it is possible to surrender qualifying interest deductions as a charge within a group in certain circumstances (i.e., from the acquisition vehicle to the target company).

Even if the acquisition company is internationally held it is likely that, given the extensive exemptions from Irish dividend withholding tax, dividends may be paid by the Irish company free of dividend withholding tax. The use of a non-Irish tax resident acquisition vehicle will usually avoid a gain on the disposal of the stock unless its value is derived principally from Irish land or mineral rights.

In an asset acquisition, if the business is intended to be carried on in Ireland after the acquisition it may be preferable to use an Irish acquisition company, as the carrying on of the Irish business by a non-Irish tax-resident company is likely to bring it within the charge to Irish tax by virtue of carrying on a business in Ireland. The non-Irish resident acquisition company could be potentially liable to both Irish and foreign tax on the Irish business income.

ii Reorganisation

Mergers of Irish companies into other companies are possible under Irish law. It is also possible to merge companies in two EU Member States under the provisions of the Cross-border Mergers Directive; and reorganisations are generally done by way of a share-for-share exchange, or business assets for shares, sometimes combined with a liquidation of one of the companies.

Reliefs from Irish stamp duty and CGT (at company and shareholder levels) are generally available for share-for-share exchanges and for intra-group business asset transfers.

Stamp duty relief is also available for instruments of transfer pursuant to certain mergers, including cross-border mergers. CGT relieving provisions for certain cross-border mergers are also available. Under the Companies Act 2014, procedures based on the Cross-Border Merger Regulations enable two Irish registered private companies (one of which must be a ‘ltd’ company) to merge, so that the assets and liabilities of one company are transferred to another and the transferring company is dissolved. This can be effected by using the summary approval procedure or court approval.

iii Exit

Ireland introduced an exit tax regime effective from 10 October 2018. The rules impose a tax on unrealised capital gains where companies migrate their tax residency and on certain other transactions outlined below.

The charge applies at the standard corporate tax rate of 12.5 per cent with an exception for scenarios where the event triggering the tax is part of a transaction designed to ensure the
Ireland

Ireland

gain is taxed at 12.5 per cent rather than the standard capital gains tax rate of 33 per cent. This is an anti-avoidance provision that ensures that a rate of 33 per cent rate applies if the event is for the purpose of ensuring that the gain is charged at a lower rate.

Broadly, the tax occurs where:

a. a company resident in another Member State transfers assets from its Irish permanent establishment to another territory;

b. a company resident in another Member State transfers a business (including the assets) carried on by its Irish permanent establishment to another territory; or

c. an Irish-resident company ceases to be tax resident in Ireland.

An amendment proposed in Finance Bill 2019 seeks to broaden the scope of the exit tax by removing the requirement in certain scenarios for the company transferring the asset or business to be resident in a member state.

Exit tax is not triggered if the assets of an Irish resident company continue to be used in Ireland by a permanent establishment of the company after the company has migrated.

There is an option available in certain instances for the exit tax to be deferred by paying it in instalments over five years.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

A general anti-avoidance provision is contained in tax legislation that denies tax advantages to transactions that are carried out primarily to create an artificial tax deduction, or to avoid or reduce a tax charge. Where a transaction is undertaken with a view to the realisation of profits in the course of a business carried on by a taxpayer and not primarily to confer a tax advantage, it will not be a tax-avoidance transaction. Nor will a transaction be a tax-avoidance transaction where it was arranged to obtain the benefit of any relief or allowance available under the Irish tax legislation that does not result in a misuse of the relevant provision.

Where a tax avoidance transaction is found to exist, the Revenue Commissioners may disallow any tax advantage arising as a result of the transaction and interest, and a surcharge may apply on any tax payable. A taxpayer may make a protective notification to the Revenue Commissioners in respect of a transaction within 90 days of beginning a transaction in circumstances where that taxpayer feels that there may be a risk that the transaction may be regarded by the Revenue Commissioners as a tax-avoidance transaction. Making a notification will protect the taxpayer from the potential application of interest and a surcharge should the Revenue Commissioners take such a view.

There is also a separate mandatory disclosure regime, which requires the promoters of tax schemes that have certain characteristics to disclose them to the Revenue Commissioners shortly after they are first marketed or made available for use.

ii Controlled foreign corporations (CFCs)

CFC rules apply for accounting periods beginning on or after 1 January 2019. The CFC rules introduce additional compliance measures on Irish-headquartered groups and on international groups that have located their regional headquarters and holding structures in Ireland.

Ireland has chosen to adopt the transitional framework under the ATAD that applies transfer pricing principles in determining whether profits of a low-taxed CFC should be
taxed in Ireland. The general thrust of the regime is to assess an Irish company with a CFC charge based on an arm’s-length measure of the undistributed profits of the CFC that are attributable to the activities of significant people functions (SPFs) carried on in Ireland.

The rules require an analysis as to the extent to which the CFC would hold the assets or bear the risks that it does were it not for the controlling company undertaking the SPFs in relation to those assets and risks. In line with ATAD, a number of exemptions are provided, including exemptions for CFCs with low profits or a low profit margin and an exemption where the essential purpose of the arrangements is not to secure a tax advantage. A one-year grace period is also allowed in respect of newly acquired CFCs where certain conditions apply.

iii Transfer pricing

Ireland has transfer pricing rules that apply to trading transactions between associated persons where the receipts are understated or the expenses overstated. The rules are currently not applicable to small and medium-sized enterprises. The introduction of transfer pricing rules in Ireland aligns the Irish Tax Code with best international practice by adopting the OECD Transfer Pricing Guidelines. Under grandfathering arrangements, related-party arrangements entered into before 1 July 2010 fell outside the scope of the rules.

Finance Bill 2019 seeks to extend the scope and application of Ireland’s transfer pricing rules by, for example: (1) extending the application of the arm’s length principle to the computation of non-trading income, capital allowances and chargeable gains relating to transactions between associated persons; (2) incorporating the OECD 2017 Transfer Pricing Guidelines into Irish law; (3) removing the previous grandfathering arrangements; and (4) extending the rules to small and medium-sized enterprises albeit with reduced documentary requirements.

iv Tax clearances and rulings

Ireland does not have a formal system of ‘rulings’ from the Revenue Commissioners. However, the Revenue Commissioners may issue informal pre-transaction opinions where clarity is sought in relation to complex issues arising, for example, regarding corporate restructurings or new inward investment projects, provided that they are given detailed and full information on the matter in respect of which the ruling is sought. The opinions of the Revenue Commissioners are not legally binding, and it is open to them to review their position when a transaction is complete and all the facts are known. However, where full disclosure of all the relevant facts and circumstances has been made by the taxpayer and an opinion has been issued, it is likely that the Revenue Commissioners would be estopped from resiling from their opinion.

X YEAR IN REVIEW

Changes to Ireland’s tax legislation in 2019 continued to emphasise Ireland’s commitment to job creation, and attracting and retaining investment, particularly in the context of Brexit.

The government has continued to reiterate its commitment to maintaining the 12.5 per cent corporation tax rate on trading profits, which is beyond doubt the cornerstone of the Irish corporation tax policy. In September 2018, it published ‘Ireland’s Corporation Tax Roadmap’. The Roadmap outlined Ireland’s actions to date in the context of the changing international tax environment (e.g., introduction of country-by-country reporting,
compliance with new international best practice by the Global Forum on Tax Transparency and the Exchange of Information, the implementation of DAC3). It also set out the next steps in Ireland’s implementation of the various commitments it has made through EU directives and the OECD base erosion and profit shifting (BEPS) reports. In particular, the Roadmap signposted the following:

- **CFC rules (BEPS Action 4 and ATAD Article 4)** – legislation was introduced in the Finance Act 2018 to introduce CFC rules with effect from 1 January 2019;
- **Multilateral Instrument (MLI) (BEPS Actions 2, 5, 6, 14 and 15)** – the final legislative steps required to allow Ireland to complete ratification of the MLI were taken in the Finance Act 2018;
- **Interest limitation rules (BEPS Action 4 and ATAD Article 4)** – given the complexity of Ireland’s existing interest limitation rules it was thought that any transposition could potentially advance at the earliest to the Finance Bill 2019; however, while Finance Bill 2019 contains a number of anti-hybrid measures pursuant to ATAD2, no interest limitation rule has been included at this time;
- **Transfer pricing rules (BEPS Actions 8–10 and 13)** – legislation is being introduced in the Finance Bill 2019 to update Ireland’s transfer pricing rules; and
- **Mandatory disclosure rules (BEPS Action 12 and DAC 6)** – legislation is being introduced in the Finance Bill 2019 to ensure Ireland fully implements the DAC6 Directive.

**XI OUTLOOK AND CONCLUSIONS**

The increase in inward investment witnessed in recent years continued into 2019, and reflects Ireland’s commitment to attracting dynamic, innovative and technology-based business investment.

In 2011, the Prime Minister launched a five-year plan for Dublin’s International Financial Services Centre with a view to creating 10,000 new jobs in this highly skilled area over a five-year period.

According to PwC’s 2017 Irish CEO Pulse Survey, multinational corporations operating in Ireland remain confident about their Irish investments, with an overwhelming majority (96 per cent) of multinational CEOs confirming that their investment in Ireland is a success. Forty-two per cent indicated that they anticipate additional capital investment over that of the previous year. Meanwhile, 49 per cent of Irish companies now plan to expand their workforce, compared to just over one-third (34 per cent) in 2013.

Evidence of these trends is provided by companies such as PayPal, Boston Scientific Corporation, Analog Devices, Dell, McAfee, Accenture, Amgen, Deutsche Bank, BNY Mellon, Symantec and Ericsson undertaking expansions of their Irish operations, and by companies such as Twitter, Google, LinkedIn, Facebook, Zynga and many other major internet companies opening their European headquarters in Ireland in recent years.

PwC’s 22nd global CEO survey published in 2019 shows that Irish leaders are cautiously optimistic, looking to find ways to grow their businesses amidst the atmosphere of uncertainty. While almost 60 per cent of those surveyed believe in Ireland’s growth prospects, there is an increase in those who are uncertain about the Irish economy. When it comes down to their own businesses, CEOs are much more optimistic. The CEOs’ focus is turning inward, to factors they can control in their environment.
# Appendix I: Treaty rates for dividends, interest and royalties (per cent)

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I INTRODUCTION

The Italian corporate tax system is mostly aligned with that of other major European countries. In past years, driven by European Union (EU) obligations and the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting project (BEPS), the Italian parliament has laid down new legislation that has introduced significant amendments to the tax system, the latest of which was the enactment of Council Directive 2016/1164, as amended by Council Directive 2017/952, known as the Anti-Tax Avoidance Directive (ATAD), which on the one hand have settled certain past inconsistencies and will provide greater certainty to foreign investors, and on the other will probably give rise to new doubts and potential litigation.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Businesses normally adopt a corporate form. The most commonly used corporate entities are the joint-stock company (SpA) and the limited liability company (Srl). SpAs require a minimum share capital of €50,000 and provide for the mandatory appointment of a board of auditors or supervisory board. SpAs may issue different classes of shares, with specific governance and economic rights (preference shares, tracking shares, etc.). Srls generally have a minimum capital requirement of €10,000 (to encourage new business initiatives, as from 2012 Srls meeting some specific requirements may have a minimum share capital of €1). Srls provide for a higher degree of flexibility as regards the relationships among members, as most of the governance provisions may be incorporated in the by-laws, including certain matters normally covered by shareholders’ agreements. A third type of corporate entity is the partnership limited by shares (SApA), whose main feature is the distinction between unlimited liability partners and limited partners, who are only liable within the limits of their capital contributions. SApAs are normally used as family holdings.

Corporate entities are autonomous taxable persons; however, subject to certain conditions, companies may elect for a tax transparency regime for corporate income tax (IRES) purposes.
ii Non-corporate

Italian corporate law provides for three types of partnership: the simple partnership (Ss), which cannot perform business activities; the general partnership (Snc); and the limited partnership (Sas).

Partnerships do not have legal personality and their partners are subject to unlimited liability, with the exception of limited partners in a Sas. Partnerships are normally adopted for small family businesses. Partnerships are fiscally transparent (i.e., their income is allocated for tax purposes to the partners). In the private equity and real estate sectors, closed-end funds are frequently used. Legally speaking, said funds are pools of assets without separate legal personality, which are managed by special regulated entities. Private equity and real estate investment funds are generally exempt from income taxes (however, such exemption regime does not apply with reference to investment funds that are not subject to the supervision by a regulatory authority). Taxation only occurs upon distribution or redemption of the units.

In 2014, Italy implemented the AIFM Directive, which introduced specific rules aimed at creating a European market of operators in alternative investment funds (AIFs). According to the Directive, AIFs can be freely established and managed throughout the European Union through the ‘EU marketing passport’; thus, without having a fixed place in the country of establishment of the fund. In the context of the Italian implementation of the AIFM Directive, investment companies with fixed capital have also been regulated in the Italian legal system.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

IRES applies to both resident and non-resident entities. Resident entities are taxed on their worldwide income, while non-resident entities are subject to tax on Italian-source income only. The taxable base for IRES purposes is the accounting result determined in the profit and loss account, as adjusted according to the provisions of the Italian Tax Code (ITC). The main adjustments relate to limits to tax deductibility of depreciation, amortisation, write-offs and interest expenses. Taxation applies on an accrual basis. Based on the allowance for corporate equity (ACE), enacted in 2011, a 'notional deduction' is allowed in the case of new equity injections in the form of cash contributions or the allocation of profits to reserves. The deductible amount under the ACE regime has varied over the past years, in particular: for 2018, the notional deduction amounts to 1.5 per cent, for 2017, to 1.6 per cent of the equity injection, and for 2016 such deduction amounted to 4.75 per cent. Any excess deductions may be carried forward without time limitations or converted into a tax credit used to decrease the regional income tax. Moreover, starting from 2017, the provision according to which companies admitted to be listed in the Stock Exchange after 25 June 2014 that meet specific requirements could benefit from an increase of 40 per cent of the ACE benefit for the tax period of admittance and for the subsequent two tax periods is no longer in force.

According to the Budget Law for 2019, the ACE should have been repealed as of 2019, but any excess deduction available at 31 December 2018 may be carried forward without time limitations or converted into a tax credit to decrease the regional income tax. In parallel

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to the prospected repeal of the ACE, the Budget Law for 2019 provided for a new regime aimed at reducing the applicable CIT rate from 24 per cent to 15 per cent to profits that are reinvested to purchase new tangible fixed assets and hire new employees (the ‘Mini-IRES’). The Mini-IRES regime has been amended during 2019 with the Law Decree No. 34 of 30 April 2019 (the ‘Growth Decree’) and provided for a gradual reduction of the CIT rate (22.5 per cent for 2019; 21.5 per cent for 2020; 21 per cent for 2021, 20.5 per cent for 2022 and 20 per cent from 2023 onward) applicable to the business income of Italian resident companies up to the amount corresponding to profits allocated to distributable reserves and within the limit of the increase of net equity from 31 December 2018.

However, based on the Budget Law for 2020, the ACE will be reintroduced and the mini-IRES will be repealed starting from tax period 2019. This means that ACE would result as it had never been repealed and the Mini-IRES never applied.

If a company does not reach a certain threshold of activity (in terms of earnings) it can be qualified as ‘dormant’; in these circumstances, a minimum deemed taxable income is calculated as a percentage of the book value of its fixed assets. Further, starting from 2012, an Italian company is also deemed as dormant when it has made tax losses for five consecutive years.

**Capital and income**

Capital gains are normally included in the overall taxable income. Subject to certain conditions, capital gains realised upon disposal of assets held for more than three years may be split into up to five annual instalments. Under the participation exemption regime, capital gains on qualifying shareholdings are subject to tax on only 5 per cent of their amount (95 per cent exemption).

**Losses**

Since 2011, tax losses can be carried forward indefinitely and offset up to 80 per cent of the taxable income of subsequent years; however, subject to certain conditions, losses incurred in the first three years from incorporation can be carried forward indefinitely and offset without limitations. Certain limits of losses carried forward apply in the case of a change of control, when a change in the main activity also occurs and certain ‘vitality tests’ are not met; losses carried forward are also limited in the case of a merger or demerger.

Pursuant to a regime of transfer of losses introduced by Budget Law for fiscal year 2017, a company is allowed to ‘sell’ – against a consideration equal to the nominal corporate tax rate – losses realised in the first three fiscal years from establishment, if certain conditions are met, in particular: (1) among the ‘seller’ and the ‘buyer’ of the losses there shall be a shareholding granting the right to 20 per cent of the profits and 20 per cent voting rights; (2) the ‘buyer’ (or the company that directly or indirectly controls the ‘buyer’) shall be listed; (3) the ‘seller’ shall not be a real estate company; and (4) the losses must refer to a new business activity.

**Rates**

Starting from 2017, the corporate income tax rate is set at 24 per cent, save for banks and other financial institutions, to which a special 3.5 per cent surcharge will apply for an overall 27.5 per cent rate. Until 2016, the corporate income tax was 27.5 per cent.

The tax rate is increased by 10.5 per cent if a company qualifies as dormant.
Administration
Corporate taxpayers must file a tax return within 11 months from the end of the financial year. The tax year for corporate income tax purposes is the financial year of the company, as determined by the law or the by-laws, or, if it is not specified, the calendar year (so filing usually by 30 November).

Corporate income tax is due in advance, with a final balance payment. The advance payment, which is due in two instalments, is usually based on a percentage of the tax paid for the previous tax year. The balance payment is due by the 30th day of the sixth month after the end of the financial year (for taxpayers with a financial year corresponding to the calendar year, the balance is due by 30 June), and any excess tax paid may either be carried forward or refunded.

There is no regular audit cycle for corporate entities, except for certain large taxpayers with turnover, revenues or earnings exceeding €100 million, who are audited once every two years.

In the event of uncertainty regarding the correct interpretation of tax provisions, the taxpayer may ask for a ruling by filing a written request with the tax authorities, which must issue a written and motivated reply (see Section IX.iv).

The tax litigation trial encompasses two degrees of judgment before a provincial tax court and a regional tax court, and a third degree before the Cassation Court, which deals only with issues on points of law. Various pre-litigation and composition procedures are available, aimed at reaching settlements with the tax authorities by virtue of significant reductions in penalties.

Tax grouping
Both a domestic and a worldwide consolidation regime are available under the Italian tax system, as outlined below.

Domestic consolidation
Election for domestic tax consolidation may be made jointly by the resident controlling company and each resident controlled company (also indirectly controlled, if intermediate controlled companies are resident in foreign white-listed countries). A company is controlled by another company if the latter directly or indirectly has the majority of the voting rights (i.e., more than 50 per cent) in the general shareholders’ meeting of the former. Under domestic tax consolidation, the taxable income of each consolidated company is aggregated and taxed at the level of the controlling company, regardless of the percentage of shareholding. Only losses incurred after the election can be offset against the profits of other group companies; losses incurred before such option may only be used at company level. Once the option is exercised, it is irrevocable for three tax years and can be renewed. Special rules apply in the case of a change of control during the tax grouping period.

Following one of the amendments mentioned at the outset, from 2015 the Italian tax system adopted a new form of domestic consolidation, namely the possibility of horizontal consolidation (i.e., in essence, consolidation of resident sister companies with a common parent resident in EU or European Economic Area (EEA) Member States): the amendment at hand followed the delivering of the European Court of Justice decision in SCA Group.3

3 SCA Group (C-39/13, C-40/13 and C-41/13).
**Worldwide consolidation**

The option for worldwide consolidation may be exercised by a resident controlling company with respect to all controlled foreign companies provided that certain conditions are met. Under this regime, the income of the controlled companies (adjusted according to Italian tax provisions) is allocated to the controlling company in proportion to its profits entitlement. Losses incurred before the exercise of the option cannot be used in the consolidation; foreign tax credit relating to taxes paid abroad is normally available. Once the option is exercised, it is irrevocable for five tax years and is subject to renewal for periods of three years. Certain specific rules apply in the case of election for the worldwide consolidation regime, or for the interruption of the election and in the case of reduction of the participation of the holding in the controlled companies.

**ii Other relevant taxes**

**Regional income tax**

Corporate entities are also subject to a regional income tax, IRAP, which is levied on the net value of the production derived in each Italian region. In particular, for commercial and manufacturing enterprises the tax base is equal to the difference between the operating income and the costs of production; in general, labour costs (other than employee-related, from 2015), bad debts and financial expenses are not deductible. For dormant companies, the tax base is equal to the minimum income determined for IRES purposes increased by employment costs and interest expenses. Special rules are provided for industrial holding companies, banks and financial entities, and insurance companies.

The standard rate is 3.9 per cent, but the Italian regions are entitled to increase or decrease this rate by up to 0.92 per cent. IRAP is partially deductible from the IRES tax base. The partial IRAP deduction reflects the interest expenses that are not deductible for IRAP purposes. As from tax year 2012, IRAP levied on the cost of personnel (for the amount that is not deductible from the IRAP tax base) has been fully deductible from the IRES tax base.

**Value added tax (VAT)**

VAT is levied on the supply of goods and services made in the course of a business, artistic or professional activity. VAT is also levied on any individuals or legal entities that import goods from outside the European Union. According to the ‘territoriality’ principle, the sale of goods is deemed to have occurred in Italy if the goods are located in Italy at the time of transfer. Services are deemed to be supplied in Italy when the service is supplied to a taxable person for VAT purposes that has established its business in Italy; or the service is supplied to a non-taxable person for VAT purposes by a taxable person that has established its business in Italy. Special provisions apply to services relating to cultural, artistic, sport, scientific, educational, entertainment or similar activities: in general, these services are considered to have been rendered in Italy if the activities carried out in relation to them physically take place therein.

VAT is ordinarily due upon the transfer of ownership of goods or, in any event, when an invoice is issued or the payment received; however, taxpayers with turnover not exceeding €2 million can elect for the VAT cash-basis regime, under which the VAT payment obligation is deferred at the moment of collection of VAT from the client. Similarly, the deduction right on input VAT arises upon the payment of purchase invoices.
The deduction of input VAT is subject to the condition that goods and services purchased are used for taxable transactions (according to the pro rata deduction). VAT on certain goods and services is always non-deductible (e.g., food and drinks, hotels).

The ordinary VAT rate is 22 per cent. Reduced rates, namely 10, 5, 4 and zero per cent (i.e., exemptions) apply to specific categories of goods and services.

**VAT group**

Pursuant to Budget Law for fiscal year 2017, Italy has exercised the option for enacting VAT group legislation (Article 11 of Directive 2006/112/EC). Starting from fiscal year 2018, VAT taxable persons established in Italy, including fixed establishments of taxable persons established abroad, subject to certain requirements – a ‘close connection’ among the applicants through certain financial (i.e., corporate control is required; in the case of a foreign parent company of Italian sister companies, direct corporate control is required), economic and organisational links – may elect to be treated as a single taxable person for VAT purposes; accordingly, dealings among members of the VAT group are not taxable for VAT purposes (unless the VAT group has opted for the application of the segregation of activities according to which some internal dealings may be taxable for VAT purposes).

The election for the VAT group is binding for three years, unless eligibility requirements cease to apply, and is automatically renewed for each following year until it is revoked. Pure holding companies are excluded from the scope of application, but controlling active parent companies or holding companies carrying out ‘mixed’ activity are not. The option must have been exercised before 15 November 2018 for the effects to be applicable as of 2019. For the following years, the deadline is 30 September. In both cases, the financial link requirement must be met as of 1 July of the year of the request.

**VAT financial consolidation**

The VAT financial consolidation is an elective regime, according to which, subject to certain requirements, the VAT periodical payments due by the companies belonging to the same group (i.e., corporate control is required) may be made by the controlling entity on a consolidated basis. The election for VAT financial consolidation has effect until it is revoked, unless eligibility requirements cease to apply.

**Registration tax, mortgage tax and cadastral tax**

Registration tax is due on deeds and agreements executed in Italy subject to mandatory registration in public registers (e.g., transfer of real estate, transfer of a business as a going concern) or voluntarily filed in such registers.

As of January 2014, the indirect tax regime applicable to real estate transfers has changed. In particular, real estate transfers that do not fall within the scope of VAT will ordinarily be subject to proportional registration tax at a rate of 9 per cent, and mortgage and cadastral taxes apply at a fixed amount of €50 each. Further, registration tax rates may vary according to the nature of the deed or contract from 0.5 to 9 per cent (15 per cent on the sale of farm land).

As a general rule, if a transaction is subject to VAT, registration, mortgage and cadastral taxes are applicable at a fixed rate of €200 each (mortgage and cadastral taxes apply at 3 per cent and 1 per cent rates, respectively, to transactions involving buildings used as fixed assets).

With respect to the purchase of entire buildings, carried out by construction or renovation enterprises between 1 May 2019 and 31 December 2021, registration tax, mortgage tax and
cadastral tax apply at the fixed amount of €200 each, provided that, within 10 years from the purchase, the purchaser: (1) puts in place the demolition and redevelopment or execution of certain renovation works on the building, in compliance with the anti-seismic legislation and obtaining a certificate of energy-efficiency; and (2) subsequently sells the building. If such conditions are not met within the 10-year term, the above-mentioned taxes apply according to ordinary rules and rates, plus a 30 per cent penalty and interest for the late payment.

**Local property tax**

The Budget Law for 2014 enacted a reform of local taxes whereby a new ‘service tax’, aimed at funding all local services and to be called IUC (the unified local tax), will be formed of an urban waste and disposal service tax (TARI), a tax related to community services provided by the municipalities (TASI) and a local property tax (IMU).

TARI applies to all properties. It is assessed on the occupant to fully cover the costs of urban waste and disposal. Although the tax is initially based on property size, municipalities may refine the tax to reflect property-specific waste production.

TASI is used to finance public services targeted to the entire community (e.g., street maintenance, streetlights). Its purpose is to tax the ownership or possession of any kind of real estate, excluding rural lands and first dwelling other than premium properties, as defined for the purposes of local property tax. The TASI standard rate is 0.1 per cent, which can be increased or reduced by the municipalities.

IMU is the local property tax levied on the ownership of immovable properties (buildings, development land, rural land) located in Italy, and its tax base is determined according to certain cadastral values. IMU standard rates on dwelling places range from 0.46 to 1.06 per cent, depending on the nature of the properties and on the municipality in which the property is located. The municipality, in fact, may decide to reduce or increase the coefficient of 0.76 per cent for an amount of 0.3 per cent. As TASI, IMU is not due in connection with dwelling places that qualify as first dwelling places, except for premium properties.

The aggregate rate of IMU and TASI cannot exceed 1.14 per cent.

The Budget Law for 2020 provides for the consolidation of TASI into IMU, starting from 1 January 2020. The maximum rate of the new IMU would be 1.14 per cent.

**Net wealth tax**

There is no net wealth tax. As of 2014, an annual stamp duty of 0.2 per cent (previously, 0.1 per cent for 2012 and 0.15 per cent for 2013) is due on the value of financial instruments held at a resident bank. With respect to clients other than individuals, stamp duty on financial instruments ranges from €100 to €14,000.

**IVIE and IVAFE**

In 2011, a tax on the value of real estate property located abroad (IVIE) and a tax on financial assets held abroad (IVAFE) were introduced. Both taxes are applicable to individuals resident in Italy.

IVIE applies at a rate of 0.76 per cent on the cadastral value set by the foreign state (EU or EEA Member States) or the arm’s-length value, save for first dwelling places that are either exempt, or taxed at 0.40 per cent in the case of premium properties. A foreign tax credit related to equivalent taxes paid in the country in which the property is located is normally allowed.
IVAFE shall be due on the value of financial instruments, current accounts and savings accounts held abroad. The tax rate is equal to 0.2 per cent on financial instruments (previously, 0.1 per cent for 2012 and 0.15 per cent for 2013) and to €34.20 on bank accounts, postal accounts and savings accounts held abroad. A foreign tax credit related to taxes paid in the country where the above-mentioned assets are held may be allowed.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Companies are deemed to be resident in Italy if, for the greater part of the tax year, they have their legal seat, place of management or main business purpose in Italy. The place of management is deemed to be the place where the main decisions regarding the business are taken (usually, where the board meetings are held).

Moreover, pursuant to certain presumptions set out by the ITC, a foreign-incorporated company is deemed as resident in Italy if it controls an Italian-resident company and, at the same time, it is either controlled by an Italian-resident person (company or individual), or managed by a board of directors with a majority of Italian-resident members. The presumption of residence can be rebutted by the taxpayer.

Among the amendments the Italian tax system underwent in 2015 and 2018, new rules have been laid down to assess the tax basis of the assets of companies that move from another country and take up Italian residence.

In this respect, starting from 2015, inbound transfers of residence are to be distinguished depending upon the former country of residence: if the company was a resident of a white-listed country, for Italian tax purposes the entry tax basis of its assets and liabilities is equal to their arm’s-length value; on the other hand, if the company is exiting a black-listed country, the entry tax basis of its assets and liabilities is equal to their arm’s-length value subject to a successful ruling. Where a ruling does not succeed, for Italian tax purposes the tax basis of the company’s assets will be the lowest among their cost basis, book value and arm’s-length value and, as to liabilities, the highest among their cost basis, book value and arm’s-length value.

Further, pursuant to the Italian implementation of the ATAD, the scope of application of such provision now covers the transfers to the Italian territory of: (1) a permanent establishment of a non-resident company; (2) a business; (3) a permanent establishment of a resident company under the branch exemption regime; and (4) cross-border mergers. In a public ruling (Resolution No. 69/E of 5 August 2016), the Italian tax authorities clarified that the entry tax regime is available also to a foreign real estate holding company established in Luxembourg, because it carries out an ‘economic’ activity. Further, in that context, the Italian tax authorities also confirmed that the assets of the foreign company that are either booked at a lower value than fair market or are no longer booked in the company’s accounts owing to full depreciation can be booked at their arm’s-length value upon entry in the Italian tax system. In a public ruling (Answer to ruling No. 11 of 28 January 2019) the tax authorities, while confirming that in a merger by absorption of a Luxemburg Company into an Italian company the entry tax basis of assets and liabilities transferred with the merger (cash, financial securities and reserves of profits and capital) is equal to their arm’s-length value, further clarified that this does not constitute abuse of law on the assumption that: (1) cash and financial securities of the merged company will not be distributed by the company resulting
from the merger; (2) the merged company has never held, directly or indirectly, shares in companies located in blacklisted countries; and (3) profit reserves of the merged company are not formed of profits from companies located in blacklisted countries.

ii Branch or permanent establishment
Under the ITC, a permanent establishment is defined as a fixed place of business through which the business of a non-resident enterprise is wholly or partly carried out in Italy (physical permanent establishment). In addition, a permanent establishment occurs when a person who is not independent from the foreign enterprise has the power to engage the non-resident enterprise and usually does so (agency permanent establishment). A fixed place of business is not considered as a permanent establishment if the activity carried out is of an internal nature (i.e., it is rendered solely in favour of the enterprise owning such fixed place of business), or has a preparatory or ancillary nature in respect of the ordinary activity carried out by the enterprise. A special definition of permanent establishment applies to businesses engaged in the gambling sector, according to which if a resident carries out betting intermediary activity by means of a fixed place of business on behalf of a non-resident – even by collecting the bets or by providing the customers with the proper machines – and the financial flows related to such activities overcome the threshold of €500,000, the non-resident is deemed to have a permanent establishment in Italy.

Starting from 2018, the legislator has introduced a new definition of permanent establishment that, on the one hand is in line with the new Article 5 of the OECD Model Convention, and on the other hand introduces a new definition of digital permanent establishment. The new definition of ‘digital’ permanent establishment covers cases of significant and continuous economic presence designed to avoid a physical one.

Such domestic definition, however, is not applicable insofar as the foreign taxpayer is covered by a double tax agreement that provides for a definition of permanent establishment that is more favourable to the taxpayer than the relevant domestic definition.

As regards the allocation of profits to permanent establishments, reference is made to OECD guidelines and principles; such principles are adopted by the Italian tax authorities according to the functionally separate entity approach.

While Italy relieves double taxation through the ordinary credit method (both in its double tax treaties and through domestic rules), a 2015 piece of legislation provides for an alternative relief method for foreign branches of Italian companies (the s.c. branch exemption). Under the branch exemption regime, an Italian company having permanent establishments located in white-listed countries can elect for the application of the exemption method rather than the credit method. The election is irrevocable and follows the ‘all-in, all-out’ approach. The election for the exemption method does not ‘defuse’ the controlled foreign corporation (CFC) legislation, but exemptions can be sought through the ruling procedure.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT
i Holding company regimes
Italian tax law does not provide for any special holding company tax regimes.

A general participation exemption regime is available under which capital gains realised by an Italian company on the disposal of shares are exempt from corporate income tax for 95 per cent of their amount, if all the following conditions are met:
the shares are held, without interruption, from the first day of the 12th month prior to
the month in which the sale occurs (shares purchased most recently shall be deemed to
have been sold first);

b the shares are accounted for as ‘financial fixed assets’ (or an equivalent accounting
classification) in the first statutory financial statements closed during the period in
which the shares are held;

c the company whose shares are sold is not resident in low-tax jurisdictions; and

d the company whose shares are sold performs an actual business activity (such condition
must not be verified for listed companies).

The condition under point (c) must be met, without interruption, from the first period of
ownership or, in case of shares held by more than five tax periods and sold to third parties,
during the five tax periods preceding the disposal, without interruption. The condition
under point (d) must be met, at least, from the beginning of the third tax year preceding the
date of disposal. Real estate companies (other than those trading in real estate and building
companies) are deemed not to perform an actual business activity, and therefore are not able
to meet the condition under point (d).

Up to 2018, a foreign jurisdiction was a low-tax jurisdiction if the nominal corporate
tax rate was lower than 50 per cent of the applicable nominal tax rate in Italy. However,
further to the enactment of the ATAD, the definition of low-tax jurisdiction has been changed
and starting from 2019 it varies depending upon the shareholding at stake. In particular, a
jurisdiction is a low-tax one if it has: (1) an effective tax rate lower than 50 per cent of the
applicable effective tax rate in Italy, in case of majority shareholdings; and (2) a nominal tax
rate lower than 50 per cent of the applicable nominal tax rate in Italy, in case of minority
shareholdings.

Capital losses realised on the disposal of shares that would benefit from the participation
exemption regime on capital gains are not deductible for corporate income tax purposes.

Under the participation exemption regime, dividends flowing from a non-low tax
jurisdiction are always exempt from corporate income tax for 95 per cent of their amount. On
the contrary, dividends derived from a company resident in a low-tax jurisdiction are taxable
in full, unless the following evidence is provided (possibly through the ruling procedure):

a genuine establishment of the foreign company occurs, in which case an exemption
from corporate income tax of 50 per cent applies (starting from 2018); and

b no effect of obtaining low taxation of the income made by the foreign company is
achieved, in which case an exemption from corporate income tax of 95 per cent applies.

Dividends are also considered to be ‘derived’ from a low-tax jurisdiction if they are distributed
by a controlled (even de facto) non-low tax entity that in turns received dividends from the
company located in a low-tax jurisdiction.

In the context of the recent changes in the domestic tax system, starting from 2015 an
indirect foreign tax credit may be available depending upon certain circumstances.

Under the Italian participation exemption regime, qualifying capital gains and
dividends are subject to an effective tax rate of 1.2 per cent (i.e., 24 per cent times 5 per cent)
starting from 2017. The effective tax rate has been 1.375 per cent until 2016 (i.e., 27.5 per
cent times 5 per cent).
ii IP regimes

In 2015, the Italian parliament laid down a new patent box regime by election, according to which certain tax incentives are granted for the exploitation of IP.

The election is effective for five fiscal years, is irrevocable, and is limited to Italian businesses and white-list foreign entities.

The regime covers income derived from the exploitation of IP, such as patents, formulae, models, licences and software copyright (qualifying income). The regime is available also for self-exploitation of IP, but in this case the amount of the incentive must be determined: (1) through a ruling procedure; or, starting from 2019, (2) directly by the taxpayer in the tax return. In such case, the taxpayer shall retain specific documentation, to be drafted in accordance with specific guidelines provided by the tax authorities. The downward tax adjustment related to the benefit shall be split into three equal annual instalments from the fiscal year in which the option is exercised. Starting from 2017, patent box elections no longer cover the income derived from trademarks.

The tax benefit is calculated by taking into account the portion of the costs that are aimed at the enhancement of intellectual property (qualifying expenditures): if all the costs borne by the business are qualifying expenditures, then all the income derived from IP will benefit from the ‘patent box’ regime.

The regime provides for taxation of the income from IP reduced to 50 per cent (for the 2015 and 2016 tax periods, the incentive was equal to 30 per cent and 40 per cent of the income, respectively).

The incentive at hand is available also in relation to the consideration received upon the sale of IP subject to the fulfilment of certain requirements, such as the reinvestment of the consideration received.

iii State aid

Starting from 2018, the legislator has introduced some measures against the transfer of business in the event the taxpayer has been granted a ‘state aid’ (e.g., start-up companies regime, discussed below). As a general rule, if a business is transferred outside of the European Union territory (and EEA Member States) within five years from the benefit, it triggers the loss of the benefit and, potentially, the application of penalties that range from 200 per cent to 400 per cent of the benefit granted. On the contrary, if a taxpayer that has been granted a state aid on the basis of the presence of their business in a specific area of the Italian territory, transfers the business to another area of Italy or of the European Union (and EEA Member States), the benefit will be lost, but no penalties apply.

A similar provision applies to the sale or transfer of assets that have benefited from a ‘hyper-depreciation’ regime (i.e., extra depreciation on the purchase of certain tangible assets), but without any application of penalties.

iv Start-up companies and SMEs

A special regime applies for start-up companies that meet certain specific requirements (e.g., turnover not exceeding €5 million, a minimum annual amount of research and development expenditures). Start-up companies are exempt from incorporation fees and stamp duties and can benefit from the non-application of the dormant company legislation. Starting from 2017, companies investing in start-up companies are able to deduct from their taxable income 30 per cent of the invested amount. For the tax years 2013, 2014, 2015 and 2016, the deduction was equal to 20 per cent of the invested amount. For the sole tax period 2019,
the Budget Law for 2019 has increased the amount of such deduction up to 40 per cent and, in case of investment in the whole share capital of a start-up held for at least 3 years, up to 50 per cent. However, such increase is subject to the authorisation of the European Commission that has not occurred yet.

The investment in each innovative start-up company may not exceed €1.8 million per tax year and shall be kept for at least three years.

The same regime has been extended, if certain requirements are met, to small and medium-sized enterprises (SMEs) as defined by Commission Recommendation 2003/361/EC (enterprises that employ fewer than 250 persons and that have an annual turnover not exceeding €50 million, or an annual balance sheet total not exceeding €43 million). The European Commission has fully authorised the extension of the regime to SMEs with its decision of 18 December 2018.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

As from 1 July 2014, the base withholding tax rate applicable to financial income has been increased from 20 to 26 per cent.

Under Italian domestic tax laws, the following withholding taxes apply to outbound payments made by an Italian-resident company.

**Dividends**

Dividends paid to non-Italian resident persons without a permanent establishment in Italy are generally subject to a 26 per cent withholding tax. Non-resident shareholders may claim the refund of up to 11/26 of the withholding tax levied in Italy (one-quarter for dividends paid until 30 June 2014) if they provide evidence to the Italian tax authorities that income tax has been paid on the same dividends in the foreign country in an amount at least equal to the total refund claimed (non-residents seeking such refunds have experienced extensive delays).

A reduced 1.2 per cent (1.375 per cent before 2017, as a result of the IRES rate reduction from 27.5 to 24 per cent) withholding tax applies to dividends paid to companies or entities resident for tax purposes in an EU Member State or in a state party to the Agreement on the European Economic Area, which allows the exchange of information.

**Interest**

Interest paid to non-Italian resident persons is normally subject to a final 26 per cent withholding tax.

**Royalties**

Royalties paid to non-Italian resident persons are subject to a 30 per cent final withholding tax to be levied on 75 per cent of the taxable amount (effective rate equal to 22.5 per cent).

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Under Italian domestic law, the following exclusions or exemptions from withholding on outbound payments are provided.
Dividends
Under the Parent–Subsidiary Directive4 as implemented in Italy, no withholding tax applies on dividends paid to a company that:

a is incorporated under one of the forms listed in Annex I – Part A to the Directive;

b is resident for tax purposes in an EU Member State;

c is subject in its state of residence to one of the corporate taxes listed in the Annex I – Part B to the Directive; and

d has held a 10 per cent minimum shareholding in the distributing company for at least one year at the time of distribution (if the minimum holding period is gained after the dividend distribution, the levied withholding tax may be claimed for refund by the non-resident).

Directive No. 2015/121 dated 27 January 2015 aimed at tackling artificial arrangements potentially put in place to benefit from the advantages of the Parent–Subsidiary Directive, is enacted through the application of the general anti-avoidance clause, which provides for that the burden of proof of artificiality of arrangements, undue tax savings and motive test lies with the tax authorities.

The enactment of Directive No. 2015/121 is limited to dividend payments made starting from January 2016. As to the payments made up to December 2015, a different rule is in place (now repealed), according to which no exemption from Italian withholding tax is granted to EU parent companies controlled directly or indirectly by one or more residents of states that are not EU Member States, unless that legal person provides proof that the principal purpose or one of the principal purposes of the chain of interests is not to take advantage of the Parent–Subsidiary Directive.

A similar provision of the French tax system has been recently deemed incompatible with the freedom of establishment (decision by the Court of Justice of the European Union in case C-6/16 of 7 September 2017, Egiom and Enka).

Interest
Under the domestic provisions implementing the Interest and Royalties Directive, interest payments arising in Italy are exempt from any Italian tax imposed on those payments upon condition that the beneficial owner of the interest is an associated company of another EU Member State (or a permanent establishment located in another EU Member State of an associated company of an EU Member State). The exemption applies if both the person paying interest and the beneficial owner have one of the legal forms, and are subject to one of the corporate taxes, listed in the Annexes to the Directive. As to the status of associated companies:

a the first company directly holds a stake equal to at least 25 per cent of the voting rights in the second company;

b the second company directly holds a stake equal to at least 25 per cent of the voting rights in the first company; or

c a third company directly holds a stake equal to at least 25 per cent of the voting rights in both the first and second company.

The relevant shareholding must be held for an uninterrupted period of at least one year.

Under domestic tax law, no withholding tax is levied on interest paid to non-resident persons on deposits or bank accounts. Furthermore, an exemption from withholding tax applies to interest on bonds and similar securities issued by the state, and by banks and listed companies, provided that the recipient is a resident of a country that allows the exchange of information (a white-listed country); to benefit from this exemption, the non-resident shall deposit the bonds with a resident bank or other qualified intermediary. As from 2012, the exemption from withholding tax also applies to interest on bonds issued by non-listed companies, provided that the bonds are listed on an EU regulated market or multilateral trading facilities.

As regards medium long-term loans (i.e., maturity over 18 months), provided the compliance with regulatory financial requirements, an exemption from withholding tax is provided on interest paid by companies to financial institutions established in a EU Member State, insurance companies set up and authorised pursuant to the laws of a EU Member State, and institutional investors supervised in the state when they are set up, to the extent that such state allows for an effective exchange of information.

Royalties
Pursuant to the Interest and Royalties Directive as implemented in Italy, royalty payments are exempt from Italian withholding tax under the same conditions mentioned above in respect of interest payments.

iii Double tax treaties
Italy has an extensive double taxation treaty network (more than 90 treaties are currently in force). Double taxation treaties concluded by Italy are generally compliant with the provisions set forth by the OECD Model Convention. Under the treaties, dividend withholding tax rates are reduced to 10 or 15 per cent in most cases, while interest and royalties withholding tax rates are frequently reduced to 10 per cent or less.

Subject to certain formalities, it is normally possible to obtain direct application of the treaty-reduced rates.

iv Taxation on receipt
No tax on gross receipts applies in Italy.

Under the participation exemption regime, both Italian-sourced and foreign-sourced dividends are exempt from corporate income tax for 95 per cent of their amount (except in cases of dividends paid by entities located in low-tax jurisdictions on which see above). No imputation credit is granted in respect of non-local underlying taxes paid at the level of the entity distributing dividends. Subject to certain conditions, a foreign tax credit is usually available (both under domestic law and the treaties) in respect of withholding taxes suffered abroad.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
Thin capitalisation rules no longer apply. As from 2008, thin capitalisation rules have been replaced by the interest barrier regime mentioned below.
ii Deduction of finance costs

Up to tax period 2018, the deduction of interest expenses for corporate income tax (CIT) purposes was subject to the following rule.

Interest expenses accrued in a given tax year were deductible up to the amount of interest income and similar proceeds accrued in the same tax year. Any excess interest was deductible up to an amount equal to 30 per cent of the earnings before interest, tax, depreciation and amortisation (EBITDA) of the same year. Any interest expenses exceeding the above threshold could be carried forward and deducted in the following tax years (with no time limitation) within the same limit of 30 per cent of the annual EBITDA. Furthermore, any excess EBITDA capacity that was not used in a given tax year to deduct interest expenses could be carried forward and used in the following tax years (with no time limitation). The provision at stake also applied to other finance costs deriving from loans, financial leases, issuance of bonds and similar financial instruments, excluding interest for deferred payments in relation to commercial debts.

Despite being almost completely in line with the ATAD wording, the interest limitation rule has been amended under the Italian ATAD implementation. Accordingly, starting from tax period 2019: (1) EBITDA capacity is calculated by taking into account fiscal rules; (2) interest income exceeding interest expenses may be carried forward indefinitely; (3) excess EBITDA capacity may be carried forward only for five years; and (4) the interest limitation rule is applicable to interest expenses so qualified under applicable accounting principles adopted by the enterprise and deriving by a financial operation or arrangement (e.g., interest accruing on trade payables which, up to 2018, were outside the scope of application of the previous interest barrier rule).

Certain special rules are provided for entities joining the tax consolidation regime: in principle, it is possible to use the EBITDA capacity of one company joining the tax grouping to deduct interest expenses incurred by another group company.

The above rules do not apply to banks, insurance companies and other financial entities, for which different rules are provided. In particular, interest expenses are: (1) deductible up to 96 per cent of their amount (4 per cent non-deductible) for insurance companies, controlling entities of insurance groups and fund management companies; and (2) fully deductible for financial intermediaries.

A special exemption from the interest limitation rule (i.e., interest expenses are fully deductible) is provided with respect to interest expenses on loans aimed at financing long-term public infrastructure projects. Such full deduction is applicable to the extent that the loans are not granted by: (1) goods owned by the manager of the project, other than goods related to the project; nor (2) entities different from such manager. The Fiscal Decree linked to the Budget Law for 2020 extends such full deduction rule also with respect to loans granted by other kind of securities, provided that they are used to finance public infrastructural projects with certain requirements. Therefore, loans granted by a pledge on the shares of the project finance company would be in principle eligible for the full deduction rule, provided that all other relevant requirements are met.

iii Restrictions on payments

Payment of dividends is subject to approval by an ordinary shareholders’ meeting. Dividends can only be paid out of realised profits and distributable reserves. According to the Italian Civil Code, an amount equal to 5 per cent of the profit of the company for the year must be set aside for the legal reserve until said reserve amounts to at least one-fifth of the share
capital; the legal reserve is not available for payment of dividends. The distribution of interim dividends is only allowed for companies that are subject to a mandatory audit (e.g., listed companies), and it is subject to certain formalities and limitations, including approval by the auditors.

iv Return of capital

Distributions of capital reserves (share premiums, informal capital contributions, etc.) are allowed upon approval by the shareholders’ meeting, and they are not subject to specific limitations, while repayment of formal share capital must be resolved by an extraordinary shareholders’ meeting and is subject to certain procedural formalities. In principle, the repayment of capital reserves is tax-neutral; a taxable income may arise if the amount distributed exceeds the tax basis of the shareholding in the distributing company. If a company can dispose of capital reserves and profit reserves, pursuant to a special presumption, for tax purposes profit reserves are always deemed to be distributed first, regardless of the allocation made in the relevant resolution for civil law purposes.

v Financial transaction tax (FTT)

The Budget Law for 2013 introduced the FTT, whose implementing rules were provided by the Ministry of Economy and Finance. FTT applies as of March 2013 to transactions related to the transfer of the ownership of securities and other financial instruments issued by companies having their registered offices in Italy and securities representing equity investment, regardless of the place of residence of the issuer (shares). Specific exclusions from the scope of application of FTT are provided (e.g., transfers of the ownership of the quotas of variable capital joint-stock companies (SICAVs), Srls and exchange traded funds (ETFs), as well as the transfer of listed shares of companies with an average capitalisation lower than €500 million).

FTT is calculated with reference to the net balance of the transactions regulated on a daily basis and the tax rate is equal to 0.1 per cent (0.12 per cent for the 2013 tax period) for transactions effected on regulated markets or in multilateral trading facilities; and 0.2 per cent (0.22 per cent for 2013 tax period) for any other transactions. FTT also applies as of September 2013 to transactions relating to financial derivatives having as their main underlying asset one or more shares (or the value of which mainly derives from shares), and transferable securities giving the right to acquire or sell mainly shares or giving rise to a cash settlement determined mainly by reference to shares (derivatives). FTT applies to ‘high-frequency’ trading activities regarding the foregoing financial instruments (shares and derivatives).

FTT is not deductible for the purposes of IRES and IRAP. Non-resident intermediaries and persons intervening in a transaction with a permanent establishment in Italy must comply with the obligations deriving from FTT through such permanent establishment. In the absence of such permanent establishment, non-resident intermediaries and persons intervening in transactions can appoint an Italian tax representative or, alternatively, can comply with the applicable provisions and procedure directly.

The compliance of the Italian FTT with EU Law is currently being tested before the European Court of Justice (Case C-565/18, Société Général SA). In his Opinion, the Advocate General concluded that the Italian FTT is not contrary to EU law.
vi Issuance of debt securities by non-listed companies

Law Decree No. 83/2012, as amended and supplemented, introduced significant amendments affecting corporate bonds listed on a regulated market or multilateral trading facilities of an EU Member State or an EEA ‘white-listed’ Member State (the qualified exchanges) issued by non-listed companies; and issued by non-listed companies and subscribed by qualified investors as per Article 100 of the Italian Financial Act, including:

- the deductibility of interest paid, or interest expenses arising from such bonds, are not subject to limitations ordinarily provided for high-yield bonds;
- the exemption for non-listed companies issuing corporate bonds listed on a qualified exchange from the limit of issuance of bonds provided for by Article 2412 of the Italian Civil Code – equal to twice the value of the share capital and reserves of the issuer available for distribution – thereby granting them the same treatment applicable to Italian-listed companies; and
- the exemption from withholding tax on interest paid to investors resident in ‘white-listed’ countries. Moreover, interest paid to Italian or EU collective investment funds and to securitisation companies are also exempt from withholding tax subject to specific requirements.

As a consequence, bonds listed on a qualified exchange issued by non-listed companies are now subject to the same withholding tax regime applicable to bonds issued by Italian banks and Italian listed companies, including the exemption regime provided for interest paid to investors resident in a ‘white-listed’ country.

vii Venture capital investment funds (FVCs)

According to a regime enacted in 2013, income from capital arising from participation in FVCs is not subject to income tax. To apply this exemption with specific reference to individuals holding quotas in the course of their business, Italy asked for the approval from the European Commission, which granted it.

The definition of FVCs, as amended by the Budget Law for 2019 includes Italian and EU/EEA white-listed collected investment vehicles (CIVs) (i.e., undertakings for collective investments in transferable securities (UCITS) and alternative investment funds (AIFs)) that invest at least 85 per cent of the collected capital in unlisted small-medium size enterprises at the stage of seed financing, start-up financing, early-stage financing or expansion financing and the residual in small or medium-sized enterprises that issue listed shares and whose revenues or market capitalisation are lower than certain thresholds.

To benefit from this exemption, investee companies must meet certain requirements. In particular:

- they must be unlisted;
- they must have their operative seat in Italy;
- their quotas or shares must be held directly, mainly by individuals;
- they must be subject to corporate income tax or similar taxes under local law, without being totally or partly exempted;
- they must have been engaged in business for no longer than seven years (up to 2018 it was 36 months); and
- they must have a turnover not exceeding €50 million, according the latest financial statements approved prior to investment by the FVC.
The quotas of FVCs may be acquired only by: investors who are considered professional investors according to Section I of Annex II to Directive 2004/39/EC; investors who may, on request, be treated as professional investors according to Section II of Annex II to Directive 2004/39/EC; and other investors if certain requirements are met (e.g., investors declare that they are aware of risks related to the investment, and undertake to invest at least €100,000).

viii Receivables of the shareholders
If a company benefits from a write-off of a receivable in the hands of its shareholders (e.g., shareholders loans), such former company is subject to tax for the amount exceeding the fiscal value of the receivable. The shareholder has to communicate the fiscal value of the receivable to the company; absent this communication, the fiscal value of the receivable is assumed to be zero. The same provision applies also to the conversion of receivables into equity.

ix PIR
The Budget Law for fiscal year 2017 introduced a beneficial tax regime available to a specific kind of investment scheme, known as Individual Plan of Saving (PIR), to be provided by Italian resident financial institutions and Italian branches of foreign financial institutions, for the benefit of non-entrepreneur individuals investing less than €30,000 per year, up to a maximum of €150,000.

According to this regime, capital gains and financial income derived from the PIR-compliant investments are exempt from the 26 per cent substitute tax, which would ordinarily apply on such income, as well as from inheritance tax.

For a portfolio of investment to be PIR-compliant, certain requirements shall be met, among which: (1) the investment in the PIR must be held for more than five years; (2) at least 70 per cent of the investment portfolio consists of shares or debt securities issued by Italian companies (or EU companies having an Italian branch); (3) 30 per cent of the issuers of such securities are non-listed companies; and (4) concentration risk in one single investment is limited to 10 per cent. PIR-compliant investments are also units of Italian or EU/EEA collective investment funds which invest the collected capital within the above thresholds.

Further requirements shall be met for PIR constituted from 1 January 2019. Indeed, the above-mentioned 70 per cent of the investment portfolio must be formed as follows: (1) of at least 5 per cent, financial securities admitted to multilateral negotiation systems issued by SMEs; (2) of at least 30 per cent, financial securities issued by non-listed companies; (c) for at least 5 per cent, shares or quotas of venture capital funds.

Finally, the Fiscal Decree linked to the Budget Law for 2020 has provided that for PIR constituted as of 1 January 2020, the above-mentioned 70 per cent of the investment portfolio must be formed of at least 30 per cent of financial securities issued by non-listed companies (25 per cent non-listed in FTSE MIB index and 5 per cent non-listed in FTSE MIB and FTSE Mid Cap index).

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Usually, the acquisition of Italian businesses is structured through the incorporation of an Italian-resident acquisition vehicle, which is adequately funded through a mix of equity, shareholder loans and bank debt. In more complex structures, one or more foreign holding companies are normally used to provide for mezzanine or hybrid financing. Deduction of
interest on debt is achieved either through the merger of the acquisition vehicle with the
target or through a tax grouping. After many years of uncertainty, in 2016 the Italian tax
authorities provided guidelines according to which the deduction of interest is, in principle,
admitted.

Frequently, the acquisition of business concerns is structured as an initial contribution
in kind into a wholly owned subsidiary followed by a sale of shares of the subsidiary; indeed,
the contribution is tax-neutral, and the transfer of shares would usually benefit from the
participation exemption regime. Although there has been some uncertainty and consequent
litigation as to the transfer taxes applicable to these transactions, the Budget Law for 2018
amended the relevant rule to clarify that non-proportional transfer taxes apply.

As regards mid- to long-term loans (i.e., loans having a final maturity of over 18 months)
and the related guarantees and transfer of receivables, it is possible – by election – to benefit
from a 0.25 per cent substitute tax instead of applying the ordinary registration, stamp,
mortgage and cadastral taxes. Medium-term loans granted by securitisation companies, EU
insurance companies and white-listed collective investment funds established in the EU or
white-listed countries included in the EEA can also benefit from such regime.

ii Reorganisation
Mergers and demergers are, in principle, tax-neutral transactions, both in a purely domestic
scenario as well as in cross-border transactions. Indeed, such corporate reorganisations do not
imply the realisation of capital gains or losses on the assets of the participating companies,
even when these gains or losses are accounted for in the financial statements; at the same
time, no taxation arises for the shareholders of the participating companies. In cross-border
mergers, tax-neutrality is achieved provided that the assets of the Italian-resident participating
company are allocated to an Italian permanent establishment of the foreign combined entity.
A similar, tax-neutral regime normally applies to the contributions of businesses in exchange
for shares.

The Growth Decree reintroduced the business combination bonus granted in case of
extraordinary transactions (e.g., merger, demerger, contribution in kind, etc.) occurring from
1 May 2019 to 31 December 2022 and involving companies not belonging to the same group.
The incentive allows to step up for tax purposes the book value of certain items resulting from
the business combination (e.g., goodwill, tangible assets) with no payment of the substitute
tax, up to an amount not exceeding €5 million, to the extent that certain conditions are
met (i.e., the business combination involves companies active for at least two years, the
involved companies do not belong to the same group, no further reorganisations occur in
following four fiscal years). The incentive is applicable as from the fiscal year following the
reorganisation for both CIT and IRAP purposes.

Under a special regime, in case of contribution of shares of a company in which the
receiving company ends up holding a control participation, the value of the shares received in
exchange, for the purposes of the taxable capital gain in the hands of the contributing subject,
is deemed to be equal to the increase in the receiving company's net equity as a result of the
contribution. The Growth Decree has extended this regime also in case of contribution of
non-control shareholdings, provided that: (1) the contributed shares grant more than 2 per
cent of voting rights or more than 5 per cent of profits (in case of listed shares) or more than
20 per cent of voting rights or more than 25 per cent of profits (in case of other shares); and
(2) the receiving entity is wholly participated by the contributing subject. Specific rules apply for the contribution of holding companies and to compute the participation exemption for taxable gains at the level of the contributor.

### iii Exit

Capital gains on shares are taxable in Italy only to the extent that the sale concerns substantial holdings (i.e., shareholdings granting more than 2 per cent of voting rights or more than 5 per cent of profits, in case of shares in listed companies; more than 20 per cent of voting rights or more than 25 per cent of profits, in the case of shares in non-listed companies), in which case taxation at 26 per cent applies. However, also these capital gains are generally not taxed in Italy, if the investor is covered by a double tax treaty entered into with Italy (note, however, that certain double tax treaties depart from the standard Article 13 of the OECD Model Tax Convention, such as those with France, Brazil and China).

A provision enacted in 2017, coupled with the guidelines issued by the Italian tax authorities in Circular Letter No. 25/E of 2017, provided that the carried interest – namely the enhanced economic rights connected to the holding of shares, units or other instruments in companies, funds or investment entities by managers and employees – qualifies as financial income subject to certain requirements, which, in general, are aimed at aligning the risk of investment to that of the ordinary shareholders (i.e., minimum investment, deferral in distribution, minimum holding period). This qualification is beneficial to managers and employees, given the lighter tax burden on the financial income (generally 26 per cent), compared to that on employment income (up to 43 per cent), and to the paying entity in relation to its obligations as withholding agent.

With respect to exit taxation, the transfer abroad of the legal seat of an Italian company is allowed under Italian corporate law. For tax purposes, the transfer of tax residence ordinarily triggers realisation of capital gains or losses on the company’s assets, unless the said assets are allocated to the Italian permanent establishment of a foreign company. The same regime applies to the transfer of a permanent establishment.

However, if the tax residence of the company or the permanent establishment is transferred to an EU Member State or a white-listed state belonging to the EEA, the taxpayer, instead of being subject to the ordinary tax regime, may elect to either defer at the moment of their disposal the exit tax due in relation to the assets that are not transferred to a permanent establishment in Italy (maximum deferral equal to 10 years); or to pay the exit tax in six annual instalments. The tax authorities may make the deferral or the instalment payment conditional upon the provision of guarantees.

The transfer may also be achieved through the incorporation of the Italian company into a foreign company; in this scenario, tax-neutrality is also achieved provided that the assets of the absorbed company are allocated to an Italian permanent establishment of the merging foreign company.

By means of the pending enactment of the ATAD, starting from 2019, the election for the deferral of taxation upon exit will no longer be available (so, alternatives will be either full payment or payment by instalments) and the payment will have to occur in a maximum of five annual instalments.
iv  Further remarks

Italian tax authorities have provided certain guidelines on leveraged buyout transactions, also by way of merger (leverage buy-outs (LBOs) and merger leverage buy-outs (MLBOs)), aimed at clarifying the tax treatment of fees and the entitlement to EU Directives or double tax conventions.

With reference to fees, the private equity firm charges to the special purpose vehicle (SPV) or to the target company for its services (i.e., transaction or arrangement fees and monitoring fees), the deductibility in the hands of the SPV or the target is denied if such fees refer to services that are provided in the exclusive interest of the investment fund and its investors. In all other circumstances (i.e., the cost refers to a service provided in the interest of the target), ordinary transfer pricing rules apply.

In addition, Italian tax authorities clarified that the SPV is not entitled to the deduction or the refund of VAT on the transaction costs (including the above fees), unless the latter actually carries out a commercial activity.

With reference to the exemption or other tax benefits provided by EU Directives or double tax conventions, such benefits are denied if the non-resident shareholders or holding company lacks ‘adequate’ economic substance (e.g., there is a light organisational structure in terms of personnel, equipment and premises; limited decisional powers; and back-to-back financial structures are in place).

IX  ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i  General anti-avoidance

In 2015, the Italian parliament enacted a piece of legislation providing for a new general anti-avoidance clause, which replaced the previously existing clause and also has disciplined the ‘abuse of law’ doctrine that was developed in recent years by the tax courts.

This rule provides that the tax authorities may disallow any tax advantage obtained through acts or transactions carried out without genuine economic reasons for the purposes of circumventing tax obligations or prohibitions, or for obtaining undue tax benefits.

The burden of proof lies with the tax authorities, which, to apply the general anti-avoidance clause, must issue an ad hoc notice of assessment to be provided with specific grounds in respect of the conduct that is deemed abusive.

It must be noted that, even prior to the enactment of the above general anti-avoidance provision, in recent years the Italian Supreme Court has delivered various decisions on the ‘abuse-of-law’ principle to tax matters, as derived from judgments rendered by the European Court of Justice. The new piece of legislation is aimed at, inter alia, providing a better definition of the boundaries of abusive conducts.

The ATAD required EU Member States to lay down a general anti-avoidance rule in each jurisdiction starting from 2019; the Italian legislator, however, deemed the domestic legislative framework to be already in compliance with this requirement through the regime in place from 2015.

ii  Controlled foreign corporations (CFCs)

Following the amendments provided for by the ATAD, CFC legislation applies to all resident taxable entities that hold a controlling interest in, or alternatively are entitled to more than 50 per cent of the profits of, a foreign entity located in a ‘low-tax jurisdiction’ and deriving more than one-third of their revenues from certain ‘passive income’.
‘Parent company’ includes a permanent establishment in Italy of non-resident companies, whereas the definition of ‘controlled foreign company’ also covers permanent establishments of resident companies that opted for the application of the branch exemption regime.

‘Low-tax jurisdictions’ are those where the effective corporate tax rate is lower than half of the CIT rate. It should be noted that this criterion for determining the countries falling within the scope of the CFC regime was changed in 2019, taking the place of the 2015-introduced system based on the nominal corporate tax rate.

‘Passive income’ is: (1) interest or any other income generated by financial assets; (2) royalties or any other income generated from intellectual property; (3) dividends and income from the disposal of shares; (4) income from financial leasing; (5) income from insurance, banking and other financial activities; (6) income from sale and purchase of goods with little or no additional economic value, carried out with related enterprises; and (7) income from supply of services with little or no additional economic value, carried out with related enterprises.

When CFC rules apply, the Italian-resident shareholder is taxed on its share of the CFC’s profits, determined according to national rules regardless of the actual distribution.

The Italian resident taxpayer wishing to disapply CFC rules has to prove that the non-resident entity carries on a substantive economic activity supported by staff, equipment, assets and premises. This burden of proof can be waived by way of a ruling.

Dividends distributed by the CFC are not subject to tax in the hands of the parent company.

### iii Transfer pricing

Transactions between resident and non-resident affiliated entities must be valued at their ‘fair market value’. Adjustments in compliance with such evaluation shall be made either if an increase or a decrease of the taxable income occurs. In this respect, adjustments made by the tax authorities of other countries can be recognised with special procedures and according to specific rules that were recently amended in 2017. The concept of fair value as defined by the ITC has, in principle, the same meaning as the arm’s-length price defined in the OECD guidelines, to which reference is also usually made by the tax authorities in their interpretative instructions.

Specific rules have been issued providing for standard transfer pricing documentation to be prepared; such rules are compliant with the EU Code of Conduct and OECD guidelines. The main effect of providing such documentation is to avoid the possible application of administrative penalties in the case of adjustments by the Italian tax authorities.

Under a special ruling procedure, it is possible to negotiate advance pricing agreements with the Italian tax authorities: the number of advance pricing agreements have been increasing over the past few years, and are likely to continue to do so in light of a recent legislation that further enhanced the international standard ruling.

### iv Tax clearances and rulings

Tax clearances and Italian tax laws on rulings have undergone significant restyling, and the recently enacted rules provide for six ruling procedures, namely:

- **a** ordinary ruling;
- **b** ruling concerning proof;
- **c** anti-avoidance ruling;
The ordinary ruling procedure relates to the correct interpretation of tax provisions in cases of uncertainty. Following the filing of the ruling request, the tax authorities must issue a written and motivated reply within 90 days. A positive reply is binding on the tax authorities for the case submitted. If no reply is provided within 90 days, it is assumed that the tax authorities agree with the proposed interpretation.

The procedures under (b), (c) and (d) allow the tax authorities to reply within 120 days, while rulings under (f) are basically an agreement between the authorities and the taxpayer that is valid from the fiscal year it is signed in and throughout the following four years.

Under the international standard ruling, it is possible to define a number of aspects such as assessing the transfer pricing of certain goods and services, determining the value of assets at exit or at entry, agreeing the fair value of intercompany royalties and assessing whether a permanent establishment exists.

X YEAR IN REVIEW

Three main pieces of legislation having tax relevance have been enacted in 2019: the Growth Decree, the Budget Law for 2020 along with the Fiscal Decree linked thereto.

The Growth Decree, the Fiscal Decree and the Budget Law for 2020 enacted some new tax rules, such as the restoration of ACE, a simplified procedure to enter IP regime, the business combination bonus, the extension of the tax regime applicable to the contribution of control shareholdings to the contribution of (non-control) substantial shareholdings.

XI OUTLOOK AND CONCLUSIONS

In 2019, the Italian economy maintained a positive trend; for instance, in the M&A sector and by attracting high net worth individuals through the flat-tax regime for new resident individuals who have not been resident in Italy in nine out of the last 10 years and wish to move their tax residence to Italy (yearly €100,000 substitute tax on any foreign-source income due) and with an enforcement of the regime for inbound employees transferring their tax residence to Italy (exemption from individual income tax on 70 per cent of the employment income from activity carried out in Italy).

The current political situation prevents a reliable forecast of consolidation of the achievements of recent years, but also in light of a strong economic structure of medium-sized businesses, we do not expect an extraordinary fall in M&A transactions.

In this respect, although in 2019 there has been a relatively limited number of tax advantageous new provisions, the newly introduced tax neutrality of the contribution of (non-control) substantial holdings may play a favourable role in corporate transactions and reorganisations.
Chapter 16

JAPAN

Kei Sasaki, Fumiaki Kawazoe and Yoshiko Nakamura

I INTRODUCTION

Even as preparations for the Tokyo 2020 Olympics and Paralympic Games are under way, Prime Minister Shinzō Abe, with the Liberal Democratic Party, is continuing the ‘Abenomics’ economic programme, targeted at increasing inbound investments in Japan and stimulating domestic demand. An area of significant reform is that of tax. On one hand, the effective tax rate for corporations in Japan has been on a gradual downslide – it was 34.62 per cent in 2014 and was lowered to 29.74 per cent in 2018 – in line with policy initiatives to encourage more inbound investments in Japan.

On the other hand, Japan has raised the consumption tax rate from 8 per cent to 10 per cent (except on selected food and beverage items and daily newspapers) as of 1 October 2019. This increase in consumption tax is expected to adversely affect the momentum in Japan’s economic recovery. The rapid growth in online purchases of digital content, goods and services, especially from vendors located abroad, has also prompted the introduction of a ‘reverse-charge’ system that allows consumption tax to be imposed on certain categories of taxpayers for their online transactions.

As for the tax reform in relation to inbound investments, localisation of base erosion and profit shifting (BEPS) actions are ongoing. Amendment to earnings stripping rules and transfer pricing rules have been introduced as well as expansion of application of rules for controlled foreign corporations.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

In Japan, with the exception of sole proprietorships, businesses generally adopt a corporate form. Under the Companies Act of Japan (Companies Act), there are four types of companies one can establish:

a stock company (KK);

b general partnership company;

c limited partnership company; and

d limited liability company (GK).

1 Kei Sasaki is a partner and Fumiaki Kawazoe and Yoshiko Nakamura are associates at Anderson Mōri & Tomotsune.
The corporate form chosen will determine whether ownership of a company is separated from the management thereof, and the extent to which shareholders or members are liable to perform the company's obligations. The main differences between these four types of corporations are as follows: a KK is owned by shareholders but managed by its directors. The three other types of companies are, however, owned and managed by their members. The shareholders of a KK and members of a GK are only liable to the extent of their investments in their respective companies. On the other hand, the liability of members in a general partnership company is unlimited. By contrast, a limited partnership company has two types of members: those with limited liability and those with unlimited liability. As their names suggest, limited liability members are only liable to the extent of their investment in the company, while the liability of unlimited liability members is unlimited.

The KK is the most widely used corporate form in Japan. The GK, although not as popular as the KK, is also often used, especially as a vehicle in structured finance. Limited partnership companies and limited liability companies, on the other hand, are not so common.

In addition to the corporate forms under the Companies Act, there are also laws in Japan that enable corporations of other forms to be incorporated for special purposes. These include:

a specific purpose companies (TMKs), which are often used in asset securitisation;
b investment corporations, which are commonly used to accumulate funds for investment in securities and real estate;
c mutual companies, which are commonly used in insurance-related transactions; and
d medical corporations, which are commonly used for holding hospitals.

ii Non-corporate

Non-corporate entities (except sole proprietorships) can generally be categorised as partnerships, silent partnerships (TKs) and trusts.

Most partnerships are general partnerships formed under the Civil Code of Japan (NKs). The partners in such partnerships are subject to unlimited liability. Additionally, there are other types of partnerships such as investment limited partnerships (LPSs) and limited liability partnerships (LLPs) that are derivatives of the NK. These partnerships may be established under special legislation. An LPS has partners with both limited and unlimited liability. LPSs are usually used for forming venture capital firms. An LLP is a partnership in which all partners are liable only to the extent of their investment in the partnership, and is typically used in joint ventures for academic research and development.

A TK is formed by way of a bilateral agreement between a business operator and its silent partners. A silent partner is someone who has contributed capital toward the relevant business operations in return for a share in the profits generated from the business. TKs are often used in structured finance.

Corporations incorporated under the Companies Act (i.e., KKS, general partnership companies, limited partnership companies and GKs) are fiscally opaque. On the other hand, partnerships such as NKs, TKs and most forms of trusts are fiscally transparent (i.e., they are pass-through entities). By comparison, TMKs and investment corporations are pay-through entities, such that the amount of profits they distribute (if any) to equity holders will be deducted from their taxable income.
III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Under the Corporation Tax Act of Japan (CTA), taxable income is derived by subtracting deductible expenses from gross profits. Deductible expenses are similar to accounting expenses, but with some important differences, and exclude certain kinds of accounting expenses. Gross profits are similar to accounting incomes, but with some important differences, and exclude certain kinds of accounting income.

There are major differences between deductible expenses and accounting expenses under the CTA, as follows:

a in respect of depreciable or amortisable assets, the amount of depreciation or amortisation permitted to be included in deductible expenses is limited. Specifically, the amount of depreciation or amortisation deductible for each year is calculated based on the useful life of the relevant asset, which in turn is determined based on the category of the relevant asset, and on the method of depreciation or amortisation adopted by the company. It should also be noted that under the Japanese tax system, depreciation and amortisation are required to be recorded first as accounting expenses before they can be registered as expenses deductible from taxable income in the relevant financial year;

b the amount of remuneration paid to officers shall not be included in the deductible expenses unless the period of remuneration payment is a constant period of one month or less, and the amount thereof is the same at each time of payment, remuneration is paid based on a provision with registration that ascertains an amount to be paid at a fixed time or remuneration is a certain kind of performance-linked remuneration;

c the amount of contribution or donation exceeding a certain amount shall not be included in the deductible expenses; and

d the amount of entertainment account exceeding a certain amount shall not be included in the deductible expenses.

Practically speaking, taxable income is derived from accounting profits. Once accounting profits have been ascertained, taxable incomes can be calculated by adding to the accounting profits the non-deductible expenses referred to above, and deducting therefrom, exclusive of gross profits, such items as certain portions of dividends distributed from a corporation.

In Japan, profits are taxed on an accrual basis and not on a receipt basis. Japanese corporations are subject to taxation on their worldwide income. Foreign corporations, on the other hand, are only subject to taxation on Japan-source income for the purposes of Japanese taxation. A foreign corporation's taxable Japan-source income differs depending on whether the foreign corporation is deemed to have a permanent establishment (PE) in Japan. Japan's system of taxable domestically sourced income adopts the 'attributable income principle'. Under this principle, in relation to taxation on business profits of a foreign corporation, only the portion that is attributable to its PE in Japan will be recognised as Japan-source income and, therefore, subject to Japanese taxation.

Capital and income

Realisation of and taxation on capital profits are usually deferred to the time of sale of the relevant asset. Where assets are sold at a profit, corporate income and capital profits will be aggregated and subject to corporate income tax at the corporate income tax rate.
Losses

Tax loss carry back
Where a domestic corporation incurs losses in a financial year, it may, simultaneously with the filing of its tax return, also file a claim for a corporate income tax refund for a certain amount of corporate income tax for any financial year commencing within one year prior to the beginning of the relevant loss-making financial year, depending on the amount of the said loss. However, where a corporation is not a small or medium-sized company (i.e., not a corporation with stated capital of ¥100 million or less, but excluding a corporation that is completely controlled by a corporation with stated capital of ¥500 million or more), this refund will not be applicable.

Tax loss carry-forward
When a domestic corporation files a final tax return that indicates losses in a financial year commencing within 10 years prior to the first day of each of its financial years, an amount equivalent to the said loss will be permitted to be included within the deductible expenses for each relevant financial year. However, where a corporation is not a small or medium-sized company and the amount of said loss exceeds the maximum deductible amount; 50 per cent of the taxable income for the relevant financial year, inclusion within the deductible expenses will not apply to the amount of the said excess.

In the case of a merger, losses are not usually permitted to be succeeded by the surviving corporation unless certain requirements for exceptional treatment are satisfied.

Under the CTA, taxable income is subject to aggregate taxation and is not taxed on an income category-by-category basis. Accordingly, in cases where losses are incurred by a business, but it receives capital gains from the sale of some assets, then said losses offset the income of the capital gain and reduce the taxable income.

Rates
The corporate income tax rate applicable to small or medium-sized companies is 15 per cent (the rate applicable to companies whose annual average income for each business year ended within three years before the start of the financial year exceeds 1.5 billion yen is 19 per cent) for income up to ¥8 million and 23.2 per cent for the portion of income in excess of ¥8 million. The corporate income tax rate applicable to companies other than small or medium-sized companies is 23.2 per cent. These rates are now applicable for financial years commencing on or after 1 April 2019. For the rates that were applicable to the previous financial years, please see the table below.

<table>
<thead>
<tr>
<th>Commencement date of the financial year</th>
<th>1 April 2018 to 31 March 2019</th>
<th>1 April 2019 to 31 March 2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small or medium-sized companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Up to ¥8 million</td>
<td>Other than those below</td>
<td>15 per cent</td>
</tr>
<tr>
<td></td>
<td>Companies whose income exceeds certain amount</td>
<td>19 per cent</td>
</tr>
<tr>
<td></td>
<td>Portion in excess of ¥8 million</td>
<td>23.2 per cent</td>
</tr>
<tr>
<td>Companies other than small or medium-sized companies</td>
<td>Overall</td>
<td>23.2 per cent</td>
</tr>
</tbody>
</table>
Other than corporate income tax, companies are also subject to, inter alia, the following
taxes, which are proportional with a rate that is flat or progressive, on profits generated:

\[ a \] local corporation tax;
\[ b \] special local corporation tax (abolished for financial years beginning on or after
1 October 2019);
\[ c \] inhabitant tax;
\[ d \] enterprise tax; and
\[ e \] special enterprise tax.

A corporation’s effective corporate income tax rate is determined by the amount of its stated
capital and the location of its office. Corporations that have stated capital of more than
¥100 million and offices located in an area where the excess tax rate is not applied have an
effective corporate income tax rate of 29.74 per cent from the financial year beginning on or
after 1 April 2018. ‘Effective tax rate’ means the tax rate taking into account the deductibility
of special local corporation tax and enterprise tax payments from taxable income.

**Administration**

Corporations are required to file their final tax return before the district director of the relevant
tax office for corporate income tax (national tax) within two months following the end of
each financial year (final return). A corporation whose financial year exceeds six months is
also required to file an interim tax return to the district director of the relevant tax office
within two months of the end of the first six months of its financial year (interim return).

In some cases, the competent district director may extend the filing deadline for a
final return by one month or more if such extension is requested. Regardless of whether
the deadline is postponed, corporations are required to pay corporate income tax by the
original tax return filing deadline. Therefore, where the tax return filing deadline is extended,
corporations are liable to pay interest on payable corporate income tax for the period of
extension.

The primary objectives of the National Tax Agency (NTA) include the enhancement
of transparency in tax filing procedures, creating predictability for taxpayers, encouraging
taxpayers’ cooperation in investigations by the tax authority, improving the efficiency of the
self-assessment system and strengthening accountability.

Matters of national tax (excluding internal consumption tax on imported goods, which
is under the jurisdiction of the Customs and Tariff Bureau) are within the NTA’s purview.
The NTA has 11 regional tax bureaux, a national tax office in Okinawa and around 500 tax
offices located throughout Japan.

Matters of local tax fall within the jurisdiction of the relevant prefectural tax office or
city office of the relevant local government.

Tax offices have the authority to conduct tax audits for corporate income tax. The
timing of such audits is not prescribed in the relevant laws and regulations. Notwithstanding
this, there is a general understanding that tax audits are conducted once every few years and
are typically focused on corporations whose profits swing widely from year to year.

Revised tax returns may be filed to increase tax liability when the declared tax amount
is less than the correct amount stated in the new tax return.

On the other hand, if the declared tax amount is more than the correct amount,
corporate income tax reassessments may be requested by taxpayers, provided such requests
are conducted within the permitted time frame (as indicated in the table below).
The district director of the relevant tax office may conduct reassessments of corporate income tax, provided such reassessments are conducted within the permitted time frame (as indicated in the table below).

<table>
<thead>
<tr>
<th>Type of request for tax reassessment</th>
<th>Permitted time frame (beginning from the deadline for filing of the relevant tax return)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>Five years</td>
</tr>
<tr>
<td>Tax reassessment in relation to transfer pricing</td>
<td>Six years</td>
</tr>
<tr>
<td></td>
<td>1 April 2020–</td>
</tr>
<tr>
<td>Tax reassessment in cases of changes to net loss amount</td>
<td>10 years</td>
</tr>
</tbody>
</table>

Taxpayers wishing to appeal a tax assessment can do so through the following avenues:

- making a request for reinvestigation to the director of the relevant tax office that had performed the original tax assessment (taxpayers are not obliged but have the right to request a reinvestigation before requesting a re-examination under (b));
- making a request to the National Tax Tribunal (NTT) for a re-examination of the original tax assessment; and
- instituting a lawsuit. (Lawsuits can only be instituted, in principle, after the results of NTT’s re-examination under item (b) has been released.)

As stated above, item (c) may be conducted only after following the procedure mentioned in item (b). On the other hand, a taxpayer may skip item (a) and go straight to item (b) instead.

**Tax grouping**

There are two regulatory frameworks in Japan in respect of tax consolidation: the full controlling interest framework and the consolidated return framework.

The full controlling interest framework applies mandatorily to intra-group transactions (including transactions involving transfers of assets, losses, dividends and interest) where all companies in the group are wholly owned (whether directly or indirectly) by the ultimate parent of the group, regardless of whether the ultimate parent is a foreign or domestic company or individual, provided that the parties to the relevant transaction are domestic companies. Under this regulatory framework, taxation on intra-group profits from transfers of certain kinds of assets, such as fixed assets, securities, monetary claims and deferred assets (qualifying assets), is deferred until those assets are transferred outside the group. Additionally, intra-group contributions, donations and dividends are disregarded. Where the full controlling interest framework applies, certain tax incentives to which corporations with
stated capital of ¥100 million or less are normally entitled would no longer be available to a small or medium-sized company that is fully controlled by a large corporation with stated capital of ¥500 million or more.

On the other hand, the consolidated return framework is, where approved by the Commissioner of the NTA, only applicable to groups in which all companies are wholly owned (whether directly or indirectly) by the ultimate parent of the group and the companies consist only of domestic companies. Under this framework, corporate income tax is calculated based on the group’s consolidated income and payable by the domestic controlling corporation as the taxpayer. In respect of subsidiaries in such groups, unrealised profits and losses of qualifying assets will be imputed to taxable income or losses for the financial year immediately preceding that in which the consolidated return applies to the group. In addition, under the consolidated return framework, taxation on profits from intra-group transfers of qualifying assets is deferred until those assets are transferred outside the group. Intra-group contributions, donations and dividends are also disregarded under the consolidated return framework.

ii Other relevant taxes

In addition to corporate income tax and other taxes on profits, which are stated above, the taxes that generally apply to businesses are, inter alia, withholding tax under the Income Tax Act of Japan, fixed property tax, consumption tax, stamp duty, registration tax and real estate acquisition tax.

Fixed property tax is proportional to the book value of the relevant property as indicated in the property register. Consumption tax is imposed on transfers of assets, with the transferor being deemed the taxpayer, although such tax is borne by the transferee in practice. Notwithstanding the above, in certain categories of online transactions, a ‘reverse charge’ was introduced and the transferee is deemed the taxpayer of consumption tax. Stamp duty is generally imposed on documents such as written contracts. Registration tax is imposed when registration is undertaken with the authorities, such as when real estate is registered on the national real estate register. Real estate acquisition tax, as its name suggests, is imposed on acquirers of real estate.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

An entity becomes a Japanese tax resident (that is, it is deemed a domestic corporation for Japanese tax purposes) if its head office or principal office is located in Japan. The place where management and control are exercised is irrelevant for the purposes of determining tax residency in Japan. Accordingly, a foreign-incorporated entity cannot be a Japanese tax resident, even though it exercises its management and control functions in Japan.

ii Permanent establishment

A foreign company will be considered to have a fiscal presence for purposes of Japanese tax if it has a PE in Japan, such as a fixed place of business (branch PE), building or site (building PE), or a person who is predominantly based in Japan to act on the corporation’s behalf (agent PE). Several factors are relevant in determining whether a PE exists. For example, in determining whether a foreign company has a PE in Japan, relevant factors include, inter alia, whether the corporation’s business is conducted at such a fixed place. Several steps can be
taken to avoid being deemed to have a PE in Japan, including using the fixed place only for the purchase or storing of goods, or for performing supporting functions such as advertising, information collection or dispensation, and conducting of market research and feasibility studies.

The definition of PE has been amended for the financial years beginning on or after 1 January 2019 to align it with the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model Convention) 2017. In addition, the most notable new rule is that the definition of PE under domestic tax law will be overwritten by the definition of PE under a relevant tax treaty applicable to a foreign company if the definition under the relevant treaty is different from that of domestic tax law. The other major amendments to domestic tax law include the following:

a After the amendments to the definition of agent PE, agent PE will include not only a person who has an authority to conclude a contract in Japan on behalf of the foreign company but also a person who plays a principal role continuously in concluding a contract in Japan on its behalf. However, an agent of a foreign company will not be considered as PE if the agent is ‘independent’ from the foreign company and acts in the ordinary course of its business unless the agent acts only on behalf of one or more related parties.

b After the amendments to the exception of definition of PE, even places that are used only for certain purposes, such as storing, exhibiting or delivering goods, etc., would not be excluded from PE unless the activity is purely preparatory or auxiliary in nature.

Japanese tax law adopts the attributable income principle, under which only the income attributable to the PE in light of the Authorised OECD Approach is taxable. Thus, profits calculated by deeming that the PE was a distinct and separate entity from the corporation, was engaged in the same or similar activities under the same or similar conditions with the corporation, and was dealing wholly independently from the enterprise, are attributable to the PE.

Treaty tiebreakers, such as Article 4, Paragraph 3 of the US–Japan tax treaty (or the US–Japan double tax treaties (DTAs)), prescribe the method by which to determine the tax residence of a person who falls within the definition of tax resident in both the US and Japan. There is no concept of branch profit tax in Japan.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
There is no special tax regime applicable to holding companies in Japan.

ii IP regimes
There is no special tax regime applicable to intellectual property in Japan, although withholding tax on royalty payments is exempt under some tax conventions.
State aid is available in certain sectors, such as the agriculture and manufacturing sectors. State aid comes in various forms, including tax exemptions, tax reductions and tax-free subsidies that encourage investments and the conducting of research and development in Japan. State aid is generally available as long as the relevant taxpayer is a tax resident of Japan, regardless of whether it is controlled by a foreign entity or individual.

iv General

The government provides several tax incentives to foreign business operators to encourage their investment in some sectors in Japan. Certain areas in Tokyo have been designated to fall within the Special Zone for Asian Headquarters, established to induce foreign companies to set up their offices and facilities in Japan. Specifically, a foreign company that establishes its Asian headquarters or its research and development centre in such special areas and also satisfies certain requirements will be entitled to enjoy tax incentives in the form of special depreciation rates or investment tax credits and several local tax exemptions.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Dividends and certain forms of profit distribution (such as capital repayment or repurchase of shares) by a domestic corporation to a non-resident or a foreign corporation are subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent in the case of dividends from listed shares).

The Income Tax Act of Japan contains different rules on sources of income in respect of interest income from Japanese government bonds, certain kinds of domestic corporate bonds and deposits with financial institutions' business offices or facilities located in Japan (bond interest), and interest income from loans to business entities that conduct business in Japan (loan interest). Under Japanese law, bond interest is deemed Japan-sourced income, and is generally subject to withholding tax at a rate of 15.315 per cent if paid to a non-resident or a foreign corporation. Loan interest attributable to business conducted in Japan is also deemed Japan-sourced income, but is generally subject to withholding tax at a rate of 20.42 per cent when paid to a non-resident or a foreign corporation.

Royalties paid to non-residents or foreign corporations by entities or residents conducting business in Japan are subject to withholding tax at a rate of 20.42 per cent. Notwithstanding the above, non-residents or foreign corporations with PEs in Japan may apply for an exemption from withholding tax on loan interest income or royalties attributable to their Japanese PEs with a competent district director of the relevant tax office. Specifically, by obtaining a certificate issued by the competent district director of the tax office and by presenting the certificate to the payers, such non-residents and foreign corporations are permitted to pay taxes on loan interest income or royalties attributable to their Japanese PEs in the form of corporate income tax instead of withholding tax.
ii  Domestic law exclusions or exemptions from withholding on outward-bound payments

As stated above, bond interest is generally subject to withholding tax. However, non-residents and foreign corporations may apply for an exemption from the withholding tax on interest income from government bonds or corporate bonds received by way of the book-entry system, and interest income from corporate bonds issued outside Japan that is paid to recipients outside Japan. It should be noted, however, that such exemption does not apply to cases where interest income on corporate bonds is paid to related parties (such as relatives or controlling shareholders with more than 50 per cent equity interest in the issuer of the relevant corporate bonds). In addition, it should also be noted that interest income on corporate bonds that is attributable to PEs of non-residents and foreign corporations is still taxable under the self-assessment system instead of the withholding tax system.

As stated above, interest income from deposits with financial institutions' business offices or facilities located in Japan is generally subject to withholding tax. Foreign corporations may, however, apply for an exemption from the withholding tax on interest income derived from deposits in special international financial transactions accounts maintained with certain financial institutions. It should be noted that interest income from the deposits that is attributable to PEs of foreign corporations is still taxable under the self-assessment system instead of the withholding tax system.

iii  Double tax treaties

As of 1 November 2019, Japan is party to 75 tax treaties with 132 countries and regions. These treaties comprise 62 tax treaties on avoidance of double taxation on income with 72 countries and regions (DTAs); 11 tax treaties on exchange of information with 11 countries and regions; a tax convention on mutual administrative assistance in tax matters among 99 countries; and a tax agreement between Japan and Taiwan.

Although Japan does not publish its general policies under the tax treaties it has entered into, most of the 62 DTAs are substantially based on the OECD Model Convention. In particular, the 2004 US–Japan DTA, which was based on the OECD Model Convention, serves as a base for many of the subsequent tax treaties entered into by Japan. It should be noted in this connection that even though the US–Japan DTA is based on the OECD Model Convention, it provides for lower tax rates on investment income such as interest, dividends or royalties in the source country to facilitate international investments; and contains anti-treaty abuse clauses, limitation-on-benefit clauses and exchange-of-information clauses to prevent treaty abuse.

The following table indicates the withholding tax rates in Japan, and how such rates are reduced or eliminated based on Japan’s DTAs with various developed and developing countries.
Japan also signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI), which has come into force in Japan as of 1 January 2019. The MLI affects Japanese bilateral tax treaties with 39 countries and regions (not including the United States), among which only 18 countries (including the United Kingdom, France, the Netherlands, Australia and Singapore) have deposited the instruments of ratification as of 26 November 2019.

**iv Taxation on receipt**

A domestic corporation that receives dividends from a domestic or foreign corporation is required to include dividends in its taxable income, although it is eligible for withholding tax credits or foreign tax credits.

However, a domestic corporation that receives dividends from another domestic corporation may exclude all or part of such dividends from its taxable income, depending on the relationship between the payer and recipient of the dividends. Where a dividend recipient holds 100 per cent of the shares in the dividend payer, received dividends may be entirely excluded from the recipient’s taxable income. Where a dividend recipient holds more than one-third but less than 100 per cent of the shares in the dividend payer, 100 per cent of received dividends after deducting the relevant interest cost may be excluded from the recipient’s taxable income. Where a dividend recipient holds more than 5 per cent but one-third or less of the shares in the dividend payer, 50 per cent of received dividends may be excluded from the recipient’s taxable income. Where a dividend recipient holds 5 per cent or less of the shares in the dividend payer, 20 per cent of received dividends may be excluded from the recipient’s taxable income. Further, such dividends are generally subject to withholding tax at a rate of 20.42 per cent (or 15.315 per cent for dividends received in respect of listed shares). A dividend recipient is eligible for withholding tax credits.

On the other hand, dividends received by a domestic corporation from a foreign corporation are generally required to be included in the domestic corporation’s taxable income.
income. Where the dividend recipient holds 25 per cent or more of the shares in the foreign dividend payer, then 95 per cent of the dividend may be excluded from the recipient’s taxable income.

If a foreign country withholds tax on dividends, interest or royalties paid to a Japanese corporation recipient, the recipient will be eligible for foreign tax credits up to a certain amount in general. However, certain types of foreign tax, including but not limited to withholding tax on dividends received by a domestic corporation holding 25 per cent or more of the shares in the foreign dividend payer, are ineligible for the foreign tax credit.

VII TAXATION OF FUNDING STRUCTURES

Entities in Japan are commonly funded through equity or debt, or both. In situations involving foreign parent companies and Japanese subsidiaries, foreign parent companies will typically provide loans to their Japanese subsidiaries until the latter achieve operational stability and necessary critical mass.

i Thin capitalisation

Japanese tax law includes thin capitalisation rules. Under these rules, if interest is paid to a foreign controlling shareholder by a domestic corporation (i.e., a Japanese corporation) when the payer’s average interest-bearing debt to the foreign controlling shareholder in the financial year exceeds three times the value of the foreign controlling shareholder’s equity interest in the payer in the said financial year, and the payer’s average aggregate interest-bearing debt in the said financial year exceeds three times the value of the aggregate equity interest in the payer, the interest income related to the excess debt will not be deductible from the payer’s taxable income. A domestic corporation may, however, apply a different debt-to-equity ratio (instead of three times) if it can prove that a different ratio is appropriate in light of the debt-to-equity ratio of similar corporations.

ii Deduction of finance costs

Finance costs such as interest or bank arrangement fees are generally considered deductible expenses. However, because Japanese tax law includes earnings stripping rules, transfer pricing rules and thin capitalisation rules, the inclusion of finance costs in deductible expenses is restricted.

Under the current earnings stripping rules, when interest payments to related foreign corporations (such as a foreign parent company or subsidiary) exceed 50 per cent of the statutory income of the payer, the portion of interest payments exceeding 50 per cent of the statutory income of the payer is not deductible from the payer’s taxable income in the financial year. However, such excess portion is carried forward for seven financial years and can be used as deductible expenses until the total amount of deductible expenses reaches a 50 per cent threshold in each of the following seven financial years.

The financial year 2019 tax reform substantively revised the earnings stripping rules, which will be effective for the financial year of foreign corporations commencing on or after 1 April 2020. Under the revised earnings stripping rules, when certain types of interest payments to another person (including an unrelated third party) exceed 20 per cent of the statutory income of the payer, the portion of interest payments exceeding 20 per cent of the statutory income of the payer is non-deductible from the payer’s taxable income in the
financial year. However, such excess portion is carried forward for seven financial years and can be used as deductible expenses until the total amount of deductible expenses reaches a 20 per cent threshold in each of the following seven financial years.

Under the transfer pricing rules, the portion of finance costs exceeding arm’s-length prices will not be deductible from the payer’s taxable income if the transaction giving rise to the relevant finance costs (including interest payments) is not conducted at arm’s length.

The thin capitalisation rules also place restrictions on the amount of deductible expenses claimable as stated above.

iii Restrictions on payments
Under the Companies Act, a KK’s distributable profits, which are subject to statutory limits, are calculated based on surplus funds available. A GK’s distributable profits are also limited to a certain amount. By contrast, the profits distributable by a general partnership company and limited partnership company are unlimited, unless restrictions on profit distribution are contained in their articles of incorporation.

iv Return of capital
A KK is permitted under the Companies Act to repay its capital to shareholders in the form of dividends through the reduction of its capital or statutory reserves. This involves approval for the capital or statutory reduction being obtained from the KK’s shareholders at a shareholders’ meeting; and the notification of the KK’s creditors about the reduction in capital or statutory reserves and, in the event of any objection to such reduction by any creditor, the taking of the required statutory procedures to protect the interests of the objecting creditor. Upon the implementation of the reduction, the KK will be generally deemed to have returned capital to its shareholders of an amount equivalent to the capital of reserves reduced.

However, if there is any portion as a result of a calculation subtracting the value of capital attributable to the shares held by the shareholder from the amount of such capital return, such portion is deemed to be a dividend instead of a capital return for tax purposes. Accordingly, if the shareholders of a KK are domestic corporations, a certain amount of deemed dividends may be excluded from the recipient’s taxable income depending on the relationship between the payer and recipient of the dividends, as stated above.

Further, if the shareholder of a KK is a domestic corporation, then the shareholder may include the capital gain or loss in its taxable income or loss. Such capital gain or loss is calculated by subtracting the acquisition cost basis of the share held by the shareholder from the capital return amount attributable to the share.

Overall, dividends distributed by a KK through the reduction of its capital or statutory reserves are viewed and taxed differently depending on which portion of the dividends is deemed to be a capital return or a dividend. Such a tax regime is not considered to be tax-neutral.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES
i Acquisition
Foreign corporations often acquire businesses in Japan by acquiring shares or assets (including employees) of a target entity in Japan. Doing so obviates the need to establish a new entity in Japan. Based on the prevailing interpretation of the Companies Act, however, a Japanese corporation cannot engage in a merger or demerger with a foreign corporation. Accordingly,
if a foreign acquirer wishes to merge with or demerge from a Japanese target entity, it has to establish a new wholly owned subsidiary in Japan (if it does not already have a Japanese subsidiary) through which to merge with or demerge from the target entity indirectly. In transactions where foreign corporations adopt such a structure, the new wholly owned Japanese subsidiary is typically financed by capital or debt, or both. The debt-to-equity ratio of such subsidiary is determined in light of the thin capitalisation rules and the earnings stripping rules.

Consideration for the acquisition of shares or assets is typically paid in cash. It should be noted, however, that consideration in forms other than cash (such as shares issued by the acquirer or a parent company of the acquirer, corporate bonds and other assets) is also permissible.

ii Reorganisation

Under Japanese tax law, mergers and demergers may be classified as tax-qualified mergers or demergers if certain conditions prescribed by the CTA are satisfied. One notable condition is that the consideration in tax-qualified mergers or demergers has to consist solely of shares in the acquirer or the wholly (directly or indirectly) owning company of the acquirer in principle. The financial year 2019 tax reform accepted shares in the wholly indirectly owning company of the acquirer to be used as a consideration in tax-qualified mergers or demergers while shares to be used therein were limited to shares in the acquirer or the wholly and directly owning parent company of the acquirer before the financial year 2019 tax reform. The tax reform became effective on 1 April 2019.

In addition, the consideration in tax-qualified mergers can include cash in the case that the acquirer holds two-thirds or more of the target corporation’s shares and the merger is conducted to squeeze out minority shareholders.

Assets and liabilities in non-tax-qualified mergers or demergers are transferred at fair market value. In tax-qualified mergers or demergers, however, assets and liabilities are transferred at book value. This means that capital gains or losses arising from transfers in tax-qualified mergers or demergers may be deferred at both the merged corporation level and the level of its shareholders. Notwithstanding this, tax-qualified mergers or demergers may not always offer the most favourable tax treatment to taxpayers where unrealised losses are deferred. However, taxpayers wishing to avoid requirements in respect of tax-qualified mergers or demergers can easily do so by paying consideration in forms other than shares. In this sense, Japanese tax law does not prevent consolidation between an acquired business and an existing local business, although mergers and demergers between Japanese corporations and foreign corporations are not permitted under the Companies Act, as stated above. Ultimately, the most suitable type of merger or demerger depends on the relevant situation.

iii Exit

Foreign corporations wishing to exit the Japanese market commonly do so by selling the shares in their Japanese subsidiaries. Capital gains arising from such sales are taxable under the CTA. As a result, foreign corporations are required to file tax returns with the applicable tax office within two months following the end of their financial year.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Japanese tax laws contain general avoidance rules such as the disallowance of acts or calculations:

- by family-owned corporations;
- in relation to organisational restructuring;
- by consolidated corporate groups; and
- regarding foreign entity profits that are attributable to a PE.

In respect of low-tax jurisdictions, the Japanese tax authorities apply the controlled foreign corporation rules (the CFC rules) in addition to other rules such as transfer pricing rules, thin capitalisation rules and earnings stripping rules.

ii Controlled foreign corporations (CFCs)

The CFC rules will apply if: (1) more than 50 per cent of shares in a foreign corporation are held directly by one or more Japanese residents (domestic corporations or individual residents in Japan) or indirectly through one or more foreign affiliates, whose more than 50 per cent shares are held by one or more Japanese residents; or (2) the foreign corporation is substantially controlled by a Japanese resident. The foreign corporation will be considered to be substantially controlled by a Japanese resident if the Japanese resident has the right to receive most of the residual property of the foreign corporation or if the Japanese resident can determine most of the policy on property disposal of the foreign corporation based on an agreement.

The CFC rules differ depending on activity of a foreign corporation.

If a foreign corporation falls within the category of a paper company, a company deemed to be an actual cash box or a company located in a blacklisted country (a Paper Company etc.), a Japanese resident, who: (1) owns 10 per cent or more of the shares in; or (2) has a substantial controlling interest in such foreign corporation, is taxed on the retained profits of the foreign corporation: (1) in proportion to the ratio of the resident’s stock ownership in that corporation; or (2) in consideration of such substantial controlling interest in that corporation unless the amount of taxes on a foreign corporation’s income that is earned in a foreign country where the head office or principal office of the foreign corporation is located is 30 per cent or more of the foreign corporation’s income (the Tax Burden Rate).

If a foreign corporation (which is not a Paper Company, etc.) does not satisfy any of the following requirements stated below in (a) to (d), a Japanese resident is also proportionally taxed on the retained profits of the foreign corporation; provided, however, that a Japanese resident is not taxed on the retained profits of the foreign corporation if the Tax Burden Rate is 20 per cent or more:

- the main businesses of the foreign corporation are not certain types of business, such as holding shares or bonds (business purpose test);
- the foreign corporation has the business offices necessary for its main business in the said foreign country (substance test);
- the foreign corporation has management and control functions in the said foreign country (management and control function test); and
the foreign corporation conducts business mainly with unrelated parties (unrelated parties test) or mainly in the said foreign country (location test). Whether the unrelated parties test or location test will apply depends on the segments of the foreign corporation's main businesses that are involved.

If a foreign corporation (which is not a Paper Company, etc.) satisfies all of the requirements stated above in (a) to (d), a Japanese resident is proportionally taxed on only the statutory tainted income of the foreign corporation (such as dividends or interest income); provided, however, that a Japanese resident is not taxed on the statutory tainted income of the foreign corporation if the Tax Burden Rate is 20 per cent or more.

### Transfer pricing

Under Japanese transfer pricing rules, a domestic corporation that transacts with related foreign entities (such as a foreign parent corporation) will, if the transaction involves a non-arm’s length consideration, be liable for tax calculated based on an arm’s-length consideration imputed on the transaction. In calculating the appropriate arm’s-length consideration, the tax authority will apply the most suitable statutory method of calculation available.

Typically, the tax authority will request further information from the taxpayer that will aid the authority to calculate an appropriate arm’s-length consideration. Where a taxpayer fails to adequately respond to such requests, or does not promptly provide such information, the tax authority will have the right to determine such arm’s-length consideration as it deems fit based on reasonable assumptions applicable to the relevant statutory method of calculation.

### Tax clearances and rulings

It is possible to obtain advance rulings from the NTA in respect of actual (as opposed to hypothetical) situations. Trade associations also frequently consult the NTA in advance for the kinds of transaction that such trade associations commonly conduct. In addition, advance pricing arrangements are also applicable under the transfer pricing rules. As a general matter, no tax clearances or rulings are required in transactions involving the acquisition of a local business.

### YEAR IN REVIEW

#### Consumption tax

Japan's national and local consumption tax rates had originally been slated to rise from 8 to 10 per cent in October 2015. However, the date of implementation of this increase was deferred to October 2019. Despite the flat rate of consumption tax applicable to all goods and services since its introduction in 1989, this regime has introduced and implemented two different rates for goods and services for the first time. The reduced tax rate of 8 per cent is now applicable in respect of certain kinds of food, beverages and daily newspapers whereas a consumption tax rate of 10 per cent is levied for the rest of the goods and services used in Japan.
ii Court cases
On 27 June 2019, two different court departments of the Tokyo District Court rendered different judgments with regard to the Anti-Avoidance Rule for Reorganisation and the Anti-Avoidance Rule for Family Corporations (Group Corporations). In the former case, the tax payer who merged with the group company, to decrease its tax burden, lost against the tax authority because the court found that no reasonable incentive or purposes were recognised with regard to such merger other than decrease of the tax burden. On the other hand, in the latter case, the tax payer won the case where the tax authority challenged a type of cross-border debt push-down transaction that consisted of several intercompany transactions. Both of these cases have been appealed. It will be in the interests of companies that intend to conduct similar intercompany restructuring transactions in Japan to follow up on these appellate court decisions to know how the courts will interpret and apply the Anti-Avoidance Rules above.

XI OUTLOOK AND CONCLUSIONS
Generally, we expect the tax authorities in Japan to continue keeping pace with developments in international tax laws, and to harmonise Japanese tax principles with such developments through legislative amendments and tax treaties. With regard to more specific issues, the recent reduction in corporate income tax and increase in consumption tax may lead to tax-driven business restructuring, especially in the supply chain and logistics sectors. Additionally, base erosion and profit shifting action plans are continuously introduced and localised over the next few years. These tax reforms are expected to affect business activities in Japan in a way that we hope is conducive to overall economic growth.
Chapter 17

LEBANON

Simon El Kai, Souraya Machnouk, Hachem El Housseini and Nour El Haddad

I INTRODUCTION

Lebanon is a country that, by tradition, remains open to foreign direct investment, and is endowed with several investment-enabling strengths, including a free market and limited restrictions on foreign investment.

The government encourages foreign investment, and continues to favour a strong role for the private sector in a liberal policy environment while maintaining minimal intervention in economic activities.

The government passed several laws and decrees to encourage investment. The Investment Development Authority of Lebanon (IDAL) was established in 1994, and was considerably remodelled in 2001 to stimulate Lebanon’s economic and social development, and to enhance its competitiveness. The long-awaited Law No. 48 relating to Public-Private Partnerships (PPP) was passed on 7 September 2017, and is expected to form the cornerstone for future infrastructure projects in Lebanon.

Despite recent domestic political instability and regional turmoil, which contributed to a decline in capital inflows and a slowdown in new investment, Lebanon has maintained a stable legal and tax environment. The government continues to express a strong commitment to improving the business environment, as well as encouraging domestic and foreign investment and public-private partnerships.

Lebanese law does not differentiate between local and foreign investors, except in sectors with specific requirements and limitations such as real estate, insurance, media (television and newspapers) and banking. Foreign investors can generally establish a Lebanese company, participate in a joint venture, or establish a local branch or subsidiary of their company without difficulty.

Some issues continue to cause frustration among local and foreign businesspeople. Impediments include red tape and corruption, complex customs procedures, some archaic legislation, lengthy judicial procedures and a weak enforcement of intellectual property rights.

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1 Simon El Kai and Souraya Machnouk are partners, Hachem El Housseini is a senior associate, and Nour El Haddad is an attorney at Abou Jaoude & Associates Law Firm.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate
The Lebanese Code of Commerce of 1942 and its amendments (Code of Commerce) distinguish between five forms of business entities, namely:

a joint-stock companies (JSCs);
b limited liability companies (LLCs);
c general partnerships;
d limited partnerships; and
e company partnerships limited by shares.

JSCs and LLCs, along with holding companies and offshore companies recognised as corporate entities since 1983, are the most widely used forms for setting up new companies in Lebanon. All such companies are required to be registered at the commercial registrar, which is overseen by the president of the tribunal of first instance in the corresponding locality.

The liability of the shareholders of a JSC is limited to their contribution to the JSC’s capital. The minimum share capital in a JSC is circa US$20,000, and the minimum number of shareholders is three. As per Law No. 75 of 27 November 2016, a JSC (including holding and offshore companies) is prohibited from issuing shares to the bearer, and all shares must be in the registered (nominative) form.

The JSC form is mandatory for certain business organisations such as insurance companies, banks and financial institutions. The JSC is run by a board of directors whose members are either shareholders or non-shareholders in the company, and are collectively responsible for running the JSC’s affairs, while a chair or general manager is responsible for day-to-day matters. The chair or general manager may propose that the board of directors appoints a deputy general manager, but the latter shall act on behalf and under the responsibility of the chair or general manager. One-third of the board of directors of a JSC must be Lebanese.

The transfer of shares of a JSC between shareholders or to third parties is unrestricted, subject only to the right of first refusal of the JSC or the other shareholders, or both, if it is expressly provided for in the JSC’s articles of association or in a separate shareholders’ agreement. It is not a requirement that the transfer deed be notarised. The transfer of shares of a JSC is tax free and exempt from stamp duty.

The liability of the partners of an LLC is limited to their contribution to the LLC’s capital.

Following the enactment of Law No. 126 dated 1 April 2019, an LLC may be composed of a sole partner who may exercise wide authorities. The minimum share capital is circa US$3,334. An LLC can be fully non-Lebanese-owned, and the management of the company can be controlled by non-Lebanese parties. When the LLC is formed by more than one partner, the transfer of shares to a non-partner is subject to the approval of partners representing at least three-quarters of the company’s capital. The transfer deed should be notarised and notified to the LLC’s director and to all the partners.

2 Existing companies with capital constituted in whole or in part of bearer shares are required to convert such shares to registered (nominative) shares within the one-year deadline set out in Law No. 75 of 27 November 2016.
Holding and offshore companies follow the legal form of a JSC and are respectively governed by Legislative Decree No. 45 (on holding companies) dated 24 June 1983 and amended by Law No. 772 dated 11 November 2006, and Legislative Decree No. 46 (on offshore companies), dated 24 June 1983 and amended by Law No. 19 dated 5 September 2008, Decree No. 7861 dated 24 March 2012 and Law No. 85 dated 10 October 2018.

The holding company’s purpose consists of:

- acquiring shares or interests in existing Lebanese or foreign JSCs and LLCs and participating in the incorporation of the same;
- managing companies in which it holds shares or interests;
- granting loans to companies in which it holds shares or interests exceeding 20 per cent and guaranteeing said companies towards third parties;
- acquiring patents, licences, registered trademarks and other protected rights, and leasing the same to entities operating in Lebanon and abroad; and
- acquiring chattels or real estate, provided the same are only employed in the context of its activities and subject to the provisions of the law governing the acquisition by foreigners of real estate rights in Lebanon.

The holding company is exempt from income tax and withholding tax on dividend distributions, and is instead subject to a progressive tax rate, depending on its capital, to a maximum of circa US$3,400 per year.

The purpose of the offshore company was considerably extended in 2008 to attract foreign investments and now includes:

- entering into agreements to be implemented outside Lebanon;
- managing other offshore companies;
- carrying out commercial operations overseas;
- acquiring shares in non-resident companies; and
- opening branches and representation offices outside Lebanon.

Following the enactment of Law No. 85, offshore companies can be formed by a sole shareholder, who may be a natural person or a legal entity, Lebanese or foreign.

An offshore company may not perform activities in Lebanon except for opening bank accounts, renting offices and owning Lebanese treasury bills, and may not carry on banking or insurance activities. The offshore company is exempt from income tax and withholding tax on dividend distributions, and is instead subject to an annual lump sum amount of circa US$666. A foreign non-resident chair or general manager of a holding or an offshore company is exempt from the obligation to hold a work and a residency permit.

Both holding companies and offshore companies are also exempt from share transfer tax, stamp duty on share transfers, etc., and present other advantages, such as the exemption from having at least two Lebanese members on their boards of directors.

**ii Non-corporate**

Physical persons may register themselves as traders at the commercial registrar of the locality where their main business is located. Traders may own commercial establishments that are deprived of legal personality. Traders are subject to income tax on their personal income at a progressive rate ranging between 4 and 25 per cent.

The Code of Commerce expressly recognises joint ventures, which are created by virtue of a contract and are deprived of legal personality except if the joint venture itself
issues invoices, in which case it shall be subject to paying value added tax. Joint ventures are not subject to registration or publication requirements, and their existence should not be disclosed to third parties. Each partner in a joint venture who deals with a third party is considered to be dealing in his or her own name and for his or her own account, and is solely responsible for the debts incurred in relation to such third party.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

*Determination of taxable profit*

Tax is levied on the net income generated during the previous year. The net income is calculated by deducting all charges and expenses determined in the law from the turnover of the taxpayer.

There are three tax assessment methods: the effective profit method (used mainly for JSCs and LLCs); the lump-sum profit method; and the estimated profit method.

Income tax applies to earnings from business ventures carried out in Lebanon or the taxation of which is attributed to Lebanon pursuant to a double taxation treaty.

ii Capital and income

Income and capital gains are taxed at different rates according to Income Tax Law No. 144 dated 12 June 1959 and its amendments (Income Tax Law). Income tax applies at a rate of 17 per cent for corporations, and at a progressive rate ranging between 4 and 25 per cent for physical persons. Capital gains resulting from the re-evaluation of assets are subject to a 10 per cent tax (with the possibility of total exemption in certain cases) and those resulting from the transfer of assets are subject to a 15 per cent tax (with partial deductions being allowed when the transferred assets consist of real estate properties). Pursuant to the enactment of Budget Law No. 144 dated 31 July 2019, physical persons or corporations may benefit from an exceptional re-evaluation of assets to mitigate any inflation before 31 March 2020. The surplus resulting from such re-evaluation is subject to a new proportional tax at a rate of three per cent in lieu of (1) the current higher rate applicable to the re-evaluation of assets, or (2) 15 per cent applicable on the transfer of assets. However, the privileged rate shall cease to apply if any of the assets which were subject to re-evaluation are sold within three years from the date of the re-evaluation. The regular tax rate shall then apply retroactively and the difference must be paid to the Treasury.

*Losses*

Losses may be carried forward for a period of three consecutive years and survive any change of ownership.

*Rates*

Corporations (JSCs and LLCs) are subject to flat income tax at a rate of 17 per cent. The payment of dividends or any other dividend-like distributions to shareholders is subject to withholding tax at a rate of 10 per cent. The effective tax payable is thus 25.3 per cent.

Branches of foreign companies are subject to income tax at a rate of 17 per cent. According to the Income Tax Law, profits earned by branches of foreign companies are
deemed distributed in full as dividends, and such distribution is subject to a 10 per cent tax on dividend distribution. The effective income tax rate payable by branches of foreign companies is thus 25.3 per cent.

Individuals are subject to a progressive tax rate ranging between 4 and 25 per cent on their income, after deducting circa US$5,000 for single individuals, in addition to approximately US$1,700 for married individuals and US$300 for every legitimate dependent child (up to five children), subject to certain conditions.

The reduced tax on dividend of 5 per cent previously given to certain listed companies has been cancelled. The standard tax on dividend rate is 10 per cent for all companies.

**Administration**

Tax returns are due annually, and must be filed before the tax authorities at the Ministry of Finance. The tax authorities may re-audit or reassess the amounts included in the tax declarations. The tax authorities may also challenge any scheme for tax avoidance or any practices contrary to the purpose of the law, in which case the violators may incur substantial penalties.

Guidance and comfort may be sought from the tax authorities regarding the interpretation of taxes and regulations, or regarding factual matters. The decisions of the tax authorities may be subject to an opposition filed by the taxpayer before the tax authorities in cases of an error or an unjustified imposition of additional taxes. The Income Tax Law also provides for a judicial recourse against decisions of the tax authorities.

The statute of limitations on taxes in Lebanon is five years.

**ii Other relevant taxes**

**Lump sum tax**

Law No. 20 dated 10 February 2017 reintroduced a new lump sum tax payable per annum (which was originally provided for in the Budget Law No. 173 dated 14 February 2000 but remained ineffective ever since), as detailed in the table below.

<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Tax amount (Lebanese pounds)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint-stock company (SAL)</td>
<td>2 million</td>
</tr>
<tr>
<td>Limited liability company (SARL)</td>
<td>750,000</td>
</tr>
<tr>
<td>Partnerships and personal establishments taxed on the basis of real profit</td>
<td>550,000</td>
</tr>
<tr>
<td>Branches of foreign companies</td>
<td>X*†</td>
</tr>
<tr>
<td>Individuals taxed on the basis of ratio profit</td>
<td>250,000</td>
</tr>
<tr>
<td>Individuals taxed on the basis of estimated profit</td>
<td>50,000</td>
</tr>
</tbody>
</table>

* The lump sum tax applies to the head office and each branch of a taxpayer operating in Lebanon. The term ‘branch’ shall be deemed to include, without limitation, offices, shops, points-of-sale, factories that conduct administrative, sales or business activities, and any other location at which the taxpayer conducts activities or receives clients.

† The corporate form of the foreign company is used as a reference to calculate the amount of the lump sum tax payable by the branch.

This lump sum tax was meant to apply irrespective of whether the target company has recorded profits, and was in principle not deductible for income tax purposes. The application of Law No. 20 was suspended for three years as of 1 January 2018 by virtue of Law No. 108 dated 30 November 2018.
Law No. 108 also provides that taxpayers who had settled the annual lump sum licence fee have the right to apply for a refund, which will be set by a decision from the Ministry of Finance. In this respect, the decisions of the Ministry of Finance No. 260 and 261 dated 30 May 2019 postponed the payment of the annual lump sum licence fee until the beginning of 2021, and set the mechanism for claiming back a refund for taxpayers who have already settled that fee.

**Tax on interest**

Pursuant to Budget Law 2019, tax on bank interest is currently payable at a rate of 10 per cent. This rate is effective starting 1 August 2019 and applied for a period of three years, following which a 7 per cent rate will apply.

**Non-resident tax**

Tax on payments made in return for services provided by a non-resident is applied at a rate of 7.5 per cent (15 per cent on the deemed profits, estimated at 50 per cent of the gross proceeds). Tax on payments made other than for services performed, such as the supply of goods, is applied at a rate of 2.25 per cent (15 per cent on the deemed profits, estimated at 15 per cent of the gross proceeds). This tax must be withheld by the resident party and paid to the relevant tax authorities.

**Value added tax**

VAT is an indirect tax on consumption levied at each stage of the production and consumption process. It is currently applied at a rate of 11 per cent. All companies whose revenues in any given quarter or year exceed approximately US$66,700 are subject to mandatory VAT registration.

Companies located in the Port of Beirut or the Port of Tripoli free zones are exempt from VAT for export purposes.

Following the enactment of Budget Law 2019, a temporary import duty at a rate of 3 per cent is imposed on imported goods that are subject to VAT for a period of three years. Such goods exclude gasoline, raw materials and equipment and products used in the industrial and agricultural sectors.

**Stamp duties**

The standard stamp duty amounts to 0.4 per cent of the amounts provided for in a contract. However, a lump-sum stamp duty of 5,000 Lebanese pounds shall apply on agreements that do not refer to an amount, or refer to the potential payment of an amount that is undetermined in the agreement or undeterminable at the date of the agreement. The variable stamp duty referred to here above becomes payable once the amount is determined or settled. Specific types of contract are subject to a lump-sum stamp duty ranging between approximately US$0.07 and US$1,334.

**Built property tax**

Built property tax is a progressive tax applied on annual net rental proceeds and ranges between 4 to 14 per cent, according to a progressive tax scheme. A taxpayer may submit a request of extraction to the Ministry of Finance subject to specific conditions.
Municipality tax
Municipality tax is a flat tax paid annually at a rate of 8.5 per cent of the yearly rent amount or the rental value of premises.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Income tax in Lebanon is territorial. Profits realised in Lebanon and profits derived from an activity in Lebanon are subject to Lebanese income tax. Accordingly, profits realised outside Lebanon but generated from an activity executed in Lebanon are subject to Lebanese income tax. On the contrary, profits realised and generated from an activity outside Lebanon are not subject to Lebanese income tax.

ii Branch or permanent establishment
Foreign companies may open branches and representative offices in Lebanon.

Branches of foreign companies are subject to the same income tax rate as Lebanese companies in respect of their profits realised in Lebanon. Representation offices of foreign companies are prohibited from undertaking any commercial activity or from deriving profit in Lebanon.

Foreign commercial companies wishing to operate a branch or a representative office in Lebanon must register at the commercial registrar and at the Ministry of Economy and Trade (MoET). The establishment of a branch or agency in Lebanon is subject to a resolution of the foreign company’s board of directors or any other authorised governing body, which should clearly indicate the nature of the prospective business in Lebanon and nominate an authorised representative.

Although registration formalities and tax rates are substantially similar for branches of foreign companies and Lebanese LLCs, a branch is the most common form for foreign investments in Lebanon.

Any foreigner who spends more than 183 days per annum in Lebanon shall be considered as a Lebanese resident for taxation purposes.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
Holding companies are exempt from income tax, withholding tax on dividend distributions, and the lump sum tax on companies introduced by virtue of Minister of Finance Decision No. 993/1 of 31 October 2016. Holding companies are subject to an annual lump sum tax, the amount of which is proportional to their capital and which ranges between approximately US$1,200 and US$3,400.

The Income Tax Law provides that the sale of shares by a holding company is subject to capital gains tax at a rate of 15 per cent if such shares have been held by the holding company for less than 24 consecutive months at the date of transfer. The sale of shares that have been held by the holding company for more than 24 consecutive months is exempt from capital
gains tax. As per Instruction 1365/S1 of 31 August 2007, capital gains resulting from the disposal by a holding company of its shares or parts in companies located outside Lebanon are exempt from capital gains tax.

Share sale agreements are exempt from the 4 per mille stamp duty.

A holding company may charge interest on loans given to its subsidiaries (at a rate not to exceed certain limits set under law, depending on the source of the amount given in the loan) and receive management fees from its subsidiary in an amount not exceeding 2 per cent of the subsidiary's annual turnover.

As per Instruction 1365/S1 of 31 August 2007, holding companies are subject to tax at a rate of 10 per cent on interest from loans granted by the holding company to its subsidiaries when the maturity of such loans is less than three years. Interest from loans having a maturity exceeding three years is tax-exempt.

A holding company is liable to pay social security contributions and payroll taxes for its employees. It is also subject to a 5 per cent tax on management fees received from its subsidiaries, and to a 10 per cent tax on royalties received from its subsidiaries from the licensing of trademarks.

ii IP regimes
Existing intellectual property rights laws cover copyright, patents, trademarks and geographical elements. All intellectual property rights registered at the MoET enjoy protection under Lebanese laws. Such registration has to be published in the Official Gazette. There is no special IP tax regime in Lebanon.

iii State aid
Tax incentives are also granted by Investment Development Law No. 360 (Investment Law) dated 16 August 2001 and its subsequent amendments, which instituted IDAL.

IDAL offers a wide range of competitive investment incentives depending upon the qualifications and criteria for each project. These incentives include:

a exemption from income tax and tax on distribution of dividends for a number of years;

b grant of work permits for various categories exclusively needed for the project;

c fee reduction on work permits and residency; and

d fee reduction on construction permits, if required for the project.

IDAL also offers a business-matching service, a one-stop shop for facilitating administrative formalities and a basket of incentives referred to as the ‘package deal’, granted after approval by the Cabinet.

The Investment Law divides Lebanon into three investment zones, with different incentives provided in each zone, and encourages investments in the fields of technology, information, telecommunications and media, tourism, industry, and agriculture and agro-industry. The Investment Law also allows for the introduction of tailor-made incentives through package deals for large investment projects, regardless of the project’s location, including tax exemptions for up to 10 years, reductions on construction and work permit fees, and a total exemption on land registration fees.

Other laws and legislative decrees provide tax incentives and exemptions depending on the type of investment and its geographical location. Industrial investments in rural areas benefit from tax exemptions of six or 10 years, depending on specific criteria, and exemptions are also available for investments in south Lebanon, Nabatiyeh and the Bekaa Valley.
The 2017 Budget Law No. 66 dated 3 November 2017 introduced a new income tax exemption for a period of five years in favour of new institutions established in one of the areas that the government wishes to promote and develop. The areas to be developed shall be determined by the Council of Ministers, and the exemption shall be granted by the Minister of Finance. In contrast, the 2018 Budget Law No. 79 dated 19 April 2018 as well as the 2019 Budget Law No. 144 dated 31 July 2019 did not provide for any similar tax incentives and exemptions. Minor reductions on registration fees were introduced as well as reductions on penalties for the late settlement of all due taxes and fees for the year 2019.

iv General

The following enterprises are exempt from corporate tax: educational institutions, cooperative associations, trade unions and other types of professional associations, Lebanese maritime and airline companies, public institutions, and holding and offshore companies.

Moreover, industrial enterprises could benefit from temporary exemptions in the event of the reinvestment of generated profits for the purchase of new industrial assets.

Law No. 296 dated 3 April 2001, which amended the 1969 Law No. 11614, governs the foreign acquisition of property. The new Law eased legal limits on foreign ownership of property to encourage investment in Lebanon, especially in industry and tourism; abolished discrimination for property ownership between Arab and non-Arab nationals; and lowered real estate registration fees to 5 per cent for both Lebanese and foreign investors. The Law permits foreigners to acquire up to 3,000 square metres of real estate without a permit; acquiring more than 3,000 square metres requires Cabinet approval.

Domestic and foreign investors may benefit from a 4.5 per cent subsidy on interest on new loans granted after 1 January 2012 amounting to up to US$10 million per project (with a ceiling of US$40 million) provided by banks, financial institutions and leasing companies to industrial, agricultural, tourism and information technology establishments. The subsidy extends to a maximum of seven years. Investors can also benefit from loan guarantees from Kafalat, a semi-private financial institution that assists small and medium-sized enterprises (SMEs) in accessing subsidised commercial bank loans.

On 10 February 1981, Lebanon and the United States signed an Overseas Private Investment Corporation (OPIC) agreement in Beirut, but no investment using OPIC insurance coverage was undertaken until 1996. OPIC is currently engaged with Lebanon in three areas: insurance, financing and investment. Since 2006, OPIC has worked with Citibank on a programme that offers loans to the private sector (SMEs, retail and housing) through selected Lebanese commercial banks. This programme began in January 2007, and to date OPIC has provided circa US$300 million in credit line guarantees.

The government’s National Institute for the Guarantee of Deposits continues to insure new investments against special risks. Other major trade and investment insurance programmes operating in Lebanon include COFACE (France), ECGD (UK), HERMES (Germany), SACE (Italian) and IAIGC (Arab Consortium). Lebanon has been a member of the Multilateral Investment Guarantee Agency, which is part of the World Bank, since 1994.
IV WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Unless reduced by virtue of a tax treaty:

a dividends paid to non-residents are subject to a 10 per cent withholding tax; and

b remuneration paid to non-residents is subject to a 7.5 per cent withholding tax.

ii Double taxation treaties

Lebanon has entered into double taxation treaties with the following countries: Algeria, Armenia, Bahrain, Belarus, Bulgaria, Cuba, Cyprus, the Czech Republic, Egypt, France, Gabon, Iran, Italy, Jordan, Kuwait, Malaysia, Malta, Morocco, the Sultanate of Oman, Pakistan, Poland, Qatar, Romania, Russia, Senegal, Sudan, Syria, Tunisia, Turkey, Ukraine, the UAE and Yemen.

These treaties are aimed mainly at preventing double taxation. Nationals of the above-mentioned countries benefit from tax exemptions insofar as such exemptions are expressly provided in the treaty between their country of origin and Lebanon.

However, owing to the principle of territoriality applicable in Lebanon, the implementation of double taxation treaties has proven to be difficult, with many impediments arising in this respect.

iii Taxation on receipt

Capital gains derived from the sale of shares held by resident companies are subject to capital gains tax at a rate of 15 per cent.

VII TAXATION OF FUNDING STRUCTURES

Entities are funded either internally through equity financing (capital funding, retained earnings, etc.) or externally through debt (bank loans, debt instruments, etc.). Particular preferences for the mode of financing depend on the business sector and on the investors’ inclination to leverage their business.

i Thin capitalisation

The Code of Commerce does not regulate thin capitalisation or provide for mandatory debt-to-equity ratios, and companies can in principle freely determine their financing scheme as they prefer. However, traders and commercial companies are required to pay their commercial debts as they fall due, and to maintain their creditworthiness, failing which they may be declared bankrupt. Accordingly, any trader who uses unlawful means to sustain its creditworthiness or incurs commercial debts beyond its repayment ability may be declared bankrupt, and, in certain cases, may face criminal charges.

The Code of Commerce also provides that the partners in an LLC should decide to either liquidate it or decrease the capital within four months following the approval of the accounts evidencing a loss of three-quarters of their capital. JSCs are subject to similar conditions following the loss of three-quarters of their capital.

Banks are subject to the circulars of the Central Bank of Lebanon governing their indebtedness, in accordance with the Basel II accords.
ii Deduction of finance costs
The taxable net income of a company is calculated after deduction of all general expenses, financial charges, depreciation and legal reserves. Finance costs are thus taken into account and deducted for the calculation of the net income of the company. No specific scheme governs finance costs per se.

iii Restrictions on payments
Pursuant to the Code of Commerce, shareholders decide whether to distribute dividends at the annual general assembly meeting held for this purpose.

The Code of Commerce subjects the payment of dividends to the existence of a net income validly documented in the company’s financial statements, and holds members of the board of directors, as well as auditors, criminally liable in the event of fraud in such financial statements. It also requires companies to make yearly deductions of 10 per cent from their net income to constitute the legal reserve amounting to one-third of the capital of JSCs and half of the capital of LLCs, and the statutory reserve, if any. The payment of fictive dividends engages the liability of the directors as well as the liability of auditors.

The Code of Commerce provides for different treatments regarding the redemption of dividends resulting from a fictive income: partners of an LLC are required to return such dividends without any conditions, whereas shareholders of the other forms of companies (including a JSC) cannot be forced to return such dividends other than in the case of an established bad faith or wilful misconduct.

There are no restrictions on the movement of capital, capital gains, remittances, dividends, or the inflow and outflow of funds.

iv Return of capital
To return part of the capital to their shareholders, JSCs and LLCs may elect to decrease their share capital.

Such a decision must be taken by virtue of an extraordinary general shareholders or partners’ assembly meeting, which shall decide the redemption of part of the capital on a pro rata basis between the shareholders or partners.

In the case of LLCs, the decision of the general assembly to buy back parts and thus reduce the capital should be seconded by a decision to cancel the redeemed parts.

JSCs, holding and offshore companies can decrease their capital through buying back their shares by allocating some of their profits in a special reserve established for that purpose. The shares acquired by the company are in such case replaced by enjoyment shares, which do not entitle their holders to any nominal amount following the subsequent liquidation of the company.

In all cases, the decision to enforce a decision to return part of the capital is subject to the creditors’ approval: a reduction of the capital is often perceived by creditors as a reduction of the commitment of the partners or shareholders, and thus a reduction of the collateral that is meant to protect their rights. Such decision is thus subject to publication requirements, and creditors making no objection thereto within three months for JSCs and within two months for LLCs.
Lebanon

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Credit is allocated on market terms, and foreign investors can get credit facilities on the local market. The private sector has access to overdrafts and discounted treasury bills, in addition to a variety of credit instruments such as housing, consumer or personal loans, and loans to SMEs.

The Code of Commerce governs the sale and purchase of shares, but does not specifically regulate the acquisition of assets, although the latter may be transferred in accordance with the general principles of law.

There are no entry barriers that would affect or restrict foreign investments, except in certain sectors specified by law (commercial representation, media, aviation, etc.).

The transfer of the shares of JSCs is tax free and exempt from stamp duty. The financing structure is not related to tax considerations but rather to the investor’s entry strategy.

Acquisition transactions are subject to capital gains tax.

ii Reorganisation

Mergers often give rise to a new legal structure, and all asset transfers resulting from such merger are in principle subject to a 15 per cent capital gains tax.

Law No. 126 of 1 April 2019 introduced new rules relating to mergers and split-ups (or demergers). The process of merging or splitting-up companies is now regulated with respect to the decision-making bodies, publication formalities and assets’ allocation. Law No. 126 further provides for some tax exemptions whereby capital gain tax shall apply on merger and split-up operations with reduced rates subject to specific conditions.

Merger and split-ups transactions are exempt from fiscal stamp duties, transfer, inheritance, notary public and registration fees. Such exemptions shall cease to apply if the split company has benefitted an existing company.

Merged and split companies must settle all taxes due before the merger or split-up operations take place. A discharge from the National Social Security Fund is not required.

In principle, there are no restrictions on a merger between a local and a non-local entity, as long as the entity resulting from such merger is located in Lebanon.

iii Exit

All companies incorporated and operating in Lebanon should have their head office on the Lebanese territory.

Relocation within Lebanon is possible subject to publication formalities and registration in the commercial registrar.

Relocation to an address outside Lebanon is not allowed, as the Code of Commerce links the nationality of the company to its country of incorporation.

The partners in an LLC can decide to change the nationality of the company by virtue of a resolution that needs to be unanimously approved. The Code of Commerce provides that ‘extraordinary general assemblies [of JSCs] cannot change the nationality of the company’ and this text has been widely interpreted as forbidding any relocation of JSCs outside Lebanon.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

General anti-avoidance rules regarding tax avoidance, consequences and sanctions are tackled in the Income Tax Law and Tax Procedure Law No. 44 dated 11 November 2008 (Tax Procedure Law), Law No. 60 dated 27 October 2016 and the decrees and decisions taken in application thereof. The Budget Law 2019 went one step further and introduced an exhaustive definition of ‘tax evasion’ to be added to the Tax Procedure Law. The Budget Law 2019 also imposed an obligation on municipalities and notary public to inform the Ministry of Finance of all companies and businesses established within their municipal territory, verify their compliance and report all relevant details in this regard, including sale agreements and irrevocable proxies.

All companies should file an ‘initiation of work’ application before the Ministry of Finance within two months of their incorporation, failing which they shall be subject to late filing penalties. The Ministry of Finance issues a certificate evidencing such initiation of work, and the company should thereafter comply with periodic tax filing obligations.

All companies should present true, accurate and timely tax filings, and are subject to penalties in the case of false or late declarations, concealment of information, or obstruction of tax controls or tax collections.

The Tax Procedure Law provides for the right of the tax authorities to requalify any operation whenever tax evasion or fraud is suspected. The tax authorities may also reassess the amount of a transaction by application of the arm’s-length principle, especially in the context of related-party transactions.

Tax avoidance may also be subject to criminal proceedings. Lebanon recognises low-tax jurisdictions and any company incorporated therein without discrimination. However, the tax authorities would always apply Lebanese tax laws to foreign companies deriving profits in Lebanon (in application of the territoriality principle) unless a double taxation treaty exists between Lebanon and the country where the foreign company is incorporated.

ii Beneficial owner declaration

Pursuant to the Ministry of Finance Decision No. 1472/1 dated 27 September 2018, all legal entities, irrespective of their form, are under the obligation to:

a identify their beneficial owner or owners (the ‘beneficial owner’), that is to say any natural person, irrespective of his or her place of residence, if any of the following conditions are met:
   • the individual holds, directly or indirectly, a minimum of 20 per cent of the legal entity’s share capital;
   • the individual holds, directly or indirectly, the majority of the voting rights in the legal entity including the right of appointment or removal of the directors or members of other supervisory bodies; and
   • the individual occupies a managerial position (i.e., exercises significant influence or control over the company); and

b declare the required information to the Ministry of Finance upon the filing by the legal entity of the start of business certificate, the submission of the annual tax declarations, or both, as applicable.
All legal entities are required to maintain a special register of beneficial owners, and maintain records demonstrating the ownership structure of the company and the control exercised over it, as well as all information and documents related to the beneficial owners for a period of 10 years, irrespective if the person in question is no longer a beneficial owner in the company, or if the company has ceased its activity in Lebanon.

### iii Controlled foreign corporations (CFCs)

There are no rules governing controlled foreign corporations per se, but Lebanon allows the incorporation in Lebanon of branches of foreign companies.

### iv Transfer pricing

Transfer pricing is subject to the arm's-length principle. The tax authorities may interfere and reassess the amount of a transaction, especially if it takes place between related parties. Particular scrutiny takes place whenever tax evasion or a manipulation of accounts is suspected. The tax authorities apply the principle lato sensu, and are usually stringent in its application.

### v Tax clearances and rulings

The tax authorities regularly deliver tax attestations indicating all due taxes paid by a taxpayer. Such certificates may also be issued following an inspection performed by the tax authorities, or upon a spontaneous regularisation request made by the taxpayer by virtue of a petition requesting the issuance of such a certificate.

### X YEAR IN REVIEW

The major breakthrough for 2019 remains the enactment by the Lebanese parliament of the Law No. 126 dated 1 April 2019, which introduced an overhaul of the Lebanese Code of Commerce aimed at streamlining businesses and encouraging foreign investments.

### XI OUTLOOK AND CONCLUSIONS

The tax rates in Lebanon remain relatively low and the tax regime relatively stable. Owing to the wide panoply of services offered to foreign investors, Lebanon is perceived as a tax-friendly jurisdiction.
Chapter 18

LUXEMBOURG

Pieter Stalman and Mélanie Staes

I INTRODUCTION

Situated in the heart of Europe, Luxembourg has built its position as a major European financial centre on its political stability, good communication with the market and its actors and powerful service sector. This as well as Luxembourg’s limited dimensions have allowed it to maintain a certain degree of flexibility in its legal system and to cope easily with an ever-increasing volume of inward investments.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

There are several forms of entity with separate legal personality through which business can be carried out in Luxembourg:

a corporate entities:
  • public limited company (SA);
  • private limited company (SARL); and
  • public company with both limited and unlimited liability shareholders (SCA); and

b non-corporate entities:
  • general partnership (SNC);
  • limited partnership (SCS); and
  • special limited partnership (SLP).

The above-mentioned corporate entities (listed under (a)) are fully subject to corporate income tax, municipal business tax and net wealth tax, and can therefore be considered as opaque for tax purposes.

The SARL is the most frequently used corporate form owing to the favourable combination of its limited liability, the flexibility of its by-laws and corporate legal rules, and the limited minimum capitalisation requirements (i.e., €12,000 or its foreign currency equivalent).

Although the above-mentioned partnerships (listed under (b)) have legal personality (with the exception of the SLP), from a corporate income tax perspective they are not

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1 Pieter Stalman is a partner and Mélanie Staes is a senior associate at Loyens & Loeff. The authors wish to thank Delphine Martel and Olivier Coulon, associates at Loyens & Loeff, for their contribution to this chapter.
separate from their partners, and are therefore transparent. The partnership is considered as a mere collection of the partners’ individual businesses for corporate income tax purposes: even though the taxable commercial income is determined at the level of the partnership, it is attributed and taxed pro quota directly at the level of the partners. Municipal business tax is instead levied directly from the partnerships that carry on a commercial activity or that are deemed to do so by virtue of the commercial nature of the majority of their partners (SNC) or of some partners holding a minimum interest in the partnerships (SCS and SLP). An SNC is deemed to carry on a commercial activity when the majority of its interests are held by a capital company, whereas an SCS or SLP is deemed to carry on a commercial activity when its general partner is a company whose capital is divided into shares holding at least a 5 per cent interest in the SCS or SLP. For the purpose of determining the nature of the activity carried out by a partnership whose interests are (fully or partially) held by another partnership, the latter is considered as a capital company when it carries out a commercial activity or is deemed to do so.

The SCS and the SLP are particularly suitable for the structuring of unregulated funds and frequently used in such context.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Business income is subject to corporate income tax and to municipal business tax. Because the taxable basis of the municipal business tax is to a very large extent derived from the corporate income tax basis, the rules for their determination are examined together, and the main differences are highlighted where relevant.

Determination of taxable profit

Resident taxpayers are taxed on their worldwide income on a yearly basis, whereas non-resident taxpayers are taxed in Luxembourg only on certain categories of income sourced therein. In principle, income is determined and taxed separately for each category of income, but all of the income derived by corporate entities and deemed commercial partnerships is considered to be of a business nature. In general, the business profit of an entity is defined as the increase in value of its net assets over the fiscal year, adjusted for capital contributions, capital repayments and profits distributed. The determination of the net asset value is based on the annual accounts of the entity. Therefore, the taxable profit in principle coincides with the financial result and is determined on an accrual basis, unless specific tax rules expressly deviate from the accounting rules or a special tax regime is in place. For this purpose, a ‘fiscal balance sheet’ is prepared, where the accounting values of the assets and liabilities are replaced by the values of the same that should be used for tax purposes where different.

In broad terms, all the expenses derived by a company that carries on a commercial activity that are related to its business are deductible unless they relate to exempt income. Some expenses are explicitly classified as deductible (e.g., non-creditable foreign taxes and

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2 See, however, Section V for a description of the exemption regimes applicable to income derived from qualifying participations and intellectual property rights.

3 See Section V for a more detailed discussion of the deductibility of expenses related to exempt participations and to partially exempt income from intellectual property rights.
VAT, real estate tax and capital duty, depreciation and amortisation), whereas some expenses are explicitly classified as non-deductible (e.g., corporate income tax, municipal business tax, net wealth tax, directors’ fees referred to supervisory services, fines, non-qualifying gifts, profits distributions).

For municipal business tax purposes, profits and losses derived through a foreign permanent establishment (PE) are not taken into account and nor are profits and losses that have already been taxed at the level of a (deemed) commercial partnership of which the taxpayer is a member.

Capital and income
Capital gains are included in the taxable basis for corporate income tax and municipal business tax, and taxed at the ordinary rates.⁴

Losses
Losses can be carried forward and offset against the taxable income of the same taxpayer that generated them (on the condition that they result from acceptable accounts) for 17 consecutive years. Losses generated before 2017 can be carried forward indefinitely. No carry-back of losses is allowed.

When a corporate reorganisation takes place (e.g., merger), the losses generated by an entity that disappears as a consequence of the reorganisation (e.g., the merged company) cannot be carried forward by the company resulting from it (e.g., the merging company).

According to case law from 2013,⁵ a change in the ‘economic owner’ of the losses (e.g., change in the ownership of the loss-making company) is of no prejudice to the carry-forward of losses unless the abusive intent of the reorganisation that led to a major change in the ownership of the company is demonstrated (in particular when the company’s activities change after the change in ownership). Following the aforementioned case law, an administrative circular was issued by the Luxembourg tax authorities confirming this analysis.⁶

Rates
Corporate income tax
The fiscal reform of 2018 reduced the corporate income tax rates. For the fiscal year 2019, the rates are: (1) 15 per cent for income not exceeding €175,000; (2) €26,250 plus 31 per cent for income exceeding €175,000 but lower than €200,001; and (3) 17 per cent for income exceeding €200,000. For 2020, these rates are expected to stay the same.

A 7 per cent solidarity surcharge applies to the aforementioned rates, leading to an aggregate corporate income tax rate of 18.19 per cent (2019).

Municipal business tax
The tax rate is determined every year by each municipality. For Luxembourg City, the rate for 2020 is equal to 6.75 per cent, resulting in a combined corporate income tax and municipal business tax rate of 24.94 per cent.

⁴ See Section V for a description of the exemption regime applicable to capital gains on qualifying participations and intellectual property rights.
⁵ Cour administrative (Luxembourg), 7 February 2013, No. 31320C.
⁶ Circular No. 114/2, 2 September 2010, Report de pertes dans le cas du Mantelkauf.
Administration

As a general rule, the fiscal year coincides with the calendar year. In such a case, companies have to electronically file the annual corporate income tax, municipal business tax and net wealth tax returns, along with the commercial and fiscal balance sheets, by 31 May of the next year. Under certain conditions and at the request of the taxpayer, this deadline can be postponed.

After a preliminary review of the tax returns, the tax authorities can request further documents and information, or invite the taxpayer to discuss potential adjustments of the returns submitted. A final assessment is then issued: the amounts due, net of the quarterly advance payments made, have to be paid within one month. Alternatively, and at the option of the tax authorities, a self-assessment procedure can apply, whereby an assessment is issued by the Luxembourg tax administration based on the tax returns submitted by the taxpayer requesting the immediate payment of the corporate taxes computed on such basis. The assessment can be reviewed later by the tax administration before the ordinary statute of limitation expires, potentially giving rise to a higher corporate tax liability.

The taxpayer can file an appeal against the final assessment within three months of its receipt, provided that such assessment leads to an actual claim from the tax administration (i.e., following the assessment, the taxpayer is not in a loss position). The taxpayer can lodge an appeal against the decision of the head of the tax authorities with the Administrative Tribunal within three months, while the decision of the Administrative Tribunal can be appealed before the Administrative Court.

The risk of a litigation procedure can be limited by asking for clarification by the tax authorities where there is uncertainty as to a correct interpretation of the tax law applied to specific circumstances (see Section IX.iv).

Tax grouping

If an option thereto is made before the end of the respective calendar year, a fiscal unity regime is available for corporate income tax and municipal business tax purposes to a Luxembourg parent company or to a Luxembourg PE of a foreign company fully subject to a tax comparable to the domestic corporate tax (group parent), as well as to qualified subsidiaries (group subsidiaries, together with the group parent, the group). Since 2016, the fiscal unity regime is also available to the Luxembourg subsidiaries of an EEA country fully subject to a tax comparable to the domestic corporate tax, or to a PE of such corporation in the EEA. Subsidiaries can be included when they are controlled, directly or indirectly, by the group parent for at least 95 per cent of their capital since the beginning of the fiscal year for which the option is exercised; and have a fiscal year coinciding with the fiscal year of the group parent.

Taxable income and losses of each company pertaining to the group are determined on a stand-alone basis and then aggregated at the level of the group parent, and adjusted to eliminate double taxation and double deduction of the same items of income. As the requirements for the application of the participation exemption regime are less strict than the requirements for the application of the tax unity, inter-corporate dividends paid under a tax

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7 The statute of limitation for the assessment and the collection of income tax is generally five years following the end of the calendar year in which the tax liability arose. However, a 10-year limitation period applies in the case of additional taxation owing to failure to file a return, or for an incomplete or incorrect return (with or without fraudulent intent).
unity regime are already fully exempt and do not need to be adjusted when determining the profit of the group. Losses generated prior to the tax unity can be used to offset the income of the group up to the taxable income of the group subsidiary that generated them. Once the regime ends, losses generated during the tax unity have to be left at the level of the group parent.

The tax unity regime lasts for at least five years; termination prior to this five-year period ending leads to a full retroactive denial of the tax unity regime. If after the five-year period the requirements for the application of the fiscal unity regime are no longer met, the benefits obtained during the tax unity are recaptured and the tax liability of each company participating in the consolidation is assessed on a stand-alone basis from the beginning of the fiscal year in which the termination took place.

On 21 December 2018, Luxembourg implemented the European Union (EU) Anti-Tax Avoidance Directive 2016/1164/EU of 12 July 2016 (ATAD 1) into domestic law and introduced, inter alia, the interest deduction limitation rule (IDLR), further described in Section VII. These rules cap the deductibility of 'exceeding borrowing costs' at the higher of 30 per cent of the earnings before interest, taxes, depreciation and amortisation (EBITDA) or €3 million. Within a fiscal unity, the IDLR automatically applies at the level of the integrating company (while the application at individual entity level requires the timely filing of a request). The definitions, options and limitations included in the IDRL are correspondingly applied and determined at the level of the fiscal unity. In practice, the application of the IDLR at the level of the fiscal unity requires first to determine the interest expenses (and equivalent) and the interest income (and equivalent) for each entity part of the fiscal unity separately, before determining the exceeding borrowing costs of the fiscal unity at the level of the integrating company by aggregating the interest income and interest expenses of each entity part of the fiscal unity.

ii Other relevant taxes

Net wealth tax

Net wealth tax is levied at a 0.5 per cent rate on the estimated net realisable value (unitary value) of the assets of businesses as of the beginning of the fiscal year. A reduced rate of 0.05 per cent applies to taxable net wealth in excess of €500 million. An independent expert’s appraisal is not required for the determination of the unitary value, which is generally determined using the accounting book values, adjusted where necessary. With regard to real estate located in Luxembourg, the unitary value is determined on the basis of cadastral values assessed in 1941, which derives from a law of 1934.8

Assets giving rise to exempt or partially exempt income (i.e., exempt participations and qualifying intellectual property rights) are generally also exempt for net wealth tax purposes, and assets allocated to a foreign PE and foreign real estate are generally exempt by virtue of tax treaties signed by Luxembourg. Liabilities are generally deductible if they do not relate to exempt assets. Provisions for liabilities, the existence of which is not certain (e.g., provisions for risks), are not deductible.

Net wealth tax is not deductible for income tax purposes and is generally not creditable in foreign jurisdictions. Net wealth tax is not due for the first year of existence of the company (as the assets as of 1 January are deemed to be nil).

8 Bewertungsgesetz, Memorial 902, 3 January 1934, page 9002.
A minimum net wealth tax applies, which can be fixed (€4,815) if the financial assets of the resident corporate taxpayer in a given year exceed (1) 90 per cent of the total balance sheet and (2) €350,000, which is the case for most holding and financing companies. In all other cases, the minimum tax is contingent on the balance sheet total of the resident corporate taxpayer, and varies from €535 to €21,400 (for a balance sheet total exceeding €20 million).

**Capital duty or registration tax**

The proportional capital duty, previously levied on contributions to newly incorporated companies, or upon transfer of the legal seat or of the effective management of a foreign company to Luxembourg or upon the setup of a local branch of a foreign company, was abolished as of 1 January 2009 and replaced by a €75 fixed duty. 9

Other ad valorem or fixed registration duties may apply depending on the assets or documents registered.

**Real estate taxation**

A real estate tax is levied annually on the unitary value of real estate properties located in Luxembourg at a rate that depends on the classification and on the location of the property. The unitary value is, as described above, determined by the Luxembourg tax administration, and generally does not exceed 10 per cent of the market value of the property.

**Value added tax (VAT)**

Being an EU Member State, Luxembourg applies EU VAT Directive 2006/112/EC. Luxembourg’s standard VAT rate is the lowest in the EU (17 per cent). Luxembourg also applies reduced rates (3, 8 and 14 per cent) to various goods and services.

Contrary to other Member States, Luxembourg has not implemented the ‘use and enjoyment’ rule that obliges non-registered holding companies to pay the VAT on services received from non-EU suppliers without being allowed to recover it.

Following decisions of the Court of Justice of the European Union (CJEU), Luxembourg strictly limited the use of the VAT exemption for ‘independent group of persons’ (cost sharing) to taxable persons performing activities of public interest. As a counterpart to the virtual disappearance of the cost-sharing exemption for the financial, fund and insurance sectors, Luxembourg implemented the VAT grouping mechanism, relying on Article 11 of EU VAT Directive 2006/112/EC.

Luxembourg also has an extensive definition of regulated funds qualifying for the VAT exemption on the management of regulated funds.

**IV  TAX RESIDENCE AND FISCAL DOMICILE**

i  Corporate residence

Collective entities are considered resident in Luxembourg for tax purposes if they have their legal seat or their central administration therein. Therefore, for domestic tax law purposes, both collective entities incorporated in Luxembourg, and collective entities incorporated abroad but having their central administration in Luxembourg or having their registered office in Luxembourg, are considered resident therein for tax purposes.

The central administration of an entity is deemed to be located in Luxembourg if the
direction of the entity’s affairs is therein concentrated. The central administration should be
determined on the basis of facts through a substance-over-form analysis; in this respect, the
place where the central accounting and archives of an entity, as well as the place where the
shareholders’ and board meetings are held, are generally considered relevant.

ii Branch or permanent establishment

A definition of PE is provided by domestic law to determine the minimum threshold of
business activity a foreign taxpayer must reach in Luxembourg to be taxed therein on the
income ‘directly or indirectly realised’ by the PE. The domestic definition of PE is broader
than the Organisation for Economic Co-operation and Development (OECD) Model
Convention definition, last updated in 2017, as it generally includes a ‘place which serves
for the operation of an established business’, and therefore does not require that the business
is realised ‘through’ such place. Further, the domestic definition includes places of purchase
and sale of goods.

As from financial years beginning on or after 1 January 2019, a new provision governs
the Luxembourg recognition of a foreign PE. Additional guidance on this changed PE
definition was also provided in an administrative circular.\(^{10}\) The new provision impacts the
recognition of a PE where a tax treaty is in force between Luxembourg and a foreign country
and provides that the verification of the existence of a PE has to be based on the criteria
set out in the relevant tax treaty in place. According to the OECD Model Convention, the
identification of a PE requires: (1) a business being carried on; (2) through a fixed place
which must be at the disposal of the enterprise carrying on the business; and (3) with a
certain degree of permanency. However, the Luxembourg law provision further states that
a resident taxpayer is considered to be carrying on a business in whole or in part through a
PE in the other contracting state if that activity in isolation (1) is an independent activity
and (2) represents a participation in the general economic life in that state, unless an explicit
provision contained in the tax treaty between Luxembourg and the other contracting state
precludes this interpretation.

Furthermore, the Luxembourg tax authorities are entitled to request proof that the
source country recognises a PE (tax returns, ruling, etc.). Such proof is to be mandatorily
provided in the event that the relevant tax treaty does not contain a certain specific anti-abuse
rule\(^{11}\) and only upon request of the Luxembourg tax authorities in other cases. If a taxpayer
is not capable of providing proof that the activity is considered a PE in the other state, the
above-mentioned administrative circular clarifies that the Luxembourg tax authorities will
consider that there is no PE.

In the absence of specific provisions in domestic law regarding the allocation of profit to
a PE (and thus the determination of taxable basis in Luxembourg), a PE should be considered
as an entity separate from the foreign head office. OECD guidelines may serve as a source of
interpretation there, such that, in a nutshell, the profits attributable to the PE are the profits

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10 Circular No. 19, 22 February 2019.
11 That is, a provision similar to Article 23A(4) of the OECD Model Convention, which reads as follows:
‘The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a
Contracting State where the other Contracting State applies the provisions of the Convention to exempt
such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such
income’.
that the PE would have derived if it were a separate and independent enterprise engaged in
the same or similar activities under the same or similar conditions, taking into account the
functions performed, assets used and risks assumed by the enterprise through the PE and
through other parts of the enterprise.

Tax treaties signed by Luxembourg mainly follow the OECD Model Convention and
limit the Luxembourg taxing rights of business income derived in Luxembourg by foreign
taxpayers to income derived through a local PE. The income taxable in Luxembourg is only
the income that is attributable to the PE (i.e., no force of attraction applies) net of the
expenses that are thereto allocable. The majority of tax treaties signed by Luxembourg provide
for the prohibition of discrimination in the tax treatment of local PEs of foreign taxpayers as
compared with domestic companies.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY
ENCOURAGE INWARD INVESTMENT

i Holding company regimes

There is no specific holding company regime in Luxembourg. The participation exemption
regime is available to both Luxembourg resident companies and PEs of non-resident
companies holding qualifying participations.

Dividends (including constructive dividends and interest on profit-sharing bonds),
liquidation proceeds and capital gains are fully exempt when the participation they refer to:

a is held, directly or through a transparent entity, in a fully taxable resident company, in a
European company meeting the requirements listed in Article 2 of the Parent-Subsidiary
Directive or in a non-resident company subject to a tax that is comparable (in terms of
rate and taxable basis) to the Luxembourg corporate income tax\(^{12}\) (subsidiary);

b is held by a fully taxable resident company or by a domestic PE of a EU company
meeting the requirements listed in Article 2 of the Parent-Subsidiary Directive, or by a
domestic PE of a company resident in a treaty country or in an EEA country (parent); and

c represents at least 10 per cent of the capital of the subsidiary (or alternatively, has a
purchase price of at least €1.2 million – for the exemption of dividends and liquidation
proceeds – or €6 million – for the exemption of capital gains) and was held without
interruption over the previous 12 months (or alternatively, the parent commits to hold
such participation for at least 12 months).

Pursuant to the amendment of the Parent-Subsidiary Directive, with the introduction of
an anti-hybrid provision (EU Directive 2014/86/EU) and a minimum common general
anti-abuse rule (EU Directive 2015/121/EU), as of 1 January 2016 profit distributions
covered by the Parent-Subsidiary Directive received by a Luxembourg company do not
benefit from the participation exemption regime to the extent that the same payments were
deductible in the country of the payor, or were paid in the framework of an arrangement

\(^{12}\) The Luxembourg tax authorities generally consider that a foreign tax is comparable with the Luxembourg
corporate income tax if the rate of the foreign tax is at least 9 per cent (i.e., half of the current corporate
income tax rate) and the taxable base is computed on the basis of criteria that are comparable to the
Luxembourg criteria.
or a series of arrangements that, having been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purposes of the Parent-Subsidiary Directive, are not genuine.

If the above-mentioned minimum holding requirement under (c) is not met, an exemption of 50 per cent is available for dividends (including constructive dividends and interest on profit-sharing bonds, and excluding liquidation proceeds) distributed by a resident fully taxable capital company, a company covered by Article 2 of the Parent-Subsidiary Directive, or a capital company resident in a state with which Luxembourg has concluded a tax treaty and that is subject in its country of residence to income tax comparable with that of Luxembourg. The exemption applies to the net dividend income (i.e., the dividend income minus directly related costs and write-offs on the participation in connection with a dividend distribution of the same year).

Costs (typically, financing costs), capital losses and write-offs relating to exempt participations are deductible as long as they exceed the exempt dividends received in the same year. Losses resulting from this deduction can also be carried forward for 17 consecutive years. Losses generated before 2017 can be carried forward indefinitely. However, such deductions are recaptured when a capital gain is realised on the disposal of the same participation (i.e., the capital gain is exempt only to the extent it exceeds the amount of the recaptured deductions).

ii IP regimes

On 22 March 2018, Luxembourg adopted a new IP regime applying to any Luxembourg tax resident carrying out a business activity in Luxembourg and owning qualifying IP.

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

The portion of the IP income benefiting from the advantageous tax treatment is calculated based on a ratio taking into account the R&D costs. The ratio corresponds to the eligible R&D costs divided by the overall R&D expenses. Luxembourg allows the eligible R&D costs to be uplifted by 30 per cent insofar as the resulting ratio does not exceed the total amount of expenditure. Expenses must be incurred within the framework of an R&D activity to be eligible, but can be undertaken either by the taxpayer itself or outsourced.

The new IP regime is in line with the recommendations made by the OECD in its base erosion and profit shifting (BEPS) action plan 5 by adopting a nexus approach to ensure that only the R&D activities having a nexus with the Luxembourg taxpayer itself benefit from the new IP regime.

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

The former IP regime was abolished in 2016 but continues to be applicable to qualifying IP that was created or acquired before 1 July 2016. This grandfathering period started on 1 July 2016 and will end on 30 June 2021. Where the taxpayer is eligible under both regimes, the taxpayer may elect the IP regime to be applied during the grandfathering period. The choice for either option is irrevocable for the entire transitional period.
iii Tax subsidies
The main subsidies and incentives are mentioned in this chapter. Business investments, professional development and employment are, however, further supported through specific tax credits granted for new investments in qualifying business assets located in Luxembourg and put to use in Luxembourg or in the EEA (with the exception of ships, which benefit from the credit even if operated abroad);13 'sustained employees’ training expenses; and hiring employees previously registered as unemployed.

The above-mentioned subsidies are available to all businesses and do not refer to any specific sector of activity.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS
i Withholding on outward-bound payments (domestic law)
Distributions paid by a resident company to non-resident shareholders are generally subject to a 15 per cent withholding tax. This includes repayments of previously contributed capital, unless such repayment is motivated by sound business reasons.

As a general rule, there is no withholding tax on outbound royalties and interest; however, outbound payments to related parties exceeding the arm’s-length measure can be requalified as hidden dividend distributions and be subject to a 15 per cent withholding tax. Furthermore, profit-sharing interest received by a ‘money provider’ as payments on loans represented by securities that, in addition to a fixed coupon, are entitled to a variable coupon that depends on the company’s profit distributions, are subject to a 15 per cent withholding tax.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
A dividend withholding tax exemption is granted provided that a participation of at least 10 per cent (or alternatively a participation the purchase price of which is at least equal to €1.2 million) was held for an uninterrupted period of at least 12 months, when dividends are paid to:

a a European company meeting the requirements listed in Article 2 of the Parent-Subsidiary Directive or a Luxembourg PE thereof; pursuant to the amendment of the Parent-Subsidiary Directive with the introduction of a minimum common general anti-abuse rule (EU Directive 2015/121/EU), as of 1 January 2016 profit distributions covered by the Parent-Subsidiary Directive paid by a Luxembourg company do not benefit from the participation exemption regime to the extent they were paid in the framework of an arrangement or a series of arrangements that, having been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purposes of the Parent-Subsidiary Directive, are not genuine;

13 Following the Tankreederei I SA decision by the European Court of Justice (C-287/10 of 22 December 2010), which ruled that the scope of application of the incentive is contrary to the freedom of movement of capital, a circular issued by the tax authorities (Circular 152-bis/3 of 31 March 2011) and an update of the law clarify that the tax credit is also applicable to new investments in qualifying business assets located in Luxembourg put to use in a state that forms part of the European Economic Area.
b a non-resident company resident in a treaty country and subject therein to a tax that is comparable (in terms of rate and taxable basis)\textsuperscript{14} to the Luxembourg corporate income tax;

c a company resident and fully taxable in Switzerland not benefiting from any exemption; or

d a fully taxable company resident in an EEA country, or a Luxembourg PE thereof.

iii Double tax treaties

As of the date of writing, Luxembourg has 83 tax treaties currently in force, which are mainly in accordance with the OECD Model Convention, and further treaties are being negotiated. The table in Appendix 1 at the end of the chapter shows for each double tax treaty in force the potential reductions of withholding tax rates applicable to outbound payments of dividends, interest and royalties according to such treaties.

iv Taxation on receipt

Economic and juridical double taxation of foreign profits is generally avoided through a full or partial exemption system. The general conditions for the participation exemption regime are described in Section V.i. When a certain participation threshold is reached in a foreign company, tax treaties signed by Luxembourg generally provide for the exemption of foreign profits as a system to relieve double taxation. When foreign dividends are not exempt, taxes levied by the foreign authority to the Luxembourg recipient can at least be partially recovered, if certain conditions are met, through the domestic foreign tax credit system. Domestic law does not provide for an indirect tax credit system of taxes levied by the foreign authority at the level of the foreign entity.

VII TAXATION OF FUNDING STRUCTURES

Entities are commonly funded with a mix of equity and debt. Whether an instrument should be considered as debt or equity for Luxembourg tax purposes has to be evaluated on the basis of a ‘substance over form’ approach (i.e., taking into account the economic rather than the legal features of an instrument). This prevalence of economic characterisation over legal appearances has been confirmed by both parliamentary history\textsuperscript{15} and case law as a principle underlying Luxembourg tax law. The parliamentary history stated that the absence of typical loan features, such as inter alia a fixed term and interest, may lead to a presumption that a loan qualifies as hidden capital. Recent cases law provide for further guidance on the relevant criteria. In the cases law,\textsuperscript{16} the Administrative Court ruled, on the basis of the overall picture, that the instruments had to be qualified as equity for tax purposes.

The equity investment can, in principle, be represented by different classes of shares that track different income or investments of the same company (or both).

\textsuperscript{14} The Luxembourg tax authorities generally consider that a foreign tax is comparable with the Luxembourg corporate income tax if the rate of the foreign tax is at least 8.5 per cent (i.e., half of the current corporate income tax rate) and the taxable base is computed on the basis of criteria that are comparable to the Luxembourg criteria.

\textsuperscript{15} Parliamentary document 571/4, commentary to Article 114 (p. 294).

\textsuperscript{16} By way of example: Administrative Court, 26 July 2017, No. 38357C, Administrative Court, 13 December 2018, Nos 40704 and 40705.
Several financing tools can be created that combine features of debt and equity according to the projected profitability of the investments, and are tailored to the needs of the investors (base reduction in Luxembourg, withholding tax planning, repatriation of profits, flexibility upon exit).

Under certain conditions, hybrid debt instruments may be issued by a Luxembourg company. These hybrid debt instruments (e.g., convertible preferred equity certificates (CPECs)) are normally treated as debt for Luxembourg legal, accounting and tax purposes, but may be treated as equity for tax purposes in the country of residence of the holder of the instrument (e.g., the United States). The expression ‘CPECs’ is often used as a general abbreviation. However, the precise terms and conditions may differ on a case-by-case basis. In addition, the above-referenced case law has made the debt qualification of instruments from a Luxembourg tax perspective a bit more of an attention point; such case law has so far not led to additional or different enquiries from the Luxembourg tax authorities.

The use of hybrid instruments will be affected by the anti-hybrid rules, described in Section X.

i Thin capitalisation

There are no specific thin capitalisation rules under Luxembourg law. However, when a loan is granted or guaranteed by related parties, and such loan finances assets different from receivables (e.g., participations, real estate, intellectual property rights), in practice, a debt-to-equity ratio of at least 85:15 is generally required. The interest payments related to the debt exceeding this ratio may be treated, for tax purposes, as dividends, and, therefore, considered non-deductible for corporate income tax purposes and subject to the 15 per cent dividend withholding tax.

In addition, the Luxembourg transfer pricing rules require intra-group financing companies to avail of an appropriate amount of equity, such that they have the financial capacity to assume the risks they run. This amount is to be determined on a case-by-case basis.

ii Deduction of finance costs

As a general rule, any arm’s-length costs incurred for the purposes of the business activity are deductible to the extent they are not related to exempt income. See also Section V.i.

The Luxembourg law implementing ATAD 1 into domestic law (the ATAD 1 Law) introduced, inter alia, the IDLR, effective as of 1 January 2019. The main elements of the IDLR as contained in the ATAD 1 Law are summarised here below.

The concept of ‘exceeding borrowing costs’ is introduced. It means the excess, if any, of a Luxembourg taxpayer’s deductible interest (and economically equivalent) expenses over that taxpayer’s taxable interest (and economically equivalent) income. As a general rule, the deductibility of a taxpayer’s exceeding borrowing costs in a given fiscal year is capped at the higher of 30 per cent of such taxpayer’s EBITDA in such fiscal year or €3 million. ‘EBITDA’ is defined as the taxpayer’s net income (1) increased by its exceeding borrowing costs, depreciation and amortisation and (2) decreased by tax-exempt income and the expenses attributable to such exempt income.

The draft law contains a grandfathering provision, pursuant to which interest (and economically equivalent) expenses incurred in respect of loans that were concluded prior
to 17 June 2016 and that were not subsequently modified are not subject to the IDLR. In
addition, the following three categories of Luxembourg taxpayers are, inter alia, excluded
altogether from the application of the IDLR:

\[ \text{a} \quad \text{a taxpayer that constitutes a ‘financial undertaking’, which is, inter}
\text{alia, the case if the taxpayer is an alternative investment fund managed by an}
\text{alternative investment fund manager as defined in point (b) of Article 4(1) of}
\text{Directive 2011/61/EU;}
\]

\[ \text{b} \quad \text{a taxpayer that qualifies as a ‘stand-alone entity’, which means a taxpayer that is not}
\text{part of a consolidated group for financial accounting purposes and has no associated}
\text{enterprise and has no PE in another jurisdiction; and}
\]

\[ \text{c} \quad \text{a taxpayer that is a member of a consolidated group for financial accounting purposes}
\text{and, in short, the ratio of equity over total assets of the consolidated group does not}
\text{exceed the same ratio of the taxpayer by more than 2 percentage points.}
\]

### iii Restrictions on payments

Distributions can be made up to the amount of freely distributable reserves as shown in
approved financial statements after the accruals to the legal reserve required by the law are
thereto allocated. Under certain conditions, interim dividends can be distributed.

### iv Return of capital

In principle, repayments of share capital contributions are subject to a 15 per cent withholding
tax. However, such contributions can be repaid to the shareholders without triggering any
taxation to the extent that the share capital repaid was not formed by allocations of profit
reserves to the share capital, which are deemed to be distributed first and the share capital
reduction is supported by valid economic reasons. Repayments that correspond to profit
reserves allocations to the share capital or that are not supported by valid economic reasons
are considered, from the perspective of the shareholders, as income from capital.

The formal repayment of capital (i.e., share capital decrease by way of cancellation of
shares) is, however, subject to limits and procedures set by corporate law: the share capital
resulting from the repayment cannot be lower than the minimum share capital required by
the law (i.e., €12,000 for a SARL and €30,000 for an SA). A higher degree of flexibility can
be obtained through the provision of a share premium reserve.

From a tax perspective, the concepts of hidden capital contribution and of hidden
capital repayment are applied, under certain conditions. Both hidden capital contributions
and hidden capital repayments benefit from the tax treatment of formal contributions and
repayments irrespective of their different accounting treatment. As a typical example, a
shareholders’ debt waiver could be considered exempt from corporate income taxes if certain
features, typical of hidden capital contributions, are present.

### VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

#### i Acquisition

See Section VII for a general comment on funding structures.
ii Reorganisation
As a general rule, the assets of a resident company merged into (or demerged in favour of) another resident company or into a foreign company are deemed realised at market value, and are, therefore, fully taxable in Luxembourg.

Domestic and European reorganisations can be performed tax-neutrally to the extent that, broadly speaking, Luxembourg’s future taxing right on latent gains is not lost because of the reorganisation (e.g., a PE is maintained in Luxembourg to which part or all of the assets incorporating a latent gain are allocated). The taxation can, therefore, be deferred to the future actual realisation of latent gains.

For domestic mergers, tax neutrality is granted if the cash payment does not exceed 10 per cent of the face value of the share capital of the absorbed company; and the merger allows the future taxation in Luxembourg of latent capital gains.

For domestic demergers, tax neutrality is granted if, in addition to the conditions set out above for mergers, the shareholders of the divided company receive, in exchange for their participation, a proportional participation in each beneficiary company (i.e., ‘proportional demerger’); and the assets transferred include at least an autonomous business unit.

If the beneficiary of the merger or of the demerger maintains the book values of the assets and liabilities acquired, the historical acquisition dates can be maintained. This rule is relevant for the application of the participation exemption regime (e.g., the date of acquisition of the participation can be maintained by the company acquiring it by way of a merger or demerger).

The same neutrality regimes apply to mergers whereby a fully taxable resident company is absorbed by a company resident in a Member State, and to demergers whereby a fully taxable resident company is demerged into companies resident in other Member States.

iii Exit
As a general rule, when a domestic business (in an incorporated or unincorporated form) leaves Luxembourg’s tax jurisdiction, exit taxation applies. Under the current law provisions, a deferral for transfers to an EU or EEA jurisdiction is under certain conditions available for a five-year period.

When a resident company transfers its legal seat and its central administration abroad, the company is deemed liquidated, and capital gains accrued on its assets and liabilities are subject to tax. The migration can, however, be performed at book values, thereby deferring the capital gain taxation, when the assets of the migrating company are attributed to a domestic PE.

When a non-resident company disposes of or transfers abroad a domestic PE, the capital gains accrued on its assets and liabilities are subject to tax. A tax deferral can be obtained if the PE is transferred to a company resident in a Member State by way of a going concern contribution, merger or demerger; and the book values of the PE transferred are maintained by the acquiring company.

When the foreign PE of a domestic company is disposed of, the accrued capital gains on the assets and liabilities of such PE are subject to tax unless a tax treaty providing for the exemption of foreign PEs is in force with the country where the PE is located.

When an asset is attributed to a foreign (exempt) PE, it is debatable whether the Luxembourg head office is taxable on the deemed capital gain realised. The main position of the doctrine is that, even if the attribution of the asset should be booked at fair market value
according to the ‘separate entity approach’, the resulting capital gain is taxable only once the asset is actually disposed of by the company and to the extent a capital gain is actually realised.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

The taxpayer is free to choose the structure or the transaction that allows the most tax-efficient results. Nonetheless, the law provides that the tax benefits deriving from the use of forms and constructions that, even though formally permitted, are aimed at mitigating or evading taxes and lack further economic reasons, cannot be recognised. In such cases, taxes will be levied that correspond to the form or to the construction that would be reasonable and appropriate in consideration of the economic reality.

The above-described general anti-abuse rule was amended effective 1 January 2019, following the implementation into Luxembourg law of the ATAD 1. Following this amendment, it is in principle sufficient for a tax advantage to be one of the main purposes of the arrangement to be caught under the general anti-abuse rule. The wording of the new rule remains, however, close to the existing wording and will require case law to further refine its interpretation.

The civil law concept of simulation can also be used by the tax authorities to deny the tax benefits deriving from a certain transaction if it can be proved that the intention of the parties is to put in place a different, hidden transaction. In such a case, the tax effects of the latter will be applicable.

In an international setting, the applicability of some tax regimes (e.g., participation exemption) is conditional to the proof of a minimum level of effective taxation of the foreign entity involved.

ii Controlled foreign corporations (CFCs)

The ATAD 1 Law includes CFC rules, which provide that where a CFC has been put in place essentially for the purpose of obtaining a tax advantage, Luxembourg corporate taxpayers are taxed on the undistributed net income of a CFC, pro rata to their ownership or control of the foreign branch or the (directly and indirectly held) subsidiary, but only to the extent such income is related to significant functions carried out by the Luxembourg corporate taxpayer. To the extent that a Luxembourg company can establish, on the basis of adequate documentation of its activities or functions, or both, that it does not perform significant functions related to the CFC’s activities, the CFC rules should not have an adverse tax impact.

The above-mentioned CFC rules only apply for corporate income tax purposes and not for purposes of the municipal business tax.

iii Hybrid mismatch rules

On 19 December 2019, the Luxembourg Parliament voted the law implementing into domestic law the Council Directive (EU) 2017/952 (ATAD 2) extending the scope of ATAD 1 to hybrid mismatches situations arising between EU Member States and third states (the ATAD 2 Law). The ATAD 2 Law is effective to book years commencing on or after 1 January 2020 (except with respect for the reverse hybrid rules, which becomes effective 1 January 2022).
The ATAD 2 Law contains hybrid instrument mismatch rules that target the situation where a payment between associated enterprises made under a financial instrument gives rise to a deduction without inclusion, with such outcome being attributable to differences in the characterisation of the instrument or the payment made under it. As a result, if such a mismatch occurs, the EU Member State that is the payer jurisdiction will deny the tax deduction of the payment.

Next to the hybrid instrument mismatch rules, the ATAD 2 Law contains hybrid entity mismatch rules. A hybrid entity mismatch involves a payment made between associated enterprises to a hybrid entity that gives rise to a deduction without corresponding inclusion, with such outcome being attributable to differences in the allocation of payments made to the hybrid entity under the laws of Luxembourg and the jurisdiction of any person with a participation in that hybrid entity. In case such a mismatch would occur, the EU Member State that is the payer jurisdiction will deny the tax deduction of the payment.

Finally, the ATAD 2 Law also contains reverse hybrid rules. The reverse hybrid rules may come into play where one or more associated non-resident entities see a Luxembourg entity as non-transparent while this entity is regarded as transparent for Luxembourg tax purposes. Reverse hybrid rules, if applicable, could result in the partnership becoming subject to corporate income tax on all or part of its income to the extent allocable to the investors that see the Luxembourg entity as opaque.

vi Transfer pricing

In 2015, the arm’s-length principle, already applied in practice, was codified in Luxembourg tax law, and in 2016, a new article dealing with the main principles on which a transfer pricing functional analysis should be based (i.e., the commercial and financial relations between affiliated companies and the economically significant circumstances of these relations) was introduced.

In addition, an obligation was included in the law for taxpayers to be able to present transfer pricing documentation upon request of the tax authorities, substantiating the arm’s-length character of related-party transactions. The burden of proof therefore lies with the taxpayer in that respect.

A circular letter issued on 27 December 2016 (the Circular) by the Luxembourg tax authorities officially clarifies the criteria to be followed for the determination of arm’s-length remuneration on intra-group financing transactions. The Circular applies to group companies whose principal activity other than holding activities consists of intra-group financing transactions, which are defined as the granting of loans or advances to associated companies financed by any financial means. While the Circular does not address other intra-group situations, such as borrowing from an affiliate to acquire receivables in the market, the principles set out in it should also be largely relevant to those transactions.

Inter alia, the Circular highlights the main substantive requirements that a group financing company established in Luxembourg is required to meet to be able to enter into an advance pricing agreement (APA) with the tax authorities. In this respect, and among other

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17 Article 56 LIR.
18 Article 56 bis LIR.
19 Article 171(3) Abgabenordung.
substance requirements, the financing company should be adequately capitalised to face the
functions performed and the risks assumed in connection to its financing activity. As such,
the amount of equity that a financing company needs should be benchmarked.

Pursuant to the Circular, it is specified that the APA procedure will only be available for
intra-group financing companies that have sufficient substance in Luxembourg and bear the
risks linked to the financing activities. A Luxembourg company will be considered as having
sufficient substance if, broadly summarised:

a the majority of its directors or managers are Luxembourg residents and have the
capacity to take binding decisions for the company;
b personnel should have the understanding of risk management in relation to the
transactions carried out;
c the key decisions regarding its management are taken in Luxembourg, and at least one
shareholders’ meeting a year takes place there;
d it has a bank account in Luxembourg;
e it is not considered as tax-resident in another country;
f its equity should be sufficient for the functions it performs, the assets used and the risks
it assumes; and

g the financing company should have fulfilled its obligations regarding the filing of tax
returns at the time when it requests an APA.

Over the last few years, the European Commission has opened several investigations with
respect to EU Member States. Those investigations notably focus on the existence of illegal
state aid by way of ATA or APA (as defined below). Under the Treaty on the Functioning
of the European Union, illegal state aid is defined as (1) a measure granted through state
resources; (2) which distorts competition or threatens to do so; and (3) affects intra-group
EU trade favouring certain undertakings or the production of certain goods. Regarding
Luxembourg, the European Commission has, inter alia, taken the position that the transfer
pricing analysis performed by a Luxembourg company part of the Fiat group amounts to
illegal state aid;20 Luxembourg and Fiat appealed against decision with the EU General
Court. On 24 September 2019, the EU General Court upheld the European Commission’s
decision stating that Luxembourg granted selective tax advantages to Fiat.21 The judgment is
important as it explicitly confirms the possibility for the European Commission to verify the
arm’s length nature of transactions between related parties. At the same time, the judgment still
acknowledges that taxpayers and Member States have a margin of appreciation, considering
that transfer pricing inherently entails a degree of inaccuracy, so that an advantage only arises
when the variation between two comparables exceeds the inaccuracy inherent to the chosen
transfer pricing method. The outcome of the Fiat case may potentially impact the transfer
pricing practice in Luxembourg, especially where Luxembourg entities carrying on both
holding and financing activities are concerned.

v Tax clearances and rulings

On the basis of a written and motivated request by any taxpayer, the competent tax office will
issue an advance decision regarding the application of the Luxembourg tax laws to certain
operations described by the taxpayer (ATA). This decision would bind the tax office, albeit

20 Case SA.38375.
21 EU General Court judgments of 24 September 2019 in cases T-760/15 and T-636/16.
only with respect to the requesting taxpayer and limited to the concrete case described by the latter. The decision of the tax office will be taken on the basis of a uniform interpretation of the tax laws and the principle of equality. An administrative fee applies, ranging between €3,000 and €10,000, determined by the Luxembourg tax authorities on the basis of the complexity of the case concerned.

On 13 July 2016, a law on the mandatory automatic exchange of information in the field of taxation, implementing EU Council Directive 2015/2376 extending the scope of mandatory exchange of information on cross-border ATA and APA, was approved. As a consequence, the Luxembourg tax authorities will, as from 1 January 2017, exchange information on ATA and APA with other Member States of the EU with retroactive effect (the exchange applies to ATA and APA amended or renewed as from 1 January 2012, provided they were still valid on 1 January 2014). ATAs and APAs that involve only individuals or taxpayers with a low turnover (i.e., less than €40 million in the year preceding the issuance of the ATA or APA) are excluded.

X YEAR IN REVIEW

A relatively large number of changes were made to the Luxembourg tax laws in 2019, or are expected to still be adopted before year-end. To the extent not mentioned above, these changes include, for instance:

a On 13 October 2019, Luxembourg issued its 2020 budget bill of law. The budget law was voted by the parliament on 19 December 2019. The main relevant tax measure is the termination of the validity of all pre-2015 ATAs at the end of the 2019 fiscal year. Taxpayers affected by this measure would have the possibility to file new ATA requests in accordance with the procedure introduced in 2015.

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

c The CJEU recently issued several judgments dealing with the concepts of beneficial owner and abuse under the Parent-Subsidiary Directive and the Interest-Royalty payments Directive (EU 2003/49/EC). In the cases at hand, the targeted groups were using intermediate holding companies to benefit from the withholding tax exemption on interest payments/dividends on the basis of the above-mentioned directives. However, the CJEU denied the benefit from the Interest-Royalty payments Directive considering that the recipient companies of the interest payments were not the ultimate beneficial owners. The CJEU identified the beneficial owner as the entity that actually benefits

22 The four joined cases were all rendered on 26 February 2019 (case N Luxembourg 1 (C-115/16), X Denmark (C-118/16), C Denmark 1 (C-118/16) and Z Denmark case (C-299/16)), in addition to two additional joined cases (case T Denmark (C-116/16) and Y Denmark Aps (C-117/16)).
from that interest economically, and accordingly has the power to freely determine the use to which it is put. In addition, the judgments provide useful indicators on how to apply the abuse concept. It remains to be seen how these judgments will impact EU Member States’ tax authorities’ positions.

XI OUTLOOK AND CONCLUSIONS

Luxembourg is committed to continuing and extending its role as a major European financial centre, ensuring at the same time the transparency and, in general, compatibility with EU laws and principles of its own tax law. Outside the taxation arena, major initiatives are being undertaken in other fields, notably that of investment funds, one of the other main drivers in the financial area.
Appendix I: Domestic and treaty rates for dividend, interest and royalty payments

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<td>Domestic rates %</td>
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It is not uncommon for a tax treaty to establish more than one highest withholding tax rate applicable to the same item of income (e.g., dividends, interest or royalties). For instance, dividend withholding rates generally decrease when certain participation thresholds are reached. At the same time, interest paid by or to the government of one contracting state is frequently exempt from withholding tax. However, because each treaty is the result of the negotiation between Luxembourg and the relevant contracting state, it is not possible to define a common rule on the application of treaty rates. For more information, reference should be made to the specific tax treaty.23

On 7 June 2017, Luxembourg (together with 67 other jurisdictions) signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI). On 14 February 2019, Luxembourg Parliament adopted the law ratifying the MLI, which was then notified to the OECD on 9 April 2019. The entry into force of the MLI with respect to Luxembourg occurred on 1 August 2019. In terms of timing, however, owing to the required national ratification procedure in both jurisdictions that are party to a matching treaty, as well as the timetable provided in the MLI, large-scale effects are not expected prior to 1 January 2020 for taxes levied at source and for financial years starting on or after 1 February 2020 for all other taxes.

The purpose of the MLI is to introduce the BEPS principles in double tax treaties. Luxembourg declared that all the signed tax treaties currently in force will be seen as covered tax treaties for the purpose of the MLI. However, a large number of treaty partners have not signed yet the MLI (including the United States). Even though Luxembourg has made several reservations about the application of the MLI, which in most instances will be applied only as far as the ‘minimum standards’ are concerned, certain MLI provisions (e.g., the principal purpose test) will affect the application of the current double tax treaties.

Source: IBFD, Amsterdam, based on information available on 21 November 2019

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I INTRODUCTION

Malta has been experiencing strong and consistent growth in its financial services industry and is fast becoming the jurisdiction of choice for setting up business with access to the European Union (EU)’s Single Market, especially in the light of the Organisation for Economic Co-operation and Development (OECD)’s base erosion and profit shifting (BEPS) project and Brexit. Economically, Malta has continued to build on the success of previous years, posting an exceptionally strong performance; the real economy grew by 4.7 per cent in the first six months of 2019 and positive results have been achieved in various sectors, including local and foreign investment, tourism and exports. The public debt target of 60 per cent of GDP has been surpassed and stands at around 45.8 per cent, and is projected to continue to reduce to 40.4 per cent in 2020.

Malta’s tax system is based on UK principles, and enjoys the approval of the European Commission and Code of Conduct Group following Malta’s EU accession. In addition, Malta is a BEPS-compliant jurisdiction, being an associate in the OECD’s inclusive process and signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI). It is only through the application of its imputation tax system and tax refund system that Malta offers the lowest effective tax rate in the EU, without resorting to rulings, harmful tax practices, hybrid entities or structures, or stateless companies. Such transparency and compliance has resulted in numerous multinationals setting up operations in Malta to enjoy a tax and cost-efficient onshore jurisdiction. The application of the refund system is buttressed by a flexible participation exemption that ensures that dividends derived from qualifying entities (companies, limited partnerships and collective investment vehicles satisfying the necessary conditions) will be exempt in Malta. Malta’s tax system allows for peace of mind and tax-neutral repatriation, given that there are no withholding taxes on dividend distributions to non-residents (as well as on interest and royalty payments). Over and above this, Malta enjoys a wide and favourable treaty network based on the OECD Model, with full exchange of information provisions. Malta is a transparent and cooperative jurisdiction, having implemented the automated exchange of information standard on tax matters as promoted by the OECD and adopted by the EU, namely the Common Reporting Standard (CRS), in its domestic law. It is also one of the first jurisdictions to have issued tax guidelines clarifying the tax treatment of transactions in distributed ledger technologies and cryptocurrencies.

1 Juanita Brockdorff is a partner and Michail Tegos is an associate director at KPMG Malta.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate
As a general rule, businesses in Malta adopt a corporate form. The most frequently used forms are private and public limited companies. Such entities have a separate legal personality and are taxed as separate legal entities. The main difference between these two corporate forms is that the private limited company is designed for a limited number of shareholders, while the public company is not. In addition, shares in a private limited company may not be freely transferred to third parties and a private limited company may also not issue shares to the public, unlike a public company.

ii Non-corporate
Limited partnerships are becoming more popular. Legislation provides for a general and a limited partnership. While a general partnership is suitable where all partners or members expect to be involved in the management of the business, a limited partnership is more commonly used when one partner (the general partner) manages the business and the other partners are passive investors. A limited partnership, the capital of which is divided into shares, is considered to be a separate legal entity. Malta has legislation that permits certain partnerships (including foreign partnerships) to opt for transparent or opaque treatment. Limited partnerships are popular for asset management structures. Foundations are becoming increasingly popular for holding business interests.

III DIRECT TAXATION OF BUSINESSES
A Maltese company or its equivalent, including a foreign company with a permanent establishment in Malta, pays tax in Malta on its profits at a rate of 35 per cent.

Should it be profitable and distribute dividends, following the distribution of dividends from taxed profits, shareholders (without distinction as to the nature of such members) are entitled to claim a partial tax refund by virtue of the operation of the imputation credit system. The most common tax refund consists of six-sevenths of the tax charge borne on the distributed profits before deducting any relief of foreign tax. This translates to an effective tax leakage of 5 per cent. Although the quantum of the tax refund depends on the nature of the income and whether double tax relief is claimed, the overall tax in Malta after tax refund will be between zero and 5 per cent.

For partnerships that opt to be treated as look-through, tax is levied on the partners at their rates reaching a maximum of 35 per cent, and subject to treaty protection.

i Tax on profits

Determination of taxable profit
Taxable profits are based on accounting profits, consisting of the profits reported in the company’s audited financial statements following adjustment for non-deductible expenses and non-taxable income. Business profits are taxed on an accruals basis, while investment income is taxed on a receipts basis.

Expenses wholly and exclusively incurred in the production of income are deductible from the taxable base. In general, business expenditure of a revenue or recurrent nature is normally deductible, while that of a capital nature is not (with the exception of depreciation
for plant and machinery and industrial buildings and structures). A minimum number of years for tax depreciation and amortisation rates are established by statute and vary according to the estimated useful life of, and hence the nature of the asset, used in the business.

While a company incorporated in Malta is taxable in Malta on its worldwide income, companies incorporated outside Malta that have their tax residence in Malta when the control and management of their business are exercised in Malta (known as resident but not domiciled companies) are subject to tax in Malta on income or capital gains arising in Malta, and income arising outside Malta is taxable in Malta to the extent that it is received in Malta, whereas capital gains arising outside Malta are not taxable.

**Capital and income**

Capital profit is not taxed generally, but only specific items of capital gains are subject to tax, namely such as derived from the transfer of real estate and real rights, securities, business, goodwill, business permits and intellectual property; and interest in a partnership.

In general, a company's gains on the transfer of capital assets are aggregated with its other income, and the total income and capital gains are charged to income tax at the standard rate. The basic rules for the computation of capital gains and losses require the determination of the gain realised on the transfer by deducting from the actual consideration received or deemed to have been received the cost to the transferor for the acquisition of the asset being transferred.

**Losses**

Trade losses may be set off against income and carried forward indefinitely and set off against the income of the following years (with the exception of losses arising because of depreciation, which can only be set off against the profits of the same and continuing trade), but no carry-back of losses is allowed. Capital losses may be set off only against capital gains. Losses can survive a change in ownership on condition that the same business is continued and no abuse is contemplated.

**Rates**

A Maltese company or its equivalent, including a foreign company with a permanent establishment in Malta, pays tax in Malta on its profits at a rate of 35 per cent, as explained above.

**Administration**

Company tax returns must typically be submitted within nine months from the financial year-end or 31 March of the following year, whichever date is the later. Companies must retain proper and sufficient records of their income and expenditure, and are required to submit together with their tax return a balance sheet and profit and loss account accompanied by a report made out by a certified public auditor. Financial statements are prepared in accordance with international financial reporting standards or the local generally accepted accounting principles.

Malta operates a self-assessment tax return regime for all taxpayers. The degree of scrutiny of returns and the likelihood of investigation will be affected by the tax authorities' risk assessment of the taxpayer rather than by a defined cycle of enquiry.
Appeals against assessments are made by means of an objection in writing to the Commissioner for Revenue, to be submitted within 30 days from the date on which a notice of assessment is served on the taxpayer. If no agreement is reached between the taxpayer and the Commissioner for Revenue at objection stage, an appeal may then be lodged with the Administrative Review Tribunal within 30 days of the service of the notice of refusal. An appeal may be made to the Court of Appeal within 30 days from the date when the Tribunal’s decision was notified to the parties and may only be made on a point of law.

Rulings are not and cannot be obtained to establish the tax base or to negotiate a transfer price, and thus cannot be used to harmful ends. Malta also exchanges its rulings under the EU’s relevant legislation.

**Tax grouping**

Group relief provisions allow for the surrender of tax losses between group companies. Two companies are considered to be members of a group of companies if they are both resident in Malta and not resident for tax purposes in any other country, and where one company is the 51 per cent subsidiary of the other or both companies are 51 per cent subsidiaries of a third company resident in Malta and not resident for tax purposes in any other country.

Intra-group transfer of capital assets is governed by a tax deferral until final disposal to unrelated parties. Dividends move intra-group in a tax-neutral fashion attracting no double or multiple economic taxation owing to the full imputation system.

Following the issue of the Consolidated Group (Income Tax) Rules (LN 110 of 2019 on 31 May 2019) Malta introduced fiscal unit rules enabling, for the first time the formation of a tax group for Maltese income tax purposes. Members of the fiscal unit may be either Maltese companies or foreign entities that fall within the definition of ‘company’ for the purposes of the Income Tax Act, provided that the parent company (the principal taxpayer) holds at least 95 per cent of two of the following rights: voting rights, profits available for distribution, or assets available for distribution upon winding up, in its subsidiaries (the transparent subsidiaries). Such election is possible provided that the accounting periods of all the members are the same and subject to the consent of minority shareholders, if any. While the election is at the option of the principal taxpayer, once made any underlying qualifying subsidiaries will join the fiscal unit automatically. On the other hand, the fiscal group may be unwound by the principal taxpayer, and any subsidiary may leave the group.

Unlike the group relief provisions, tax consolidation provides for a full integration of the tax position of its members. As a result, intragroup transactions (excluding transfers related to immovable property situated in Malta) are disregarded for tax purposes. The main benefit of the fiscal unit arises from the cash flow advantage when compared to the current operation of the partial shareholder tax refunds. Through the fiscal unit the group may achieve an identical effective tax rate without the time lapse between the payment of the standard corporate income tax rate of 35 per cent and the receipt of the shareholder refund at the level of the shareholder as the new rules will immediately reduce the tax due by the principal taxpayer to the lower effective tax rate. From a practical perspective, tax shall be payable by the principal taxpayer on behalf of all members of the group and only one tax return will be filed. Principal taxpayers are also responsible for the preparation of a consolidated balance sheet and consolidated profit and loss account covering all the companies in the fiscal unit. The fiscal unit is subject to certain anti-abuse measures.
ii Other relevant taxes

Malta, as an EU Member State, is part of the harmonised EU VAT system. Malta’s standard VAT rate is 18 per cent. Malta also applies reduced rates (5 and 7 per cent) to various goods and services. With effect from 1 June 2018, Malta introduced VAT grouping, whereby two or more legal persons, at least one of which operates within the financial or gaming sectors, may opt to be treated as a single taxable person for VAT purposes.

Malta has stamp duty legislation. However, exemptions are available, for instance, for intra-group transactions. Maltese stamp duty consists of a tax on documents evidencing transfers of real estate and real rights, securities or an interest in a partnership. Duty is chargeable on the higher of the amount of consideration and the market value.

There are no capital duties, net wealth or turnover taxes for incorporated businesses in Malta.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

While companies that are incorporated in Malta are considered to be resident in Malta, companies that are not incorporated in Malta are considered to be resident in Malta when the control and management of their business are exercised in Malta. While the terms ‘management and control’ are not defined in Maltese law, on the basis of UK jurisprudence, which is generally followed in Malta, a company is regarded as being managed and controlled in Malta if key strategic or commercial decisions are made in Malta. Thus, where a company would prefer avoiding becoming fiscally resident in Malta it would not hold board meetings in Malta. From a Maltese tax perspective, it is possible to transfer the tax residence of an entity by changing the place of control and management of the entity. It is also possible to transfer the legal seat in and out of Malta. On taking up tax residence in Malta or redomiciling to Malta, an entity is allowed to increase the tax base cost of its assets up to market value.

ii Branch or permanent establishment

A foreign entity can establish a tax presence in Malta where it creates a branch, agency or similar permanent establishment in Malta, in that the general rule is that income derived from trading in Malta is taxable, while trading with Malta is not. Generally, income and gains arise from trading in Malta where they are derived from the carrying on of some activity in Malta, such as providing services in, negotiating a transaction in or renting property situated in Malta. While the term permanent establishment is referred to, it is not defined under domestic law, and as such, taxation is governed by the source basis as indicated above subject to the protection and application of tax treaties. Most of Malta’s treaties currently adopt the OECD Model Tax Convention (2014) definition of the term permanent establishment with certain variations, and thus afford the corresponding protection of the permanent establishment threshold and tiebreakers for establishing treaty residence.
V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
Malta is a popular holding domicile because of the fact that it adopts a flexible 100 per cent participation exemption on profits derived from a qualifying company (namely dividends) and from the transfer thereof (namely gains). To benefit from said participation exemption, the Maltese company’s holding must entitle it (in substance or form) to any two of the following rights (known as ‘equity holding rights’): a right to vote; a right to profits available for distribution; and a right to assets available for distribution on a winding-up of such company. Typically, as with most participation exemption jurisdictions, Malta has an ownership test that is set at 5 per cent. However, such test does not require a minimum holding period. Furthermore, where the ownership test is not fulfilled, the participation exemption may be acceded by satisfying alternative conditions, including a holding with an acquisition value of €1.164 million held for an uninterrupted period of 183 days, or one that entitles the holder to a right to sit upon, or appoint a director to, the board, or to a right to purchase the remainder of the capital.

While the participation exemption is typically available where a Maltese company holds shares in a subsidiary (or a foreign partnership that opts to be treated as a company for Maltese tax purposes), it may also be availed of when the Maltese company is a partner in a limited partnership similar to a Maltese limited partnership, or where the Maltese company is an investor in a collective investment vehicle that provides for limited liability of its investors.

With respect to dividends, the participation exemption is applicable where the qualifying company is resident or incorporated in the EU, or is subject to a 15 per cent minimum tax rate, or has a maximum of 50 per cent its income derived from passive interest or royalties, or is not held as a portfolio investment and it would have been subject to tax at a rate of at least 5 per cent. The exemption on dividends received from participating holdings in an EU Member State is available to the extent that such dividends would not have been tax-deducted by the relevant subsidiary in that other Member State.

The exemption method is extended equally to income attributable to a permanent establishment outside Malta of a Maltese company and gains derived from the transfer of such permanent establishment.

No withholding tax is levied on dividends paid to non-resident shareholders, who in addition may dispose of their shares in the holding company without incurring a tax liability where the holding company does not own, directly or indirectly, real estate in Malta.

ii IP regimes
Royalties and similar income can obtain the equivalent of an innovation or patent box exemption where, by being subject to the general tax system, such income is subject to tax at the standard rate, and any profits derived therefrom distributed to the company’s shareholders would benefit from the tax refund system. Such refund would allow for an ordinary foreign tax credit such that no tax leakage would occur where withholding taxes suffered on such income would amount to 5 per cent or more. In the light of the BEPS project’s modified nexus approach, it is advisable that development, enhancement, maintenance, protection, and exploitation of intangibles functions are performed in Malta.
Following the issue of LN 208 of 2019 on 13 August 2019, Malta introduced patent box deduction rules, which allow taxpayers actively involved in the development and exploitation of IP to opt for the application of special rules on calculating deductions ('Patent Box Deduction').

The Maltese Patent Box Deduction allows taxpayers that exploit qualifying IP to deduct their expenses related to such IP in terms of more favourable conditions than provided by the general deduction formula. The Patent Box Deduction is calculated based on the following formula: 95 per cent (qualifying IP expenditure / total IP expenditure) × income or gains from qualifying IP. Where:

- total IP expenditure includes all expenditure directly incurred in the acquisition, creation, development, improvement or protection of the qualifying IP; and
- qualifying IP expenditure is equivalent to total IP expenditure excluding certain types of expenses, particularly acquisition cost of IP and costs paid to related parties for the development of qualifying IP.

The above deduction may be applied against income or gains from qualifying IP derived on or after 1 January 2019.

Only income or expenses from IP that meet the definition of ‘qualifying IP’ are eligible for the Patent Box Deduction. Qualifying IP includes the following categories of intangibles, provided that in any case the qualifying IP is granted legal protection in at least one jurisdiction:

- patents, including patents pending issuance/extension;
- non-patent IP protected by legislation (including those related to plant and genetic materials and plant/crop protection products);
- orphan drug designations, utility models and software protected by copyright; and
- intellectual property assets that are non-obvious, useful, novel and that have features similar to those of patents. Only those holders who are regarded as ‘small entities’ (i.e., entities with group turnover of up to €50 million and gross IP revenue of up to €7.5 million) are eligible to use such IP for the purpose of the Patent Box Deduction.

Marketing-related IP assets including brands, trademarks and tradenames are not considered as qualifying IP, and thus fall outside the scope of the new rules. Moreover, companies that are involved purely in holding and marketing IP without active development will have to set up R&D activities to be eligible to benefit from the new Patent Box Rules.

The Patent Box Deduction rules target taxpayers that are involved in the active exploitation of IP. The eligible beneficiary should satisfy the following conditions:

- be able to demonstrate that all important functions in relation to creation, development, improvement or protection of the qualifying IP are carried out by such beneficiary, solely or in cooperation under the terms of a cost sharing agreement, either directly; or
  - through a permanent establishment situated in a jurisdiction other than that of the beneficiary (provided that income of such permanent establishment is subject to tax in the jurisdiction of residence of the beneficiary); or
  - through other enterprises (and employees of other enterprises) provided that such functions are performed under the specific directions of the entity claiming the benefit.
b legally own qualifying IP or hold an exclusive licence in respect of such IP. If the IP is developed under a cost sharing agreement, the entity must own a share in the ownership of the qualifying IP or be the holder of an exclusive licence;
c the entity must be specifically empowered to receive income from qualifying IP; and
d have a sufficient level of substance in the jurisdictions where activities in respect of the qualifying IP are being carried out.

The new Patent Box Deduction rules are based on the nexus approach as developed by the OECD, which requires a direct link between the benefits derived from favourable taxation and actual R&D activities. Only taxpayers engaged in the development of IP (either themselves or through independent subcontractors) may benefit from the Patent Box Deduction. The Patent Box Deduction rules exclude the application of the new deduction formula by taxpayers whose functions do not go beyond pure holding, deriving passive royalty income without contributing (directly or indirectly) to the development of the IP.

iii State aid
To promote innovation, special R&D incentives are aimed at providing assistance to enterprises in respect of eligible expenditure incurred on industrial research and experimental development projects to develop innovative products and solutions. Eligible expenditure includes personnel costs, costs of instruments and equipment, costs of building, and costs of contractual research, technical knowledge and patents. The maximum level of assistance that may be provided varies from 25 to 70 per cent depending on the size of the company and the nature of the R&D project in line with the EU's state aid guidelines.

On 17 December 2017, the European Commission conditionally approved the Maltese tonnage tax rules for a period of 10 years. The compatibility of the Maltese tonnage tax rules with EU state aid rules will further strengthen the reliability and confidence of shipowners and ship managers towards the Maltese flag and its supporting legislative framework. Such rules bring clarity with respect to those activities eligible under the tonnage tax exemption, now distinguishing shipping activities from ancillary services. Moreover, further clarity is brought with respect to ship management activities through the possibility for these to operate non-EU flagged vessels from the EU. The activity of dredgers and tonnage boats together with a definition of intra-group bareboat out activities was an additional novelty. The Maltese flag of confidence, and not convenience, at present has the largest fleet in Europe and the sixth-largest worldwide.

iv Blockchain and cryptocurrencies
The government of Malta created the Malta Digital Innovation Authority for robust and investor-friendly oversight in relation to blockchain, distributed ledger technology and artificial intelligence. The Maltese tax authorities have issued guidelines to address and clarify the income tax, VAT and stamp duty implications arising in connection with digital assets and cryptocurrencies. Foundations established in Malta may as of 2018 issue and deal in digital tokens.

v Insurance and funds
Malta has a long history in the insurance business dating to covering maritime risks, and in more recent times it has become a domicile of choice for setting up insurance undertakings, serviced by global insurance managers present locally, especially in the light of Brexit.
Similarly, it is a preferred domicile for investment funds, be they retail funds or alternative investment funds. Besides the fact that funds invested overseas are completely exempt from tax, Malta does not impose any tax on the net asset value of the fund. In addition, the licensing procedure, which is based on EU norms, is mindful and reactive to clients’ needs. Securitisation vehicles are growing in number, with the special vehicle being recognised and not requiring a licence while having equal access to tax neutrality. Indeed, Malta is reportedly the fastest-growing securitisation jurisdiction within Europe, with key benefits including, inter alia, bankruptcy remoteness, limited litigious recourse, and privileged claims of investors and securitisation creditors by operation of law, not merely contract.

vi Notional interest deduction

Notional interest deduction (NID) was introduced to achieve an equal treatment of debt and equity financing, by granting an additional deduction for the return on equity financing. In addition, the NID may simplify matters within Malta’s full imputation system in view of the resulting reduction in the imputation credits resulting from claiming the NID.

The NID is optional and can be claimed by companies and partnerships resident in Malta (including Maltese permanent establishments of foreign entities) against their chargeable income for the year. The NID is calculated by multiplying the deemed notional interest rate by the balance of risk capital that the undertaking has at year-end. The notional interest rate is the risk-free rate set on Malta government stocks with a remaining term of approximately 20 (which is currently approximately 2 per cent) years plus a premium of 5 per cent. The NID would thus currently be expected to be about 7 per cent. Risk capital includes share capital, share premium, reserves, interest free loans and any other item that is shown as equity in the financial statements as at year end. The maximum deduction in any given year cannot exceed 90 per cent of chargeable income before deducting the NID. Any excess can then be carried forward to the following year. Any remaining chargeable income is subject to tax at the standard rates. When a company or partnership claims a NID, the shareholder or partner is deemed (for tax purposes) to have received the corresponding notional interest income from the company or partnership. Distribution of profits relieved from tax by the NID, however, will not be charged to tax. The legislation includes an anti-abuse provision to prevent abuses of the NID. Malta’s NID has been declared as not constituting a harmful practice by the EU’s Code of Conduct Group (Business Taxation).

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

There are no domestic law withholding taxes for payments of dividends, interest or royalties to a non-resident to the extent that the non-resident does not have a taxable presence in Malta (either in the form of the management and control being in Malta or having a permanent establishment in Malta) and the non-resident is not owned and controlled by, directly or indirectly, or acts on behalf of, a person who is ordinarily resident and domiciled in Malta.
ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Relief from withholding taxes emanates from domestic law and is not dependent on tax treaties. Nevertheless, Malta has adopted the EU Parent–Subsidiary Directive and Interest and Royalties Directive.

iii Double tax treaties

Malta has around 75 tax treaties currently in force, which are mainly drafted in accordance with the OECD Model Tax Convention (2014), while further treaties are being negotiated. Malta has signed the MLI with approximately 75 per cent of its treaty network potentially affected. Depending on the other Contracting State, the MLI could enter into effect for Malta as early as 1 January 2020. Given that Malta does not have withholding taxes on outbound investment income, the withholding tax rate in such treaties invariably will be zero. While Malta provides domestically for an ordinary foreign tax credit (in addition to a participation exemption where applicable), treaties will operate so as to match double tax relief on non-local withholding on inward payments of dividends, interest and royalties to a resident.

iv Taxation on receipt

Malta has a full imputation tax system that completely eliminates the economic double taxation of company profits. Shareholders in receipt of dividends are entitled to a tax credit equal to the tax borne on the profits out of which the dividends are paid. Although Malta is a credit country, economic double taxation relief has been extended to foreign dividends received. In addition, principles of exemption have been used as explained in the holding company regime.

Thus, Maltese tax law provides for three main forms of double taxation relief of foreign-source income, available in the following order: treaty relief, unilateral relief and flat rate foreign tax credit.

Treaty relief takes the form of a tax credit granted for foreign tax paid on income received from a country with which Malta has signed a tax treaty. The amount of the credit is the lower of Maltese tax on the foreign income and the foreign tax paid. Unilateral relief operates in a similar way to treaty relief, but it only applies where treaty relief is not available. The rationale of the full imputation tax system is also extended in relation to foreign companies by extending the unilateral relief to the underlying tax borne by the foreign company on the profits out of which dividends are paid to a Maltese resident (economic double tax relief). Relief for such underlying tax is available in respect of dividends received from any shareholding in a foreign company and also in respect of the underlying tax paid by any subsidiaries in which the foreign company holds, directly or indirectly, at least 5 per cent of the voting rights. The flat rate foreign tax credit is another form of unilateral relief available to companies, taking the form of a tax credit for foreign taxes deemed to have been suffered on qualifying income and equal to 25 per cent of the net amount received.

2 For more information on Maltese withholding tax rates, see home.kpmg.com/mt/en/home/insights/2016/02/malta-double-tax-treaties.html.
VII TAXATION OF FUNDING STRUCTURES

In Malta, both equity funding and debt funding are beneficial from a tax perspective. Equity funding (including non-statutory equity such as shareholders’ contributions) will maximise the notional interest deduction, while debt funding (including profit-participating loans, which are regarded as pure debt for Maltese tax purposes) will allow the deduction of actual interest expenses. Entities are commonly funded with a mix of equity and debt.

i Thin capitalisation

Malta has a general anti-avoidance rule, and while it does not have transfer pricing legislation, on loan-in, loan-out arrangements a tax-profitable margin is expected aligning the Maltese entity’s return with the business or entrepreneurial risks it assumes. Malta implemented the EU’s Anti-Tax Avoidance Directive (ATAD, 2016/1164), and specifically the interest limitation rules came into force on 1 January 2019. Exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30 per cent of the taxpayer’s earnings before interest, tax, depreciation and amortisation (EBITDA). Exceeding borrowing costs refer to net interest expense (broadly, interest income less interest expense on all forms of debt and other costs economically equivalent to interest and expenses incurred in connection with the raising of finance).

The legislation includes opt outs in relation to a de minimis threshold (exceeding borrowing costs up to €3 million can be deducted), a stand-alone entity exemption (not being part of a group of companies), grandfathering of loans concluded before 17 June 2016, an exclusion from scope of long-term infrastructure projects that are considered to be in the general public interest, as well as allows a group to equity ratio carveout. This limitation will also not apply to financial undertakings (credit institutions, insurance and reinsurance companies, occupational retirement pension funds, EU social security pension schemes, alternative investment fund managers, alternative investment funds, undertaking for collective investment in transferable securities funds and over-the-counter derivative counterparties).

Taxpayers may carry forward, without time limitation, exceeding borrowing costs and, for a maximum of five years, unused interest capacity, which cannot be deducted in the current tax period.

ii Deduction of finance costs

Finance costs can be deducted in that interest incurred in obtaining capital to generate income will be tax-deductible against the income so generated. The general rule is that expenses wholly and exclusively incurred in the production of income are deductible from the taxable base. Hence, business expenditure of a revenue or recurrent nature is normally deductible, while that of a capital nature is not.

iii Restrictions on payments

A Maltese company is only able to distribute dividends to its shareholder or shareholders if it has enough distributable reserves in terms of company law – that is, if after the distribution the company would still be solvent.
iv Return of capital
A reduction of share capital is tax-neutral in Malta; however, company law requirements need to be adhered to (a lapse of three months from publication of reduction being a main requirement). Equity funding can also be achieved with other means that do not require reduction of share capital, such as a shareholders’ capital contribution.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Typically, acquisitions are structured as asset or share purchases, which have different tax consequences for the seller and purchaser. In a share deal involving a company that does not own non-business Maltese real estate, a seller who is not resident in Malta has no exposure to tax on capital gains. By contrast, an asset deal involving a Maltese business owned by a company resident and domiciled in Malta normally exposes the company to tax on capital gains from the transfer of the business and the recapture of previously claimed tax depreciation. For the purchaser, an asset deal generally may present advantages in that the tax depreciation is calculated on the amounts at which assets are acquired, avoiding the need to undertake extensive due diligence regarding the assets, liabilities and obligations inherent in acquiring a company.

ii Reorganisation
Mergers, both domestic and cross-border in the EU, allow for tax deferral. Maltese legislation provides for an exemption from capital gains tax where assets are transferred between companies that are deemed to be a ‘group of companies’. A ‘group of companies’ is defined to include companies that are controlled and beneficially owned directly or indirectly as to more than 50 per cent by the same shareholders. This is further qualified for intra-group transfers of immovable property situated in Malta or securities in a property company (essentially defined as a company that owns immovable property in Malta, directly or indirectly, through its shareholdings in other bodies of persons). In this case, the ultimate beneficial shareholders of the transferor and transferee companies must be substantially the same, with only a 20 per cent variance in each individual's shareholding in the two companies. Where the applicable conditions are met, no loss or gain is deemed to have arisen from the transfer. The cost base of the assets does not increase for tax purposes, but the tax on the capital gain is deferred until a subsequent transfer outside the group.

iii Exit
There are no exit taxes in Malta. Therefore, transfer of tax residence, transfer of legal seat and liquidation can be done tax neutrally in Malta. However, ATAD contains exit tax rules and Malta introduced the same to come into force on 1 January 2020. The rules provide the taxation of capital gains arising upon the transfer of assets, and the subsequent loss of right to tax any arising capital gains, in the following circumstances:

a a transfer of assets from a head office located in Malta to a permanent establishment in another jurisdiction and vice versa;

b a transfer of residence of a Maltese resident entity to another jurisdiction (to the exclusion of assets that remain effectively connected to a Maltese permanent establishment); and
a transfer of business carried on in Malta by the taxpayer’s permanent establishment, to another jurisdiction.

The transposed law, in an identical manner to ATAD, prescribes an immediate payment of the due tax with the possibility of payment in instalments over the period of five years in cases of transfers to an EU Member State or to a party to the European Economic Area Agreement, which might possibly require providing a guarantee.

The introduction of exit taxation in Maltese corporate income tax law is novel; however, coupled with the application of the step up of the value of assets at time of transfer to or from Malta, there should be no resultant double taxation.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

The taxpayer is free to choose the structure or the transaction that allows the most tax-efficient results subject to the Maltese anti-avoidance rules, which are statutory rather than judicial. A general anti-abuse rule (GAAR) is intended to preserve the integrity of the Maltese income tax base by vesting the Commissioner for Revenue with broad discretion to disregard certain schemes and transactions that reduce the amount of tax payable by a taxpayer. Additionally, should a taxpayer implement any scheme with the sole or main purpose of avoiding, reducing or postponing liability to Maltese tax, or of obtaining any refund or set-off of tax, the Commissioner for Revenue is entitled, by an order made in writing, to subject the taxpayer to tax so as to effectively nullify or modify the scheme and the consequent advantage. Several specific anti-abuse provisions are found throughout the Maltese legislation in an attempt to prohibit very specific or particular forms of activity.

The transposition of ATAD has widened the application of the existing GAAR by including an additional rule, addressing any arrangements that are put into place with the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law and are thus not genuine when having regard to all the relevant facts and circumstances. The ATAD GAAR will therefore target all non-genuine transactions (to the extent that they are not put in place for valid commercial reasons that reflect economic reality) performed in a domestic or a cross-border situation.

Albeit the wording of the ATAD GAAR is broader, reflecting the wording used in the long-standing GAAR in the Merger Directive, an analysis of case law construing the latter conveys that the Court of Justice of the EU has applied a strict interpretation thereof, requiring an essential or sole purpose. The result is that such interpretation may assimilate its effect to that under the current existing GAAR at least to the extent coupled with economic substance.

ii Controlled foreign corporations (CFCs)

In view of ATAD, Malta introduced CFC rules entering into force on 1 January 2019. Based on the CFC rules, income derived by subsidiaries or attributed to permanent establishments may in certain circumstances be taxed in Malta as the jurisdiction of the parent or head office. The formal cumulative conditions for the CFC rule to apply are:
a in the case of an entity, where the Maltese taxpayer alone or together with associated entities holds a direct or indirect participation of more than 50 per cent of the voting rights, or of the capital or is entitled to receive more than 50 per cent of the profits of such entity;
b the corporate income tax (CIT) paid by the non-resident entity or permanent establishment is less than 50 per cent of CIT payable if it were resident in Malta; and
c exceeding the minimum thresholds (non-resident entity or permanent establishment with accounting profits less than €750,000 or with accounting profits equal to less than 10 per cent of its operating costs).

If the above-mentioned conditions are fulfilled, the non-distributed income of the CFC may be included in the tax base of the Maltese parent, or Maltese head office, where the income arises from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage. There should be no CFC charge where there are no significant people functions in Malta that are instrumental in generating the income of the CFC.

iii Transfer pricing
To date, Malta does not have transfer pricing legislation, but certain anti-abuse provisions may be applicable.

iv Tax clearances and rulings
Rulings are not and cannot be obtained to establish the tax base or negotiate a transfer price, and thus cannot be used to harmful ends. Although tax principles are well founded on UK tax principles, it is possible that the tax treatment of transactions and structures be confirmed in writing by the Maltese tax authorities. This is especially useful for somewhat complex transactions and structures, because it provides certainty of the tax treatment that will be adopted. An advance revenue ruling is valid for five years and can be renewed for another five-year period. A ruling will remain binding on the tax authorities for a period of two years from the time of any change in legislation affecting the ruling.

X YEAR IN REVIEW
When considering anti-BEPS rules, Malta considers that before bringing in further new rules (which are changing the international tax systems), sufficient time ought to be dedicated to test the operation of these new rules, as otherwise Malta and the EU run a substantial risk of having a disjointed system that ultimately will not work and will divert businesses to third countries. We expect shortly the implementation of the Anti-Tax Avoidance Directive 2 (2017/952) and the Mandatory Disclosure Directive (2018/822) into Maltese legislation.

XI OUTLOOK AND CONCLUSIONS
Malta is committed to continuing and extending its role as a major European financial centre, ensuring at the same time transparency and compatibility with EU laws.
Chapter 20

MEXICO

Eduardo Barrón

I INTRODUCTION

Mexico’s federal tax system is principally based on three taxes: income tax, value added tax (VAT), and special tax on production and services (IEPS, per its acronym in Spanish). Other taxes exist, but these three taxes constitute the principal source of tax revenue for the government, which is significantly supplemented with oil and energy-related revenue.

While aspects, some significant, naturally change over time, this system has generally been consistent in its structure and the key content of the relevant tax laws, Mexico’s Income Tax Law (MITL) and VAT Law. In this chapter, we focus on those consistent characteristics as of 2019, and also refer to recent changes because of a recently approved federal tax reform by a new administration, which incorporates general anti-avoidance rules adopting principles of the base erosion and profit shifting (BEPS) action plan, as well as new tax legislation on businesses performed through digital platforms.

Mexico has a significant double taxation agreement (DTA) network. Additionally, it has 30 agreements in force for the reciprocal protection of investments and free trade agreements with 46 countries, and has been active in the negotiation of the Trans-Pacific Partnership Agreement. These conditions, and its geographic proximity with the United States, have allowed the country to perform industrial hub functions, with particular success in the automotive industry.

Mexico is predominantly a capital-importing country, and its tax system (including common characteristics of its DTAs) reflects this. However, over recent years leading Mexican business groups have consistently looked for opportunities abroad, therefore outbound capital movements have also become relevant.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

From a commercial perspective, the stock company (SA) has prevailed for a long time now over other commercial company types established in Mexico’s General Law of Commercial Companies. This type of company requires a minimum of two shareholders, can be administered through a board of directors or a sole administrator, and requires an internal

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1 Eduardo Barrón is an international tax partner at Deloitte Impuestos y Servicios Legales, SC (Deloitte Mexico). The author would like to thank Carl E Koller Lucio for his assistance in preparing this chapter.
audit organ. A minimum paid-in capital is no longer established, although a minimum of 20 per cent of that established in the company’s by-laws must be effectively paid in at the time of incorporation.

More recently, the investment-promoting SA (or SAPI), introduced as part of the Law of the Stock Exchange in December 2005, gained favour as a versatile vehicle for co-investing parties. In particular, the SAPI allows for shareholders’ agreements and concepts such as tag-along and drag-along rights and obligations, series of shares with special or restricted rights, and special rules regarding entry and exit of shareholders. Shareholder rights are not opposable to the share-issuing company as a third party, although this situation may be altered if the company itself is a party to the shareholders’ agreement.

Given the SAPI’s success, the traditional SA was overhauled through amendments published in June 2014, and a number of the SAPI’s more attractive aspects, such as those mentioned above, are now statutorily available for the ordinary SA, although differences remain.

For closely held commercial companies, an attractive alternative, given its easier corporate compliance requirements and simpler company statutes, is the limited liability company (SRL). As in the case of the SA, a minimum of two partners is required; however, a maximum of 50 partners applies. SRLs cannot issue shares, although they can issue non-negotiable certificates reporting participation in the company. Unlike the SA, the SRL’s members may decide whether the company will have an internal audit organ. As a matter of law, and not of special by-law rules or shareholders’ agreements, the members of an SRL have a say on who may become a new member in the SRL, as well as a correlative right of first refusal. By-laws can regulate the payment of supplementary capital contributions to the company.

As regards commercial activities, the SA, SAPI and SRL can carry out the same acts and activities; however, for certain areas, such as the financial sector, an SA may be required.

Nonetheless, for companies planning to carry out financial activities, a multiple object financial company (SOFOM) can grant credit to the public from various sectors and perform operations of financial leasing and factoring through obtaining funding resources by financial institutions or by issuing public debt, or both. Since 2006, a SOFOM can opt to become a non-regulated entity, which has some limitations on the activities it may carry out, but it is subject to a reduced regulatory burden.

Regarding company incorporation and organisation, Mexican companies are governed by their contractual by-laws. These are established by the shareholders, so there are not different instruments such as articles of incorporation and by-laws. Such contractual by-laws cover all aspects of corporate acts and organisation, and are different from the shareholders’ agreements mentioned above.

Again, regarding organisation, while the administrative organ (board or single member) is the organ charged with legally representing the company, the maximum authority within the company is the partners’ or shareholders’ assembly.

In the case of companies in which different capital groups invest, shareholders generally speaking, and non-residents in particular, should take special care with shareholder assembly convening rules to guarantee that they have a good arrangement protecting their right to be convened.
All such commercial companies can take the variable capital modality; this is reflected in the corporate denomination used; for example, Co X, SA de CV, instead of Co X, SA. This modality allows for flexible rules governing the increase and decrease of contributed capital without modifying the company’s social statutes.  

We can also add that, while the General Law on Commercial Companies establishes a type of company akin to the incorporated limited partnership, with unlimited liability for the administrative partner and limited liability for the passive partners, this type of company has truly fallen into disuse, has some dated aspects—including restrictive rules on member entry and exit—and, even if used, would not be a pass-through but rather a taxed entity.

The typical entity for independent professional services is the civil partnership (SC). In this respect, Mexico’s legal system does differentiate between commercial and entrepreneurial acts with which business profits identify, and lucrative civil activities, such as the rendering of professional services; therefore, the use of the word ‘business’ does not necessarily comprehend both activities, and it is sometimes difficult to draw a distinction between a commercial act and a profitable civil act. This differentiation can be relevant for tax treatment purposes.

Foreign investment in Mexican companies must be reported to the competent federal authority.

ii Non-corporate
A non-corporate entity often used both for carrying on business activities or for administrative or collateral control purposes is the trust. A trust must typically be established with a bank acting as trustee or fiduciary, which implies a minimum administrative cost for using this vehicle. This cost increases if the trust in question is used to develop business activities.

The trust is a transparent vehicle for tax purposes, so the person to whom the trust property may revert (whether the settlor or the beneficiary) is deemed to be the owner for tax purposes.

When business activities are carried on through a trust, it must be registered with the tax authorities. A taxable profit or loss will be determined for the activity; provisional tax payments made through the same; and then the annual tax profit or loss will be assigned to the beneficiaries, who may proportionally apply the provisional tax payments made by the fiduciary. Tax losses from the trust can only be amortised from tax profits generated through the trust activity, except when the trust is wound down, in which case, for the amount of unrecovered resources contributed to the trust, the losses can be deducted from other taxable income. A non-resident carrying on a business activity through a trust shall have a permanent establishment (PE) in Mexico for those activities.

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2 The tax authorities have on occasion taken the position that such capital contributions not recorded with a commercial or civil notary cannot be considered by them as capital contributions, although such lack of formality is precisely the sort of benefit that variable capital rules grant. However, they have been unsuccessful in a number of litigation cases, and the Taxpayer’s Attorney General has also criticised the practice.

3 Business or entrepreneurial activities are defined by the Federal Fiscal Code as industrial, commercial, livestock, agricultural, fishing or forestry activities; personal independent services are defined by the VAT Law as those that do not fall within such business activity definitions.

4 Although some passive investment activities are excluded through administrative rules, we are critical of this rule as being overbroad, because a truly passive investor in a trust with entrepreneurial activities is more easily assimilated to a shareholder than a person with active business activities, and shareholders in Mexican companies do not constitute a PE in Mexico for having such quality.
Another vehicle is the association in participation (AenP), similar to the unincorporated limited partnership contract found in some common law countries. The associating party carries out the activities in its own name, using the cumulative resources contributed to the partnership by that party and by the associated parties; the associating party has unlimited liability for the activities carried out and the associated parties are only liable to that party for the amounts of their contributions. One defect is that associated parties’ contributions are exposed to the associating party’s liabilities, even if derived from activities not associated with the AenP activities. Given its nature, this vehicle should be fiscally transparent; unfortunately, a narrow-sighted tax policy has prevailed regarding the AenP and the vehicle is taxed as if it were an incorporated person.

iii  Brief comments on private equity investment
Private equity is relatively new to Mexico. According to a number of annual surveys, a certain notable presence as a financing source commenced around 2001, although it has grown steadily since and is now a relevant source of financing. Perhaps as a consequence, Mexico’s tax system has lagged behind this phenomenon and has been ill equipped to deal with some private equity situations. However, this situation has been slowly improving with the addition of miscellaneous tax rules that allow for transparency, as well as several changes in the 2020 tax reform to facilitate private equity investment.

As noted above, what would otherwise be a natural vehicle for private equity investment, the AenP, is not tax-transparent, thus subjecting its profits to the general income tax rate, and to interest and dividend withholding taxes for non-residents commented on further below. The trust, in turn, with exceptions irrelevant for private equity purposes, creates a PE situation even for passive investors. The incorporated limited partnership is very dated in its statutory regulation, is no longer common and would not be transparent for tax purposes.

There is one trust vehicle established in the tax incentives section of the MITL that aims to facilitate private equity-type investment into Mexico. This trust will allow the equity and finance resources pooled for various financing projects, and the dividend and interest income generated for the investors through those projects, to flow transparently through the trust; DTA benefits would apply individually to such investors. This instrument is designed with financing involving numerous projects in mind. However, this vehicle does not solve essential withholding tax problems arising when a non-resident collective investment vehicle amalgamates private equity funds coming from a multitude of jurisdictions, and identification of withholding tax rates and DTA benefit purposes is required for each and every fund source.

Thus, Mexico’s tax system is still missing a vehicle that both minimises taxable stages for financial resources being provided by private equity and stabilises withholding rates for foreign private equity sources.

III  DIRECT TAXATION OF BUSINESSES

i  Tax on profits
The MITL essentially taxes resident corporations and individuals, non-resident corporations or individuals with a PE in Mexico, and non-residents with taxable income coming from a source of wealth found in Mexico; it is divided into Titles I to VII, each of which respectively governs the following:

a  general aspects;

b  corporate taxation (residents and PEs);
In this chapter we concentrate on corporate taxation and outbound income taxation.

**Determination of taxable profit**

The MITL applies a worldwide taxation principle for residents. Corporate income is taxed on an accrual basis† regardless of where the source is found. Taxable income and deductions follow the MITL’s special rules, so different items’ treatment may vary from their financial accounting reporting treatment.

Regarding deductions, the concepts of expenses, cost of goods sold and investments are deductible, and deductions are also provided for items such as returns, discounts and rebates, non-collectible accounts receivable, and certain losses deriving from the loss or sale of deductible property. Deductions of interest, social taxes and contributions to certain pension and retirement funds are specially regulated.

Allocation of expenses under the MITL is literally provided for only in certain cases of PEs, and is expressly barred in the case of expenses made abroad and shared with persons that are not corporate or individual regime income tax subjects in Mexico. Denying proration shared with non-residents not subject to taxation in Mexico covered by a DTA is potentially discriminatory. However, through a 2014 administrative rule, following a Supreme Court precedent, this expense can be deducted, although it is very inflexible and the compliance burden is relevant. Not only does this rule include meeting transfer pricing parameters and keeping proof of the expense made abroad on file in Mexico, but requires a multi-party agreement that establishes the exact procedure to distribute the expenses, thus not all apportionment-of-expenses agreements would immediately comply with this structure.

A distinguishing feature of the Mexican tax system is the requirement to obtain a digital internet tax receipt (CFDI) to support any deduction. These receipts are digitally stamped upon issuance by the tax authorities’ IT platform. The regulations regarding the issuance and requirements for CFDIs have gradually been updated. Some of the most significant changes include formal requirements that must be included in the CFDI and, most recently, the issuance of a supporting tax receipt upon payment.

The concept of deductible investments includes fixed assets, deferred costs and expenses, and certain preoperative outlays. These items are deductible by applying the maximum authorised annual depreciation or amortisation percentages; the taxpayer has a limited ability to apply lesser percentages from time to time. Special percentages have been established for the generation of clean-sourced, renewable energy as well as for certain oil and gas industry cases established in the Hydrocarbons Revenue Law.

A peculiarity of the system is that an inflationary effect is given to the difference between cumulative qualified credits and debts by considering the tax year’s inflation rate: when the credits exceed the debts, a deductible inflationary adjustment is allowed by applying

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† However, SC-type company income is taxed on a receipt-basis, and some items (for example, certain payments to individuals) also generate their tax effects on a receipt basis.
the inflationary effect to such difference; when debts are the greater of the two, a taxable value is likewise determined on the difference. Other tax assets, such as net operating losses, favourable tax balances, retained earnings for tax purposes, among others, are also subject to inflationary effects.

The tax is paid on an annual basis; the fiscal year is necessarily identified with the calendar year.

**Capital and income**

No differentiation is drawn between taxation of ordinary income and of capital gains; both are taxed within the same taxable base. While capital gains generated through the transmission of shares are accumulated as income together with other income, and subject to other deductions, losses coming from transmission of shares may only be deducted in the measure that taxable gains from the transmission of shares are accumulated as income in the current tax year or in the 10 following tax years.

**Losses**

Tax losses determined as per the MITL rules may be offset from tax profits of the following 10 years. There is no carry-back rule. A special 15-year rule exists for deepwater oil exploration and production operations.

Tax losses may not be transferred by merger, although they may be allocated between the relevant companies in the case of split-offs. In the case of a merger where a loss-sustaining company subsists after another company is merged into it, such subsisting company may only offset its losses existing before the merger from tax profits generated by the same lines of business as those that generated the losses.

Regarding change of controlling ownership, limitations allowing for the amortisation of losses apply that in general terms can be described as follows. Specifically, losses can only be offset from tax profits generated from the same lines of business as those that generated the losses when income as shown in the annual financial statements over the past three years is less than the cumulative tax losses amortisable and there is a change of controlling ownership in the company. Change of controlling ownership is defined as a change in ownership of more than 50 per cent of direct or indirect ownership of voting right shares over the past three years.

**Rates**

The corporate income tax rate is 30 per cent.

**Administration – federal**

Provisional income tax payments are made on a monthly basis by applying the profit quotient of the previous tax year (the taxable profit divided by all income, both corresponding to the previous year) to the income obtained in the year through to the month to which the provisional tax payment refers; tax losses from previous years may be subtracted from the provisional tax profits determined for the monthly instalment payments; and prior provisional tax payments are creditable against the resulting tax.

The annual tax return may be filed no later than March of the tax year following that to which the return refers.
The authority charged with designing legislative tax policy for consideration by Mexico’s Ministry of Finance and Public Credit (SHCP). The authority charged with revenue collection and auditing taxpayers is the Tributary Administration Service (SAT); however, state tax authorities may have coordinated powers to audit federal taxpayers.

Rulings can be sought from the tax authorities; negative replies cannot be challenged until applied as part of an assessment issued to the taxpayer’s detriment. Favourable rulings are binding on the tax authorities as long as the facts argued are correct.

Audits principally come in the form of requests for taxpayer information and documentation to be filed at the tax authorities’ offices, or domiciliary visits where the tax authorities conduct the audit at the taxpayer’s address. The time limit for conducting the audit is, as a general rule, one year. In past years, the tax authorities initiated the audit of the fourth or fifth previous tax year. The ongoing pattern is that audits begin from most recent years to older fiscal years.

Official letters of observations are issued before an assessment is made; observations are likewise directly notified to corporate administrative organs (if no member of a board is designated to such effect, in the specific case of SAs, the president of the board of directors is the legal representative of the same).

Assessments may be challenged through an administrative appeal (within a term unfortunately reduced, as of 2014, from 45 to 30 working days) or through a tax lawsuit before the Federal Tribunal of Fiscal and Administrative Justice (within 30 working days). In case of a unfavourable result, a final appeal (amparo) may be made to the federal judiciary.

Directly settling controversies with the federal tax authorities is legally not provided for; however, the Taxpayers’ Attorney General’s Office (Prodecon) does have powers to oversee settlements in certain cases (see Section XI).

Local taxation

Each of Mexico’s 32 federative entities has its own tax system. Commonly, there is a revenue collection administrative split of powers between municipal authorities and state authorities. Real estate property acquisition or sale taxes, property taxes, payroll taxes and other like items are common state taxes. Some states may have a local tax on gross income coming from independent personal services or leases.

Tax grouping

As of 2014, a minimal group ‘integration regime’ exists. In essence, this regime allows an integration factor to be determined in function of the percentage of group results that represent losses and, in application of such factor, companies within groups can defer a part of their individual tax for three years. Tax so deferred must be paid at the end of a three-year period, adjusted for inflation.

Other relevant taxes

In addition to income tax, the other relevant federal tax contributing significantly to tax revenue is VAT. VAT taxes sales, the rendering of services (which includes allowing the use of intangibles), the temporary use of tangible property and the importation of such items. The rate is generally 16 per cent, although a 2019 fiscal incentive allows for a reduced 8 per cent rate in specific municipalities located in the northern border of the country. Certain foods and medicines, as well as the exportation of goods and a limitative list of intangibles and services, are taxed at a rate of zero per cent.
There is a special VAT regime for maquiladoras (please refer to Section IV for further information on this type of entity) or IMMEX (in-bond) companies, to avoid the cash outflow that will otherwise result from temporal importations (recoverable through accreditation upon the exportation of the transformed goods), companies can apply for certification (this requires fulfilling sundry requisites, with tax-compliant suppliers being one of them). Such certification grants this type of company the possibility of applying a credit against the importation VAT for the account of the taxpayer. Uncertified companies may opt to guarantee payment of the import VAT.

A special tax on goods and services exists, and taxes such sundry items as fuel, tobacco products, alcoholic beverages and high-calorie foods.

Payroll taxes are a common feature of the Mexican tax landscape, yet these are local taxes, not federal. Tax rates are usually found in the 2 to 3 per cent rate range.

iii Employee profit-sharing
Another feature of investing in Mexico is worker profit sharing (PTU), a constitutionally established right for workers. As a general rule, profits to be distributed to workers are 10 per cent of the taxable profit. Such amount is payable in April or May of the year following that to which the profits refer. PTU effectively paid out in the year may be decreased from the taxable profit of the year before tax loss amortisation (and can also increase the amount of a tax loss). Unpaid PTU accrues to the following year’s PTU.

Over the years, a common practice to mitigate the PTU impact and other labour and social security taxes by corporate groups was the establishment of service companies to render all human resource services to the operative companies; thus, the employees share only in the service company's profits. Amendments to Mexico’s Federal Labour Law towards the end of 2012, amendments to tax legislation, and the issuance of judicial precedents and authorities tax criteria on outsourcing have put a question mark over the effectiveness of such arrangements, which continue to be used.

iv Tax on digital platforms
Among other changes in the tax reform for 2020, an additional section was added to the MITL, for the withholding of income taxes generated from the sale of goods or the provision of services through the internet, via technology platforms, computer applications and similar platforms.

This addition to the law is based on Action 1 of BEPS, in an effort to adapt the tax framework to facilitate the payment of taxes for individuals performing business activities, such as the sale of goods or provision of services through the internet, through digital platforms. The taxation will be made to individuals that now would need to provide their fiscal information through an automatic withholding that ranges from 2 to 10 per cent, depending on the activity, on the total revenues generated minus VAT. If, however, the individuals do not provide their fiscal information, the applicable withholding rate will be of up to 20 per cent.

Furthermore, the tax reform also considers this digital service to be subject to a 16 per cent VAT rate for both Mexican entities and foreign entities carrying out activities through digital platforms; however, certain requirements must be met, otherwise this services will be considered as imports and subject to customs regulations.
Although the framework for this taxation is already established in the tax reform, this will not enter into force until June 2020, and specific tax rules are expected to be issued no later than January 2020.

It is also worth noting that no taxes have been directly established for the digital platforms themselves, although they would need to get set up their systems to enable the compliance with their new obligations as withholding agents.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Incorporated persons that have established ‘the principal administration of the business or their effective seat of direction’ in Mexico are deemed tax residents in the country. Problems with such residency rules have been known to arise from time to time; for example, when a company incorporated abroad has its board integrated by Mexican residents and no proof can be obtained about the board acting outside of Mexico.

DTA double taxation rules may deny any DTA benefits to the dual-resident corporation or subject a case to the mutual agreement procedure.

ii Branch or permanent establishment

Mexico follows traditional Organisation for Economic Co-operation and Development (OECD) PE rules in the legislative design, and has incorporated changes based on Action 7 of BEPS, therefore PE taxation of business income or professional service income can arise from the following general hypothesis:

a when a place of business is found in the country through which entrepreneurial activities or professional services are performed;

b when the non-resident has an agent, different from an independent agent, whom repeatedly carries out the conclusion of contracts or habitual performance of the main role that leads to the conclusion of contracts by or on behalf of the foreign resident for the disposal, granting of temporary use or enjoyment or provision of services by the foreign resident; and

c when the non-resident habitually acts through an independent agent that is not acting within the ordinary framework of his or her activities.

It is important to mention that it will be presumed that an individual or legal entity is not an independent agent, when it acts exclusively or almost exclusively on behalf of foreign related parties.

Specific rules refer to:

a PEs arising for insurance companies when collecting premiums or insuring against risk within the national territory through an agent that is not an independent agent (excluding reinsurance);

b trusts with entrepreneurial activities, for the settlor or beneficiary carrying on the activities through the trust; and
services relative to construction works, demolition, installation, maintenance or erections on real estate, or for projection, inspection or supervision activities related to the same, when the activity lasts longer than 183 calendar days, whether consecutive or not, within a 12-month period.\textsuperscript{6}

The MITL enumerates cases considered places of business; cases where an independent agent is not considered to act within the ordinary course of their business;\textsuperscript{7} and cases where no PE is deemed to arise – for example, as long as the activities carried out are considered as auxiliary or preparatory activities, this shall be an exception to the creation of a PE. However, an anti-fragmentation rule is incorporated, which eliminates access to the exceptions when complementary operations are carried out in other places of business, PE or related parties in Mexico.

As a general rule, income attributable to the PE includes that deriving from the carrying on of the business activities. The sale of goods or real estate within the national territory by the central office or another PE of the person shall also be attributable to the PE. Income obtained by the central office, in the proportion in which the PE contributed to the expenses necessary to obtain the income, shall likewise be attributable to the PE.

Flow of after-tax profits from the PE to the taxpayer abroad is subject to the 10 per cent dividend tax. To identify the nature of the cash flow, a PE will also have both an after-tax net profit account (CUFIN), further commented on below, and a capital allotment account; the presumption is that the last cash flows out are capital reimbursements.

Additionally, a special case of PE is established in the Hydrocarbons Revenue Law to the effect that a PE arises when a non-resident carries out oil and gas activities referred to by such law in national territory or within Mexico’s exclusive economic zone for a period of more than 30 days in a 12-month period.

**DTA modifiers**

Regarding scenarios where no PEs arise, Mexico’s DTAs typically include the case of a place of business solely engaging in the delivery of goods for the account of the non-resident, an exemption case not provided for by the MITL. Usually contained in the DTAs is the standard OECD rule considering that no income can be attributable to the mere purchase of goods.

Likewise, Mexico’s DTAs usually contain the rule of determining the taxable income of the PE as if it were a separate independent entity operating at arm’s length.

A few DTAs follow some aspects of the UN Model Double Taxation Convention (i.e., those with India and Hong Kong) and will allow a continuing presence in a source country to render services to be constitutive of a PE. However, it is questionable whether this premise for a PE can be derived from the MITL’s own PE rules to start with, although the tax authorities have taken up such positions on a number of occasions in the past.

\textsuperscript{6} Special rules have been established in the Hydrocarbon Revenue Law for certain oil and gas industry cases, but DTA benefits should still apply to those cases when covered.

\textsuperscript{7} Essentially taken from the Commentary on Paragraph 6 of Article 5 of the OECD’s Model Tax Convention on Income and on Capital, as explained up to the July 2010 version.
**Case of maquiladoras**

Under both the MITL and the DTA with the United States, when an agent different from an independent agent transforms an inventory of goods owned by the non-resident utilising assets also owned by the non-resident, a PE is deemed to arise. Specifically, the PE is deemed to exist when the economic and legal conditions existing in the relationship between the two parties is different to that which would be carried out by two independent parties.

Safe harbour rules exist in the MITL according to which even in these cases no PE shall be deemed to arise if either of the following two requisites are met: that the taxable profit be at least 6.5 per cent of costs and expenses, or 6.9 per cent of the value of most assets used to carry on the activity; and that an advanced pricing agreement be obtained from the tax authorities regarding the maquiladora’s consideration.

Among other requirements and restrictions, the current rules also require that at least 30 per cent of the assets used be owned by the non-resident or a related party, and that the maquiladora obtain its income exclusively from the transformation of the non-resident’s inventory.

**V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT**

i Holding company regimes

No special holding company regimes, such as those with participation exemptions, withholding exemptions or exemptions for receipts of non-local dividends or income, exist; likewise, no special IP regimes, such as the patent box regime, exist.

ii State aid

Depending on the sector or activity, some federal or local donations, grants or subsidies may be available, although the new tax reform has in some cases limited state aid amounts. An amendment to the Income Tax Law for 2017 regulates when such government grants or economic aid shall not accrue as taxable income.

**VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS**

i Withholding on outward-bound payments (domestic law)

To tax income obtained by non-residents, other than income attributable to a PE, Title V of the MITL taxes specifically identified types of income tax, as well as the cases in which such types of income are deemed to come from a source of wealth found in Mexico.

Specifically, with respect to dividend, interest and royalty income, the following can be briefly noted.

Regarding dividends, the source of wealth is considered to be found in Mexico when the person distributing the income is a resident of Mexico. A 10 per cent withholding rate was established as of 2014 for dividends distributed to non-residents and individuals, regardless of their residency. This is a somewhat unfortunate development, as there was no income tax withholding for the account of non-resident shareholders for a significant number of
years and, given Mexico’s considerable DTA network, the resulting new situation will be
one of quite disparate taxation (exemptions, and 5, 8 and 10 per cent rates) for non-resident
shareholders.

In the case of royalties (the same set of rules taxes technical assistance and publicity),
the source of wealth is deemed to be found in Mexico when the intangibles or technical
assistance is beneficially used in Mexico, when the party paying the royalties or for technical
assistance or publicity is a resident of Mexico or the PE of a non-resident found in Mexico,
and when industrial, commercial or scientific equipment is leased to a foreign entity. A 25 per
cent withholding rate is applicable.

In the case of interest, the source of wealth is defined as being found in Mexico when
the capital is placed or invested in Mexico, or when the interest-paying party resides in
Mexico or is a PE of a non-resident found in Mexico. Exemptions exist for governmental
entities, and withholding rates vary from 4.9 to 35 per cent depending on the nature of the
beneficiary or of the financial agreement.

ii Anti-hybrid rules
Following the recommendations of the final report of Action 2 of BEPS, changes were
introduced with the 2020 tax reform aiming a deny of deduction of payments done to
related parties or through a ‘structured agreement’, where the revenue ends up subject to a
preferential tax regimes and to the payments made by a controlling entity when they are also
deductible for a related party.

iii Capital gains on traded securities
Beginning from 2014, capital gains deriving from the sale of listed securities may be subject
to the 10 per cent withholding rate on the gain from the alienation. These were exempted
items of income before 2014.

iv Double tax treaties
Mexico has numerous DTAs in place as noted in the table below, and is negotiating other
double tax agreements. In addition, it has information exchange agreements with a number
of jurisdictions.

The following table outlines the usual maximum withholding rates allowed under each
DTA; however, special rules, requirements (including effective beneficiary requirements) or
exceptions may apply in all cases:

<table>
<thead>
<tr>
<th>Country or jurisdiction</th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>10 per cent if share ownership exceeds 25 per cent; 15 per cent in other cases</td>
<td>Zero per cent for qualifying financial institutions or certain government entities</td>
<td>10 per cent in the case of copyright royalties for certain artistic works; 15 per cent in other cases</td>
</tr>
<tr>
<td>Australia</td>
<td>Zero per cent if share ownership exceeds 10 per cent; 15 per cent in other cases</td>
<td>10 per cent for qualifying creditors, debtors or securities; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Austria</td>
<td>5 per cent if share ownership exceeds 10 per cent; 10 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Bahrain</td>
<td>Zero per cent</td>
<td>4.9 per cent in the case of interest paid to banks; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Country or jurisdiction</td>
<td>Dividends</td>
<td>Interest</td>
<td>Royalties</td>
</tr>
<tr>
<td>-------------------------</td>
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<td>-----------</td>
</tr>
<tr>
<td>Barbados</td>
<td>5 per cent if share ownership exceeds 10 per cent; 10 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Belgium</td>
<td>Zero per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>5 per cent for interest paid to financial institutions or derived from qualified securities; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Brazil</td>
<td>10 per cent if share ownership exceeds 20 per cent; 15 per cent in other cases</td>
<td>15 per cent</td>
<td>10 per cent under the protocol to the treaty</td>
</tr>
<tr>
<td>Canada</td>
<td>5 per cent if share ownership exceeds 10 per cent; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>Zero per cent in the case of copyright royalties for certain artistic works; 10 per cent in other cases</td>
</tr>
<tr>
<td>Chile</td>
<td>5 per cent if share ownership exceeds 20 per cent; 10 per cent in other cases</td>
<td>5 per cent to banks under the protocol to the treaty; 10 per cent to insurance companies, qualifying and sales credit under the protocol to the treaty; 15 per cent in other cases</td>
<td>10 per cent under the protocol to the treaty</td>
</tr>
<tr>
<td>China</td>
<td>5 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Colombia</td>
<td>Zero per cent</td>
<td>5 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Costa Rica*</td>
<td>5 per cent if share ownership exceeds 20 per cent; 12 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Denmark</td>
<td>Zero per cent for corporate beneficial owner with at least 25 per cent participation; 15 per cent in other cases</td>
<td>5 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Ecuador</td>
<td>5 per cent</td>
<td>10 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Estonia</td>
<td>Zero per cent</td>
<td>4.9 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Finland</td>
<td>Zero per cent</td>
<td>10 per cent for banks, qualifying securities and operations; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>France</td>
<td>5 per cent if 50 per cent of the capital of the Mexican entity is held by a French resident; 15 per cent on other cases</td>
<td>5 per cent for banks and insurance companies under the protocol to the treaty; 10 per cent in other cases under the protocol to the treaty</td>
<td>10 per cent under the protocol to the treaty</td>
</tr>
<tr>
<td>Germany</td>
<td>5 per cent if the effective beneficiary of the dividends is German resident and owns more than 10 per cent of the Mexican entity; 15 per cent in other cases</td>
<td>5 per cent for financial entities; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Greece</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Zero per cent</td>
<td>4.9 per cent for financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Hungary</td>
<td>5 per cent in the case of 10 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Iceland</td>
<td>5 per cent in the case of 10 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>India</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Country or jurisdiction</td>
<td>Dividends</td>
<td>Interest</td>
<td>Royalties</td>
</tr>
<tr>
<td>------------------------</td>
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</tr>
<tr>
<td>Ireland**</td>
<td>5 per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>5 per cent for financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Israel</td>
<td>5 per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Italy</td>
<td>15 per cent</td>
<td>10 per cent under the protocol to the treaty</td>
<td>Zero per cent in the case of copyright royalties for certain artistic works; 15 per cent in other cases</td>
</tr>
<tr>
<td>Jamaica</td>
<td>5 per cent in the case of 25 per cent or greater participation; 10 per cent in other cases</td>
<td>Zero per cent for qualifying financial institutions or certain government entities</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Japan</td>
<td>5 per cent in the case of 25 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent for interest paid to financial institutions and qualifying securities markets; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Kuwait</td>
<td>Zero per cent</td>
<td>4.9 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Latvia</td>
<td>5 per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>5 per cent for interest paid to and by financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Zero per cent in the case of 10 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>8 per cent in the case of 10 per cent or greater participation (in the case of Mexico); 5 per cent in the case of 10 per cent or greater participation (in the case of Luxembourg); 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Malta</td>
<td>Zero per cent</td>
<td>5 per cent for financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5 per cent in the case of 10 per cent or greater participation; 15 per cent in other cases; exemption for Dutch entities if, under the local laws of Netherlands, dividends are exempted</td>
<td>5 per cent for financial institutions and qualifying securities markets; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>New Zealand</td>
<td>5 per cent in the case of 10 per cent or greater participation; zero per cent with respect to specific participations of at least 80 per cent of the voting power for at least 12 months before the date the dividend is declared; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Norway</td>
<td>Zero per cent if share ownership exceeds 25 per cent; 15 per cent in other cases</td>
<td>10 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Panama</td>
<td>5 per cent in the case of 25 per cent or greater participation; 7.5 per cent in other cases</td>
<td>5 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Peru</td>
<td>10 per cent in the case of 25 per cent or greater participation; 15 per cent in other cases</td>
<td>15 per cent</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Country or jurisdiction</td>
<td>Dividends</td>
<td>Interest</td>
<td>Royalties</td>
</tr>
<tr>
<td>-------------------------</td>
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</tr>
<tr>
<td>Philippines</td>
<td>5 per cent in the case of 75 per cent or greater participation; 10 per cent in the case of 10 per cent participation up to the aforementioned 75 threshold; 15 per cent in other cases</td>
<td>12.5 per cent</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Poland</td>
<td>5 per cent in the case of 25 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent for financial institution and qualifying securities; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Portugal</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Qatar</td>
<td>Zero per cent</td>
<td>5 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Romania</td>
<td>10 per cent</td>
<td>15 per cent</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Russia</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>5 per cent</td>
<td>5 per cent for interest paid to financial institutions; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Singapore</td>
<td>Zero per cent</td>
<td>5 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>Zero per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>South Africa</td>
<td>5 per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>South Korea</td>
<td>Zero per cent in the case of 10 per cent or greater participation; 15 per cent in other cases</td>
<td>5 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Spain</td>
<td>Zero per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>4.9 per cent for banks, insurance companies or qualifying securities; 10 per cent in other cases</td>
<td>Zero per cent in the case of copyright royalties for certain artistic works; 10 per cent in other cases</td>
</tr>
<tr>
<td>Sweden</td>
<td>5 per cent in the case of 10 per cent or greater participation; zero per cent in the case of 25 per cent or greater participation if at least 50 per cent of the voting power of the shareholder is owned by residents of Sweden; 15 per cent in other cases</td>
<td>10 per cent for interest paid to financial institutions; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Zero per cent in the case of 10 per cent or greater participation or to pension funds; 15 per cent in other cases</td>
<td>5 per cent for financial institution or qualifying securities; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Turkey</td>
<td>5 per cent in the case of 25 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent for interest paid to banks; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Ukraine</td>
<td>5 per cent in the case of 25 per cent or greater participation; 15 per cent in other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>Zero per cent</td>
<td>4.9 per cent for interest paid to banks; 10 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>Zero per cent for dividends paid to pension funds; 15 per cent in other cases</td>
<td>5 per cent for banks, insurance companies and qualifying securities; 10 per cent for other qualified loans by financial institutions of operations; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
<tr>
<td>United States</td>
<td>5 per cent in the case of 10 per cent or greater participation; 10 per cent in other cases</td>
<td>4.9 per cent for banks, insurance companies or qualifying securities; 10 per cent for other qualifying financial institution loans or operations; 15 per cent in other cases</td>
<td>10 per cent</td>
</tr>
</tbody>
</table>
v Multilateral instrument

In 2014, the OECD issued its report on Action 15 of the BEPS plan, in which the convenience and the viability of adopting a multilateral mechanism to level the use and prevent the abuse of double tax treaties is thoroughly discussed. As a result, the tax authorities of more than 80 countries have signed the Multilateral Instrument (MLI) with the completion of Action 15 of the BEPS plan, with Mexico being a signing party thereof.

The MLI intends to include and extend the application of the provisions of BEPS Actions within bilateral tax treaties. Likewise, it will give greater certainty regarding the application of the agreements covered by the MLI. It is important to mention that the MLI does not directly modify the text of the bilateral treaties, but its provisions apply in conjunction with the existing provisions of such treaties.

Through the MLI, Mexico will adopt the minimum standard on anti-abuse rules for its entire double taxation treaty network. Among the alternatives to do so, Mexico opted for the inclusion of a simplified limitation of benefits test, which means that a non-Mexican resident claiming treaty benefits would only be able to do so if it is a qualified tax resident. In general terms, a tax resident of a treaty partner county would be considered a qualified tax resident through a test of its ownership chain. If its ultimate shareholders are also tax residents of the same jurisdiction or a publicly traded entity, treaty benefits should be available. Otherwise, a test on the substantial presence of such tax resident in the relevant jurisdiction would need to be evaluated.

Nevertheless, if the treaty partner jurisdiction choice for the adoption of the minimum standard is not compatible with the position of Mexico in the MLI (i.e., the principal purpose test), then a more subjective test would need to be done through the principal purpose test of the relevant structure or arrangement, to define whether treaty benefits would be applicable.

The following jurisdictions have also opted for the simplified limitation of benefits test: Argentina, Armenia*, Bulgaria*, Chile, Colombia, India, Indonesia, Kazakhstan*, Russia, Senegal*, Slovakia and Uruguay.8

Although already in force for the first five signatories, Mexico has not yet ratified the MLI. Thus if Mexico ratifies the MLI in 2020, the treaty shall enter into force on the first day of the month following the expiry of a period of three calendar months beginning on the date of the deposit by such signatory of its instrument of ratification, acceptance or approval, but, the provision applicable to the withholding of taxes shall enter into force on the first day of the next calendar year (i.e., 1 January 2021).

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8 The asterisk indicates jurisdictions with which Mexico does not have a DTT in force.
vi  Taxation on receipt
As a general rule, income tax paid abroad, including withholding tax, is creditable against the income tax determined as per the MITL rules. This requires accumulation as taxable income of the gross income amount before taxation abroad.

In the case of dividends, in comparison to those received by a resident corporation from other resident companies, which are not taxable income, dividends coming from non-residents are taxable income. However, tax paid abroad on the profits from which the dividend distribution came is creditable against Mexican income tax. Given a greater flow of capital investment abroad by Mexican companies, this same system of accreditation was streamlined as of 2014. Currently, the characteristics of this accreditation system are as follows.

Taxes paid abroad by foreign companies, both first corporate tier and second corporate tier, can be creditable. Formulae are established in the MITL to determine the proportion in which the income tax was paid by such companies with regard to the profits distributed directly or indirectly to the Mexican resident company.

Regarding foreign tax credits, the following additional aspects may be noted.

A limit to the creditable amount is established in function of the corporate tax rate applicable in Mexico, wherefore any tax paid above that rate on the gross profits in question is not creditable.

For direct income, a taxable profit to determine the limit of the creditable tax is established that takes into account deductions totally or partially identified with obtaining such income.

Regarding dividend income, an accounting entry system is established to identify each tranche of income taxed abroad and the corresponding tax credit limit per year, to not commingle foreign tax credits applicable to such income. Failure to register with this system impedes accreditation from applying.

Taxpayers must keep on file documentation proving the payment of the tax to be credited abroad, although for jurisdictions covered by a broad agreement for the exchange of tax information, the certificate of withholding shall suffice.

When tax paid abroad cannot be credited against the income tax payable in Mexico for such income, a 10-year term over which such accreditation can take place is granted. The omission to apply the foreign tax credits when the taxpayer is in a position to do so will cause the credits to be lost in the measure that they were not applied.

VII  TAXATION OF FUNDING STRUCTURES
Unlike other Latin American countries, Mexico does not have exchange controls or any similar restrictions to prevent or restrict cash flows into or out of the country. Exchange rates are defined by the open market, and almost all forms of hedging for currency fluctuation are available.

Under these circumstances, entities are commonly funded with a combination of equity and debt. Depending on the type of business, inbound financing may take place through a simple internal loan or a more sophisticated structured financing; for example, in the case of infrastructure development businesses.
i  Thin capitalisation
Thin capitalisation rules are included in the MITL seeking to prevent companies from using debt as a means to distribute profits to shareholders through interest payments.

Interest paid on interest-bearing loans granted in cash by related parties in excess of three times shareholders’ equity may not be deducted. These rules are, however, not applicable to taxpayers that obtain an advanced pricing agreement from the tax authorities, to financial institutions, or to infrastructure investments linked to strategic economic areas or to the generation of electric energy.9

Additionally, the 2020 tax reform has included another limitation on the deduction of interest, consisting of calculating a net interest (accrued interest minus interests received), which will not be deductible in the amount that exceeds an adjusted fiscal profit (tax profits plus accrued interest) by 30 per cent. However, the non-deductible amount can be deducted on the three following fiscal years.

ii  Deduction of finance costs
The definition of interest under the MITL is rather exhaustive and most likely will include any type of revenue derived from financing operations. Interest, discounts, premiums, commissions and guarantee fees would be considered an interest expense, among other concepts, together with the gain on transfer of financial instruments.

Interest expense, together with other costs related to securing financing, would be generally deductible. Currency fluctuation would be considered interest for tax purposes; this means that the revaluation or devaluation of debt will have a tax effect that could either result in additional taxable income or deductions depending on the specific situation.

The MITL has rules on back-to-back loans related to transactions between related parties. Interest deriving from triangular financing arrangements among related parties shall be treated as dividends for income tax purposes when the interest proceeds from back-to-back credits, including credits granted through a financial institution residing in this country or abroad.

In general terms, back-to-back credits are deemed to consist of:

a operations whereby a person furnishes cash, assets or services to another that in its turn furnishes cash, assets or services directly or indirectly to the former or to a related party of said person or former person; or

b operations in which a person grants financing and the credit is guaranteed with cash, a cash deposit, shares or debt instruments of any nature of the creditor or a related party of said creditor are also deemed back-to-back credits for such purposes to the extent of such guarantee.

An exception to this rule applies in operations whereby financing is granted to a person and the credit is guaranteed by shares or debt instruments that are the property of the borrower or of a related party residing in Mexico, if the borrower is unable lawfully to dispose of such shares or instruments, unless the borrower defaults on any obligation contracted under the respective credit agreement.

9 The MITL that came into effect in 2014 did not expressly consider the exception for the generation of electricity until an amendment for 2016; as per a transitory rule, this exclusion shall apply retroactively even as of 2014.
iii Restrictions on payments

**Tax**

Mexican legislation provides for a 10 per cent withholding tax on dividends paid to non-residents and individuals, regardless of their residency, from profits generated from 2014. Additionally, dividends are taxed at the level of the paying company on a grossed-up basis at the corporate tax rate in the year of payment, if the dividend does not come from the CUFIN balance (net after-tax profit account). In such a scenario, the income tax paid can be credited by the Mexican company against its income tax liability of the current year or of the next two years.

The CUFIN concept is similar to the earnings and profits statement. It attempts to reflect the true economic earnings of the company for tax purposes that have already been subject to corporate taxation.

The CUFIN balance shall be increased by the taxable profits of the year (minus paid income tax and non-deductible expenses), the amount of dividends received from other companies that are residents in Mexico, and with the income, dividends or profits generated or distributed by investments made in a preferential tax regime; and shall be reduced by any dividend or profit paid out during the year.

**Corporate**

Regarding corporations, rules in the General Law of Commercial Companies require financial statements approved by the shareholders’ or partners’ assembly showing the retained profits for dividends to be payable. Losses from prior tax years must be redeemed or absorbed through other shareholders’ equity items or capital reductions before the dividends can be paid. Supreme Court precedent would require profits to be determined once each fiscal year closes. A capital reserve (20 per cent of contributed capital stock) is also needed, which is built up through 5 per cent of each year’s profits.

iv Return of capital

Mexican entities can repay capital to their stakeholders as long as they comply with corporate law and the legal entity’s own by-laws. A two-prong test is necessary to determine if a capital redemption should give place to taxation.

For this purpose, taxpayers must keep a record of the effectively paid-in contributed capital for tax purposes through the capital contributions (CUCA) account. It will register all capital contributions made to the Mexican entity by its shareholders and its balance is restated by inflation on an annual basis.

Capital redemptions out of the CUCA balance can be paid with no further Mexican tax consequences. However, capital redemptions in excess of CUCA would be considered a deemed dividend and, therefore, subject to CUFIN-related consequences (if the CUFIN balance is insufficient, then the gross up and tax determination mentioned above occur). A first test compares CUCA per share to reimbursement per share, and a second test compares the CUCA balance to the shareholder equity value to determine whether, for tax purposes, profits are being distributed to the shareholder.
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

Mexico has one of the largest networks of DTAs in its region, with over 50 treaties in force and a handful of treaties under negotiation and renegotiation.

This fact brings an extensive array of options to define an appropriate and efficient corporate structure. However, although some treaties can bring significant benefits over others in the specific cases of capital gains and interest withholding rates, attention must be paid to the substance of the structures and the anti-abuse rules that each DTA or applicable legislation may impose.

i Acquisition

Stamp duties or direct taxes on equity are not applicable in Mexico. This fact gives a lot of flexibility to either setting up operations or acquiring operating businesses in Mexico. When setting up in Mexico, companies should focus on a structure that allows for certainty while doing business in Mexico and a flexible and efficient exit in the future.

This is normally achieved through application of DTAs. As mentioned above, capital gains are taxed under the general tax regime. However, in the case of non-Mexican residents, direct or indirect disposal of Mexican shares may be taxed at a 25 per cent rate over the gross proceeds of a disposal of shares, or at a 35 per cent rate over a net gain if certain requirements are met, such as appointing a Mexican legal representative, not residing in a low taxation jurisdiction and filing a special report before the Mexican tax authorities containing tax calculations certified by a third-party registered certified public accountant (CPA).

Nevertheless, depending on the structure of the non-Mexican investor, they may be able to claim a reduction on the 35 per cent statutory rate through the application of a DTA.

In addition to capital gains, as mentioned above, as of 2014 Mexico incorporated a 10 per cent withholding tax on dividend payments to non-residents and individuals. Owing to the fact that this tax was not previously part of Mexican legislation, most Mexican treaties include the approach suggested by the OECD on a dividend’s tax reduction or even elimination in the case of countries with a capital exemption regime, adding another ingredient to corporate structuring from a tax perspective.

Finally, it is uncommon to see non-residents establishing entrepreneurial activities directly in Mexico. Although in theory any activity undertaken in the form of a taxable branch or PE should be subject to the same tax regime as a Mexican legal entity, this is a figure that is perhaps not very frequently used because of the practical complexity of profit attribution and the inability to limit responsibility for legal purposes.

ii Reorganisation

Mexican legislation provides the possibility of transferring Mexican shares with a deferral of the corresponding tax, to the extent that certain requirements are met. The transfer of shares must be done within the same group and the consideration must be in the form of shares of the acquiring entity. The tax deferral is only possible with the authorisation of the tax authority, which may be a time-consuming process.

Similar restructure operations are contemplated in some DTAs, as in the case of the convention between the US and Mexico, the main difference being that the transaction can be carried out under an exemption through the application of the DTA; therefore, an authorisation from the tax authorities is not necessary, although certain formalities may apply.
In addition, mergers and spin-off transactions are allowed under Mexican corporate law.

Mergers between Mexican corporations can be carried out under tax-free circumstances if certain requirements are met, which consist of having business continuity over the activities of the merged entities with some exceptions; filing certain notifications to the tax authorities after the operation takes place; and ensuring compliance with the residual tax obligations for the entities that may have ceased to exist in the event.

Similarly, a tax-neutral demerger or spin-off of a Mexican corporation may be carried out to the extent that the shareholders in the new and spun-off entities remain the same for three years (one year prior to and two years following the transaction) and comply with residual tax obligations for a demerger entity in the event that it disappears after the transaction; and if the transaction is duly notified to the tax authorities.

A test on the monetary assets position also needs to be done. In cases where any of the entities’ monetary assets result in more than 51 per cent of its total assets, a capital redemption may need to be recognised over the demerged entity and the tax-free treatment may be partially or totally lost.

If a merger takes place within five years following another merger or a spin-off, then additional information may need to be filed before the relevant tax authorities to obtain an authorisation for tax-neutral effects.

iii Exit

Although ‘exit taxes’ as such do not exist within the Mexican tax regime, when the restructure of a business results in the relocation of functions, assets or risks from Mexico to another jurisdiction, a transaction may be deemed to exist and should be valued under transfer pricing regulations so that if any tax consequence is identified, it can be considered for tax purposes.

Migration of legal entities is also a possibility to relocate business activities from Mexico to another country. This can be done through a change in the place where its management is executed to another jurisdiction.

In any of those cases, a deemed liquidation for income tax purposes would take place. Although the rules are not very clear, the Mexican company would need to determine if a tax should be recognised considering the fair market value of its total assets against the tax basis that may apply.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

As of the 2020 tax reform, articles have been added to the tax legislation for transparent entities, which establishes that these will be considered as Mexican entities, and thus subject to taxation in Mexico, for those that have their effective management headquarters in the country, unless there is a DTA.

Additionally, when a resident in Mexico has direct participation over a transparent entity or foreign legal entity, or indirect that involves other entities with this nature, income tax will be paid for the income obtained through them in proportion to their participation therein.

Furthermore, there is a provision applicable to cross-border transactions involving low-tax jurisdictions that gives the tax administration the possibility of recharacterising
transactions entered into by taxpayers under the assumption that a simulation of acts took place. Although this disposition has been available for tax administration since 2008, it has not been extensively used in tax assessments.

It is worth mentioning that tax authorities have attempted to include additional rules into the Mexican tax system that could allow the analysis of the substance over form of transactions, but such attempts have failed in obtaining approvals in the legislative processes.

**ii Controlled foreign corporations (CFCs)**

CFCs and entities or contractual arrangements obtaining passive revenues that are subject to a low tax rate will be subject to taxation in Mexico, regardless of the moment at which such profits are actually taxed. However, the tax paid abroad could be credited against Mexican income tax generated for those activities.

The 2020 tax reform has included specific regulations for CFC-generated income, such as specifying when an entity has effective control of a CFC, as follows: (1) when the entity has over 50 per cent of voting shares; (2) when it has rights over more than 50 per cent of the assets; (3) when the combination of this two rights exceeds 50 per cent; (4) when the financial statements of the CFC are consolidated in the entity; and (5) when the entity has the complete right to define agreements on assembly or administrative meetings. For related parties, this are obliged to comply with requirements even if they do not have the effective control.

For the purposes of Mexican CFC anti-deferral rules, passive revenue would include that obtained from interest, dividends, royalties, services, and even trade revenue in some cases, especially when the origin or destination of the traded goods involves Mexico. It is understood that passive revenue is subject to a low tax rate when it is either not taxed at all or when taxed at a rate lower than 75 per cent of the tax that would have applied had such revenues been taxed under Mexican tax legislation, with special rules for dividend payments.

Therefore, as a general rule, income from this kind of activity that is subject to taxation at a rate lower than 22.5 per cent would be subject to anti-deferral rules; however, some exceptions may also be applicable.

**iii Transfer pricing**

Mexican regulation on transfer pricing is rather mature and must be observed for transactions with related parties, whether they reside in Mexico or abroad. It follows OECD guidelines and is generally harmonised with other jurisdictions. However, there are certain topics that are relevant to the Mexican approach.

This first point can be found on the definition of related parties. A party would generally be considered related when there is a participation in the control, capital or administration of another, or when a party in common has a participation in such elements. Under this definition, one party having a single share in another party makes them related, even if from a factual analysis it can be concluded that they operate at arm’s length, which can result in unnecessarily onerous compliance issues.

The ‘best method rule’ under Mexican tax legislation indicates that transactional methods are preferred over general profit-based methods, as opposed to OECD guidelines, which suggest the use of the method that best adapts to the circumstances under analysis. As such, a comparable uncontrolled price method should be applied whenever possible, and then the gross profit-based methods would be preferred over the transactional net margin or profit-split methods.
As per the use of statistical methods to perform as transfer pricing analysis, the Mexican approach is also aligned with global practices of building a range with comparable transactions data; however, and although not stated in Mexican regulations, Mexican tax authorities do not necessarily accept the comparison of multiple year data for the corresponding tested party. In other words, the Mexican taxpayer information from a single year would need to be compared against multiple-year data of comparable transactions, which in some cases can create distortions in the analysis.

As of 2016, country-by-country reporting is considered for companies belonging to certain multinational groups qualified by level of consolidated income, to which effect three different returns shall have to be filed: a master informative return of related parties within the global group, a country-by-country informative return for the multinational group and a local informative return for the local related parties. These returns must be filed by 31 December of each year. Fines in the range of US$10,000 to US$20,000 are established for an omission in filing or incorrectly filed information.

In 2018, a series of tax rules for transfer pricing adjustments were amended to provide clarity to the recognition of income and the deduction of the corresponding adjustments that may derive from a transfer pricing self-evaluation. Furthermore, additional requirements and supporting documentation would need to be provided when such adjustment yields a deduction for Mexican tax purposes.

iv  BEPS-inspired limitations to deductions
As of 2014, there are BEPS-inspired rules that can limit deductions in the case of payments to hybrid entities or in the case of double non-taxation.

v  Informative returns
The following returns are mandatory under Mexican legislation, and each entity could be subject to certain filings under certain scenarios.

The Information about Fiscal Situation (ISSIF) return is mandatory for entities falling within any of the following scenarios: (1) entities earning taxable revenues in the year exceeding 644,599,005 Mexican pesos; (2) entities that are part of the optional group regime under MITL; (3) entities that are part of the federal public administration; (4) foreign residents with a permanent establishment in Mexico; and (5) entities resident in Mexico that carry out transactions with foreign related parties (subject to certain thresholds). ISSIF is due by 30 June of the following year to that in which the taxpayer falls within any of the scenarios listed above. Note that this return could not be filed if a taxpayer elects to file instead a statutory tax report of its financial statements (also due by 30 June of the following year) per Article 32-A of the Federal Tax Code.

In addition, the 2016 Mexican tax reform amended the Income Tax Law to implement the transfer pricing (master file/local file) documentation requirement. Mexican companies must submit the required documents by the end of the year (i.e., 31 December) following the fiscal year. This reform also introduced country-by-country reporting by large multinational enterprises based in Mexico.

Filing Form 76 is mandatory whenever an entity performs transactions under the scope of such form. Among others, the following could trigger such obligation: (1) financial operations; (2) transfer pricing adjustments; (3) equity participation and tax residency; (4) reorganisations and restructurings; and (5) other relevant operations. All of the above are pursuant to the thresholds stated by the law and the regulations issued by tax authorities.
X YEAR IN REVIEW

2019 was the year in which a takeover of a new administration took place, because of the elections carried out throughout 2018. One of the main changes is the 2020 tax reform mentioned throughout this document, which is adapting our legislation towards international tax trends based on OECD recommendations and the BEPS project.

XI OUTLOOK AND CONCLUSIONS

Certain notable amendments were approved for 2019, as follows:

a. the implementation of anti-hybrid rules, such as the taxation of transparent entities as Mexican entities;

b. a broader PE concept and changes in PE constitution presumptions;

c. adaptation of CFC rules, specifically regarding effective control;

d. taxation of individuals receiving income from digital platforms through withholding, as well as VAT on said services;

e. further limitation on interest payments; and

f. leasing of industrial, commercial or scientific equipment by a foreign resident will now be considered as a royalty.

Another notable development since 2015 has been the introduction of a publicly traded security that will allow certain businesses of the oil and gas, electric energy and infrastructure sectors to partially divest shares of special purpose vehicles placed in a trust, which in turn will place certificates on the stock exchange, and a transparent tax regime for investors following the master-limited partnerships models found in the US. It has generally been referred to by the misnomer Fibra E, as the acronym Fibra refers to the Mexican version of a real estate investment trust, whereas the new investment security actually relates to very different businesses and risks. 2016 saw adjustments to the model that make it more competitive; notably, gains on the sale of shares by a sponsor to a trust can be deferred up to 15 per cent per annum if paid with tradable certificates issued by the trust.

Regarding the tax authority–taxpayer relationship, we note the following: a hallmark of the current administration continues to be to audit in depth all VAT refund requests. This continues to cause significant delay in the payment of such refunds for up to six months.

Regarding taxpayer audit planning, supply chain tax planning and, generally, transnational companies with excessively low taxable profits as compared to their overall income, continue to be targeted for audit.

The ability of Prodecon to mediate settlement efforts between the tax authorities and taxpayers on substantive issues involving the interpretation of laws and rules continues to represent an opportunity to lessen the pressure on a tax system in which the tax authorities do not have powers to settle directly with taxpayers and are under the strict scrutiny of an internal control organ, to the degree that such authorities often take a questionable pro-government stance for fear of incurring personal liability. However, an increasing demand for the settlement mechanism, even in cases that may not warrant its use, has put a new strain on this option.
Chapter 21

NETHERLANDS

Jian-Cheng Ku and Rhys Bane¹

I INTRODUCTION

For many years, the Netherlands has been considered the gateway to Europe for non-European companies and investors. The certainty provided by advance tax rulings (ATRs) and advance pricing agreements (APAs), the country’s extensive participation exemption regime, the excellent Dutch network of tax treaties and bilateral investment treaties, flexible corporate law and the country’s business-friendly infrastructure are all key elements in this respect.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Dutch (holding) companies are generally organised as limited liability companies or as cooperatives.

Limited liability companies

Limited liability companies come in two forms: private limited liability companies (BV) and public limited liability companies (NV).

Both types of companies have legal personality and capital that is divided into shares. As the NV and BV both have limited liability, their shareholders are not liable for the company’s debts. While NVs are typically used for companies going public (i.e., listed on a stock exchange), BVs are generally used for smaller businesses or as a holding or finance vehicle.

NVs and BVs in principle pay Dutch corporate income tax (CIT) on their worldwide profits, with a branch exemption and participation exemption regime to eliminate international double taxation. Both types of companies are considered to be Dutch tax residents by virtue of being incorporated under Dutch law. Dividend distributions by NVs and BVs are subject to Dutch dividend withholding tax, with reductions and exemptions pursuant to domestic law and the application of a tax treaty.

Cooperatives

The Dutch cooperative is a special form of association. By and large, the general Dutch CIT rules governing associations also apply to cooperatives. However, in addition to these general rules, certain specific rules apply to cooperatives only. Like all associations under Dutch law,

¹ Jian-Cheng Ku is a partner and Rhys Bane is an associate at DLA Piper Nederland NV.
a cooperative must have a board of directors and members and, if the articles of association allow, a supervisory board. Moreover, the cooperative regime is quite flexible: no minimum capital requirements apply, only two members (at least) are required and dividends may be distributed freely.

In accordance with Dutch law, a cooperative’s objective (as formalised in its articles of association) must state that it provides for specific material needs of its members pursuant to agreements that are not insurance contracts and that have been concluded with those members as part of the cooperative’s business or causes that benefit the members.

Cooperatives have historically (up to 31 December 2017) been an attractive legal form for international holding companies, in that, as a rule, the members were not subject to Dutch dividend withholding tax (subject to specific anti-abuse rules). This general exemption, however, has lapsed as of 1 January 2018 for cooperatives of which the main (≥70 per cent) activities consist of holding participations or intercompany financing. Holding and financing cooperatives are now, in principle, subject to Dutch dividend withholding tax.

ii  Non-corporate

Pursuant to Dutch law, partnerships are formed by means of a partnership agreement that governs the long-term cooperation between two or more partners. A partnership is not a separate legal entity; however, Dutch partnerships can sue and be sued, and can enter into contracts in their own name.

Dutch partnerships come in the form of a general partnership (VOF), a limited partnership (CV) or a professional partnership. The most important differences between these forms are expressed in how they interact with third parties, including representation, liability and the right of recourse. Whereas general and limited partnerships are considered to be subcategories of professional partnerships, the statutory provisions for a professional partnership essentially apply by analogy to general and limited partnerships. An important consideration is that the liability of general partners in a VOF and general partners in a CV is unlimited, while the liability of limited partners in a CV is limited to the amount of their respective capital contributions.

Dutch domestic tax rules distinguish between ‘closed’ and ‘open’ CVs. An open CV is regarded as non-transparent (opaque) for the limited partner interest, and is, therefore, (partly) a taxpayer for Dutch tax purposes; conversely, closed partnerships are transparent. A look-through approach applies to these closed CVs, meaning that only the partners in the CV may be subject to tax. The ‘consent requirement’ is a crucial factor in determining whether a CV is regarded as an open or closed partnership. A CV qualifies as open if limited partners can join and exit the partnership – except by bequest or inheritance – without unanimous consent from all other partners (i.e., both general and limited partners).

III  DIRECT TAXATION OF BUSINESSES

i  Tax on profits

General

Dutch CIT is levied on Dutch and non-Dutch tax residents. Dutch tax residents are in principle subject to Dutch CIT on their worldwide income. Non-residents are subject to CIT only insofar as they enjoy Dutch-source income, which falls into two categories:
taxable profits derived from a business that is conducted through a permanent establishment (PE) or a permanent representative in the Netherlands (see Section IV.ii); or

taxable income derived from a substantial interest in a company that is a resident of the Netherlands, provided that:

- the main purpose (or one of the main purposes) for holding the interest is to avoid Dutch personal income tax in the hands of another person (subjective test); and
- an arrangement (or a series of arrangements) is in place that is not genuine (objective test).

For purposes of condition (b), an arrangement or a series of arrangements is considered not genuine if and to the extent it is not based on valid commercial reasons that reflect the economic reality.

Whether an arrangement has been put into place for valid commercial reasons may depend on the substance at shareholder level. Valid commercial reasons may be present if, inter alia, the shareholder conducts a material business enterprise and the shareholding is part of the business enterprise's assets; the shareholder is a top holding company that performs material management, policy and financial functions for the group; or the shareholder functions as an intermediate holding company within the group structure.

Under the substance rules as amended as of 1 January 2020, if an intermediate holding company satisfies the Dutch minimum substance requirements, the wage sum criterion (generally a wage sum of €100,000) and the office space criterion (office space for at least 24 months), the burden of proof with respect to purpose for holding the interest and the absence of valid commercial reasons that reflect the economic reality, shifts to the tax inspector. If the aforementioned substance requirements are not met, the taxpayer has to prove that the interest is not held with the main purpose (or one of the main purposes) to avoid Dutch personal income tax in the hands of another person or that the structure is based on valid commercial reasons that reflect the economic reality.

**Determination of taxable profit**

Dutch CIT is levied on a taxpayer’s taxable profit, being the net income earned and capital gains less deductible losses, as determined annually in accordance with the principles of sound business practice. Under this general principle, which has been widely developed under Dutch case law, profits and losses are attributed to the years based on principles of realisation, matching, reality, prudence and simplicity. In principle, all business expenses may be deducted from the taxable profit, including interest on loans (subject to interest deduction limitation rules), and annual amortisation and depreciation on assets used for the taxpayer’s business.

**Losses**

In general, tax losses can be carried back to be offset against the previous year’s taxable profits, and can be carried forward for six years for losses made in fiscal years starting on or after 1 January 2019. Loss carry-backs and carry-forwards are applied in the order in which the losses arose (meaning that a loss will first be offset against the previous year’s profits, and then against future profits).
However, special rules for loss relief may apply to the trade in ‘loss-making companies’. A company’s losses may not be offset against future profits if 30 per cent or more of the ultimate interest in that company changes among the ultimate beneficial owners or is transferred to a new shareholder. This rule offers a number of exceptions, however (the going-concern exception, for example).

In view of the Dutch participation exemption regime (see Section V.i), taxpayers may not deduct losses on the disposal of a qualifying participation from their taxable profit. In addition, a write-off of the cost price of a participation is not deductible. However, liquidation losses, whether foreign or domestic, may be deducted from the taxable profits, provided that certain requirements are met. The liquidation loss amount is determined on the basis of the difference between the liquidation proceeds and the cost price of the participation.

**Rates**

The standard CIT rate is 25 per cent. The first €200,000 of annual taxable profit is taxed at a step-up rate of 20 per cent. To further bolster the investment climate, legislation has been adopted to lower the CIT rates, including a top-bracket CIT rate reduction to 21.7 per cent in 2021 (2019: 25 per cent; 2020: 25 per cent) and a lower bracket CIT rate reduction to 15 per cent in 2021 (2019: 19 per cent; 2020: 16.5 per cent).

**Administration**

Taxpayers must file annual CIT returns with the Dutch tax authorities within five months of the end of their financial year. It is possible to apply for an extension of this filing deadline.

Dutch taxpayers are allowed to file their returns in a functional currency (i.e., a foreign currency other than the euro) if their annual reports are drawn up in the same foreign currency. As such, a Dutch taxpayer can ensure that fluctuations between the euro and the functional currency do not lead to taxable profits (e.g., foreign exchange results on outstanding debt or receivables).

**Tax grouping**

The Dutch consolidation regime (fiscal unity) offers the possibility for taxpayers to opt for treatment as a single taxable entity for Dutch CIT purposes. A Dutch resident parent company and its Dutch resident subsidiaries may form a fiscal unity if certain requirements are satisfied, the most important being that the parent company, directly or indirectly through other fiscal unity members, must hold at least 95 per cent of the legal and economic title to the shares issued by the subsidiaries. As a result, the assets and liabilities of the entities included in the fiscal unity are consolidated, meaning that intercompany transactions are eliminated and that the business income of the fiscal unity members is balanced for CIT calculation purposes. Although each member of the fiscal unity remains jointly and individually liable for the CIT due by the entire fiscal unity, the CIT assessments are only imposed on the parent company. A fiscal unity (for Dutch CIT purposes) is optional (i.e., it is not formed by operation of law) and therefore requires a prior request to that effect.

Following the judgment of the Court of Justice of the European Union (CJEU) in *XBV* of 25 October 2017, in which the CJEU declared the Dutch fiscal unity regime (partially) breaches the freedom of establishment, emergency reparatory legislation to bring the fiscal unity regime in line with the EU freedom of establishment was adopted. The emergency reparatory legislation proposal has retroactive effect up to 1 January 2018. The legislation decreases the scope of the consolidation of the Dutch fiscal unity regime for a number of
Dutch CIT rules that affect non-Dutch resident companies (which could not be included in the Dutch fiscal unity because of not being a Dutch tax resident), where these rules would not affect Dutch resident companies that are a part of a Dutch fiscal unity.

Given the foregoing, the Dutch fiscal unity regime is currently under review and may be replaced by a group relief or group contribution regime. The Dutch government is currently still reviewing the options with respect to the future of the Dutch fiscal unity regime.

ii Other relevant taxes

Value added tax (VAT)

VAT is charged on supplies of goods and services in the Netherlands and is based on the various EU VAT Directives. The standard VAT rate is 21 per cent. A reduced rate of 9 per cent is charged on designated supplies, while a zero per cent rate applies to supplies related to international trade. In addition, various VAT exemptions exist in the Netherlands, pursuant to which no VAT is charged (although it is important to bear in mind that in some cases the corresponding input VAT cannot be deducted).

The Dutch VAT Act provides for a deferment system for VAT, under which taxpayers must declare import VAT in their periodic tax returns but simultaneously deduct it, meaning that on balance no VAT is actually paid.

Excise and import duties

Excise duties, being a consumption tax, are levied on alcoholic products, tobacco and mineral oil products. Import (or customs) duties are levied on various products that are imported into the Netherlands from outside the EU. The Netherlands does not impose export duties.

Real estate transfer tax (RETT)

The acquisition of the legal or economic ownership of real estate (or rights relating thereto) located in the Netherlands is subject to real estate transfer tax at a rate of 6 per cent (7 per cent as of 2021; 2 per cent for residential properties). Various exemptions may apply in situations involving mergers or reorganisations.

Moreover, the acquisition of shares in a real estate company, being a company where real estate assets make up more than 50 per cent of the assets, of which at least 30 per cent consists of real estate located in the Netherlands, is also subject to Dutch RETT.

Wage tax and social security contributions

In principle, individuals in employment are subject to wage tax, which the employer withholds from their wages and remits to the tax authorities. This applies not only to wage tax on salary payments, but also to social security contributions. Dutch wage tax is considered to be an advance levy, meaning that individuals may credit it against their Dutch personal income tax due.

Highly skilled expatriates may claim a special tax facility, known as the ‘30 per cent ruling’. The 30 per cent ruling is a tax-free reimbursement of 30 per cent of an employee’s (gross) salary, which may be applied if the employee has been recruited or assigned from abroad and has specific expertise that is difficult to find in the Dutch labour market.

Other

The Netherlands does not levy any stamp or capital duties.
IV  TAX RESIDENCE AND FISCAL DOMICILE

i  Corporate residence

Pursuant to Dutch tax law, the place of residence of a corporate entity is determined on the basis of all relevant facts and circumstances, in particular taking into account the place of effective management.

However, the Corporate Income Tax Act, 1969 (CITA) provides an important exception to this principle by applying the ‘incorporation fiction’. Pursuant to this fiction, entities such as NVs and BVs are deemed to be tax residents of the Netherlands by virtue of being incorporated under Dutch law. Accordingly, an entity incorporated under Dutch law is in principle fully liable to Dutch CIT regardless of its taxable place of residency, except limited by a bilateral tax treaty.

ii  Branch or permanent establishment

Taxable profits from a business that is conducted through a PE or a permanent representative (referred to as a ‘Dutch business’) in the Netherlands are in principle subject to Dutch CIT. As of 1 January 2020, Dutch domestic law refers to the relevant tax treaty for the definition of a PE, the CITA explicitly states that a Dutch business is deemed to include:

a  income and gains derived from real estate located in the Netherlands, including direct and indirect rights in Dutch real estate and rights to explore and commercially operate Dutch natural resources;

b  profit-sharing rights in, or entitlements to, the net value of a business that is effectively managed in the Netherlands, except insofar as those rights or entitlements are not derived from securities;

c  receivables on companies that are residents of the Netherlands, provided that the lender holds a substantial interest in the company concerned; and

d  activities performed by a member of the management or supervisory board of an entity that is a resident of the Netherlands, even if the authority is restricted to those parts of the business that are located outside the Netherlands.

In determining the profits attributable to a PE, the Netherlands follows the authorised Organisation for Economic Co-operation and Development (OECD) approach, which has been largely incorporated into the Dutch PE profit allocation decree of 2011.

V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i  Holding company regimes

Participation exemption regime

Under the Dutch participation exemption regime, all benefits (i.e., dividends and capital gains) derived by a Dutch company from a qualifying participation in another entity are exempt from Dutch CIT.

The Dutch participation exemption generally applies if the following conditions are both met: the Dutch company holds 5 per cent or more of the nominal paid-up share capital of a company, which capital is divided into shares (the ‘5 per cent ownership condition’); and the entity in which the Dutch company participates is not held as a portfolio investment (the ‘motive test’ or ‘non-portfolio investment condition’).
The non-portfolio investment condition means that the participation exemption does not extend to subsidiaries that are held as portfolio investments (the 'motive test'). A subsidiary is considered to be held as a portfolio investment if the Dutch resident (shareholder) company's only object is to obtain returns that may be expected from normal active asset management. If the taxpayer has a mixed motive, the predominant motive is decisive. According to parliamentary proceedings, a subsidiary that is engaged in a business and that is owned by an intermediate Dutch holding company linking the subsidiary’s activities and those of the larger group is not considered to be a portfolio investment. However, the motive test is deemed not to be met if more than 50 per cent of the subsidiary’s consolidated assets consist of a shareholding (or shareholdings) of less than 5 per cent; or the subsidiary’s predominant function – together with the functions of its lower-tier subsidiaries – is to act as a passive group finance, licensing or leasing company.

ii IP regimes

The Netherlands offers a favourable tax regime for profits from qualifying IP developed by a Dutch taxpayer. Under this ‘innovation box’ regime, profits from the research and development (R&D) of qualifying assets are taxed at a lower CIT rate of 7 per cent (instead of 25 per cent) to the extent that the R&D profits exceed a threshold equal to the sum of the costs incurred to develop the IP.

Since 1 January 2017, the Dutch innovation box regime is aligned with the OECD’s base erosion and profit shifting (BEPS) Action 5 (countering harmful tax practices more effectively, taking into account transparency and substance). Pursuant to Action 5, states are required to modify their IP regimes in terms of accessibility and their economic substance. Consequently, the Netherlands incorporated the ‘modified nexus’ approach into the CITA, pursuant to which only intangible assets developed by the taxpayer itself will qualify for the application of the amended innovation box regime. A nexus formula will determine what portion of the R&D income will qualify for the innovation box regime.

In addition, the Netherlands offers an R&D wage tax credit, which, in fact, functions as an entry ticket to the innovation box regime.

iii State aid

Following the publication of the non-confidential version of the decision in the Starbucks case on 27 June 2016 by the European Commission in which it held that an APA between the state and Starbucks Manufacturing BV (SMBV) constituted illegal state aid, the General Court ruled that the Netherlands has not granted fiscal state aid to Starbucks on 24 September 2019.

The General Court ruled that the European Commission has not been able to establish that the APA concluded between the state and SMBV conferred an advantage to SMBV.

If the European Commission appeals the General Court decision, the decision may be overturned by the Court of Justice.

On 18 December 2017, the European Commission announced it had opened an in-depth investigation into the Netherlands’ tax treatment of Inter IKEA. The case revolves around two APAs concluded between Inter Ikea Systems and the Dutch tax authorities.
VI  WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i  Withholding on outward-bound payments (domestic law)

Dividend withholding tax is levied at a rate of 15 per cent from those persons – whether resident or non-resident – who are entitled (either directly or through depositary receipts) to proceeds from shares or profit-sharing certificates in a Dutch resident entity. The actual amount of dividend withholding tax due is calculated on the basis of the proceeds of such shares or profit-sharing certificates.

Cooperatives are subject to dividend withholding tax if they can be classified as a ‘holding cooperative’. This is the case in all situations where the activities of the cooperative consist, in short, subject to all relevant facts and circumstances, for more than 70 per cent of holding and finance activities. Only less-than-5 per cent membership rights continue to benefit from an unconditional exemption from dividend withholding tax.

The Netherlands does not impose any withholding tax on (outgoing) interest or royalty payments, except for interest on certain hybrid loans. As of 1 January 2021, the Netherlands will impose a (conditional) withholding tax on interest and royalty payments. The withholding tax only applies to interest and royalty payments made to ‘low tax jurisdictions’. The Dutch list of low tax jurisdictions is published in December of the year preceding the year of application of the list. The list for 2020 (not yet relevant for the conditional withholding tax) contains the following jurisdictions: American Samoa, American Virgin Islands, Anguilla, Bahamas, Bahrain, Barbados, Bermuda, British Virgin Islands, Cayman Islands, Fiji, Guam, Guernsey, Isle of Man, Jersey, Oman, Samoa, Trinidad and Tobago, Turkmenistan, Turks and Caicos Islands, United Arab Emirates and Vanuatu.

ii  Domestic law exclusions or exemptions from withholding on outward-bound payments

Dutch tax law provides for various statutory exemptions from dividend withholding tax on dividend distributions, such as the Dutch participation exemption regime (see Section V.i) and the fiscal unity regime (see Section III.i).

Generally, Dutch dividend withholding tax is an advance levy that may be credited against the Dutch CIT due the level of the shareholder. In addition, several special tax regimes are adopted into the Dutch Dividend Withholding Tax Act pursuant to which no (owing to an exemption) or less (owing to a refund or reduction) Dutch dividend withholding tax is levied.

For example, an exemption may apply if the beneficiary of the dividends is an EU resident and its shareholding in the distributing company would have qualified as a participation under the Dutch participation regime if it had been a Dutch resident company. Under certain conditions, it is also possible for non-European companies with investments in Dutch companies, such as pension funds, to claim back the tax withheld.

As of 1 January 2018, the Netherlands unilaterally applies a zero per cent rate for all distributions to qualifying (>5 per cent) corporate shareholders in the European Union (EU) or European Economic Area (EEA) and entities tax resident in a country that has concluded with the Netherlands a double taxation treaty with a dividend clause (irrespective of whether than treaty itself provides for a zero per cent rate). An anti-abuse rule also applies, denying the exemption if the shareholding is both held with the principal purpose, or one of the principal purposes, of avoiding the levy of dividend withholding tax and the shareholding
is part of an artificial (non-genuine) structure or transaction or series of transactions. As of 1 January 2020, the division of the burden of proof with respect to the anti-abuse rule will be similar to the division of the burden of proof as described in the non-resident taxpayer rule described in Section III.i.

iii Double tax treaties
The Netherlands has one of the most extensive treaty networks in the world (currently standing at almost 100 bilateral tax treaties), providing for, inter alia, beneficial allocation of the taxing rights on capital gains and reduced withholding tax rates.

Moreover, the tax treaties concluded by the Netherlands typically protect against discriminatory taxation by any state other than the resident state of the taxpayer. Most bilateral tax treaties concluded by the Netherlands provide for a reduction of dividend withholding tax (down to 5 or even zero per cent).

As an OECD member state, the Netherlands has ratified the Multilateral Convention to Implement Treaty Related Measures to Prevent BEPS, more commonly known as the MLI. As of 1 January 2020, most of the Dutch bilateral treaties will be changed by the MLI (subject to reciprocity) to include the (mostly anti-abuse) measures introduced by the MLI. The Netherlands endorsed many MLI features, including mandatory and binding arbitration if the contracting jurisdictions do not reach a mutual agreement. The main anti treaty-abuse rule elected by the Netherlands is the principal purposes test (PPT).

iv Taxation on receipt
Dividends, interest and royalties received by resident companies are generally included in the taxpayer’s tax base with the exception of dividend distributions that qualify under the participation exemption regime (see Section V.i).

Moreover, given the extensive tax treaty network, Dutch-resident companies can generally avoid double taxation on foreign-sourced income by claiming relief in respect of incoming dividends, interest and royalties. If no tax treaty is available, relief from double taxation is usually provided under the Dutch unilateral rules for the avoidance of double taxation.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
The Netherlands does not have debt-to-equity rules or similar anti-interest stripping provisions.

ii Deduction of finance costs
General
Pursuant to settled case law of the Dutch Supreme Court, the characterisation of a financing arrangement as debt for Dutch tax purposes in principle follows the characterisation of such arrangement for civil law purposes. In this respect, a repayment obligation is considered to be an essential element for the financing arrangement to qualify as debt for civil law purposes. However, there are three exceptions applicable to this general rule, pursuant to which the debt is reclassified as equity for Dutch tax purposes, namely in cases of:
a sham loan (where the parties only created the appearance of a loan, while in fact intending to realise an equity contribution);  

b a loss financing loan (where it is immediately clear from the terms of the loan that the claim resulting from the loan is (in part) worthless, because the loan cannot be repaid and, as result of which, the funds have permanently left the taxpayer's capital); and  

c a hybrid financing (or participating) loan (where, based on the terms of the loan, the lender in fact is participating in the borrower's capital. In this scenario, debt is reclassified as equity if:  

• the duration of the loan is perpetual (i.e., more than 50 years), or the loan is repayable only in the event of the debtor's bankruptcy or liquidation;  

• the consideration payable on the debt is entirely or almost entirely contingent on profits; and  

• the loan is subordinate to all other creditors.

As a consequence, interest payments on a reclassified loan qualify as dividend distributions for Dutch tax purposes and are treated accordingly (i.e., subject to Dutch dividend withholding tax and – for qualifying participations – exempt under the participation exemption regime).

If none of these exceptions apply, the arm's-length interest expense should be deductible for Dutch CIT purposes (subject to any interest deduction limitation rules). In this regard, the Dutch Supreme Court has developed the concept of 'non-businesslike loans'. A loan between related parties is considered to be non-businesslike if the loan is granted under terms and conditions that would not have been agreed upon by independent (unrelated) parties in similar circumstances.

However, if it is not possible to determine a businesslike interest (by doing so, the loan in essence would become profit-sharing or deviate from the parties' original intentions), the loan is considered to carry a non-businesslike risk of default. These loans generally lack a loan agreement, a repayment schedule or any security. As a result, write-down losses on these loans are non-deductible. Using the ‘suretyship analogy’ method, as developed by the Dutch Supreme Court, the interest rate can be determined by considering the rate that a third party (i.e., a bank) would charge if the parent company put itself forward as guarantor.

A final factor in establishing whether the interest expense on a financing arrangement is deductible for Dutch CIT purposes is the existence of various specific interest deduction limitation rules.

Anti-base erosion
Dutch tax law provides for an anti-abuse provision that specifically targets situations that can be described as ‘base erosion’. The common feature of such structures is that (group) equity is converted into debt using transactions that have a somewhat artificial character (and are not based on valid business reasons). Interest on and fluctuations in the value in respect of loans that are legally or de facto, directly or indirectly, owed to related entities, are not deductible to the extent these loans relate legally or de facto effectively, directly or indirectly, to one of the following transactions: distributions of profit or repayments of capital by the taxpayer (or an affiliated entity or individual) to a affiliated entity; capital contributions by the taxpayer (or an affiliated entity or individual) in a affiliated entity; or acquisitions or increases by the taxpayer (or an affiliated entity or individual) of an interest in an entity that becomes an affiliated entity as a result of the acquisition or increase.
However, this anti-abuse provision does not apply if the taxpayer can demonstrate that the debt and tainted transaction are predominantly motivated by business reasons (business motive exception), or the interest is taxed at the level of the recipient at a rate of (at least) 10 per cent (subject-to-tax exception), unless the tax inspector can establish that the debt and tainted transactions are not predominantly motivated by business reasons.

**Earnings stripping**

Under the earnings stripping rule that the Netherlands had to implement pursuant to the EU Anti-Tax Avoidance Directive (ATAD), net interest expenses is fully deductible up to the higher of 30 per cent of the earnings before interest, taxes, depreciation and amortisation (EBITDA) and €1 million. Any interest that was non-deductible owing to the application of the earnings stripping rule can be carried forward indefinitely.

### iii Restrictions on payments

Pursuant to the Dutch Civil Code, a company limited by shares may make distributions to its shareholders and other entitled persons only to the extent its net assets exceed the sum of its called-up and paid-up capital and the reserves as required by law or the company’s articles of association.

Moreover, a distribution test applies to BVs pursuant to which the company may only distribute profits to its shareholders (and other entitled parties) to the extent this does not interfere with the company’s ability to pay its exigible and current debt.

### iv Return of capital

A repayment of capital has no adverse tax consequences from a Dutch CIT perspective. However, a repayment of capital recognised as paid-up capital for Dutch dividend withholding tax purposes will trigger dividend withholding tax if and to the extent the taxpayer has net profits, unless the general meeting of shareholders has resolved in advance to make the repayment and the articles of association have been amended to reduce the nominal value of the ordinary shares by an equal amount. The capital recognised as paid-up capital for dividend withholding tax purposes may consist of formal capital, informal capital and share premium.

Hence, to repay capital (recognised as paid-up capital for Dutch dividend withholding tax purposes) without triggering Dutch dividend withholding tax, the nominal value of the ordinary shares must first be reduced by amending the articles of association.

**VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES**

### i Acquisition

**Share deal**

A share deal, in which the shares in a Dutch entity are acquired, may be conducted either directly by a foreign entity or indirectly through a Dutch (acquisition) entity. In this respect, cooperatives are frequently used as shareholders for Dutch acquisition entities, given that Dutch cooperatives are in principle not subject to Dutch dividend withholding tax, provided that they comply with the anti-abuse rules (see Section I.i).

If the shares are purchased indirectly (i.e., through a wholly owned Dutch acquisition entity), a fiscal unity may be formed between the acquiring entity and the Dutch target
The Netherlands

A company subject to certain requirements. Accordingly, interest expense on the acquisition
debt at the level of the Dutch acquisition entity may be offset against the profits of the target
entity (subject to the limitations on interest deduction for acquisition debt; see Section VII.ii).

If the shares are acquired directly (i.e., by a foreign company), the foreign shareholder
may become liable to Dutch CIT pursuant to the non-resident taxation rules for foreign
substantial shareholders if it does not satisfy the anti-abuse rules (see Section III.i).

Asset deal
An asset deal can be executed either directly by a foreign entity or indirectly through a Dutch
entity that acquires the Dutch business or assets. In principle, the gains realised upon the sale
of the assets are subject to Dutch CIT. However, provided that certain requirements are met,
it is possible to defer the CIT due by applying a ‘reinvestment reserve’ that provides for a
rollover mechanism for Dutch CIT due in respect of the gains realised.

ii Reorganisation
Dutch civil law offers various possibilities for mergers and demergers: a stock merger, business
enterprise merger, a legal merger or demerger, and a legal spin-off. The CITA provides for
several facilities – subject to certain conditions – by allowing a rollover of book values for the
assets and shares transferred. In these cases, the transfer is effected on a non-recognition basis.

iii Exit
Dutch tax residents relocating their businesses to outside the Netherlands are in principle
subject to Dutch CIT in respect of their realised and unrealised profits (i.e., hidden reserves
and goodwill). Similarly, for entities migrating into the Netherlands, a step-up of all assets
and liabilities applies.

If certain conditions are satisfied, the CIT due may be deferred if the taxpayer’s new
place of residence is an EU or EEA Member State.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION
i General anti-avoidance
In principle, Dutch tax law allows taxpayers to arrange their affairs so as to minimise the
amount of tax payable. However, they may not initiate actions intended predominantly to
reduce the amount of tax they that would otherwise pay. Although no statutory anti-abuse
provisions exist under the CITA, various different doctrines can be seen in Dutch case law,
which are sometimes used interchangeably. However, these doctrines are not panaceas, and
they may only be applied by the Dutch tax inspector as a final resort.

The doctrine of ‘independent determination (or reclassification) of the facts for tax
purposes’ describes the process in which the court labels a fact or set of facts from a Dutch
tax perspective. The court may go beyond the formal paperwork and evaluate the ‘substance’
of a transaction (e.g., the proper classification of debt versus equity, sale versus lease and
compensation versus disguised dividend).

The non-statutory concept of fraus legis (‘abuse of law’) gives the tax authorities the
possibility to challenge the validity of a transaction if the decisive motive for entering into

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the transaction is to avoid taxes (subjective element), and the transaction is in breach of the purpose and intent (objective element). The transaction will then be considered abusive and will be treated differently from its legal form.

ii Controlled foreign corporations (CFCs)
The CITA does not provide for any specific CFC rules. However, subsidiaries are subject to an annual mark-to-market requirement if the taxpayer together with its affiliates holds at least 25 per cent of the shares in a subsidiary that is held as a portfolio investment and moreover is subject to a low-tax regime (where the indicative threshold is a rate of 10 per cent), and 90 per cent of the subsidiary’s assets (including its lower-tiered subsidiaries) consist of low-taxed passive assets.

If a subsidiary fulfils these criteria, its profits are taxed at the level of the Dutch shareholder. However, a credit system is in place to prevent double taxation on these profits.

As of 1 January 2019, the Netherlands has introduced the EU ATAD ‘Model A’ Controlled Foreign Corporations (CFC) rules (which have an income-based approach) for CFCs in low-tax jurisdictions (jurisdictions that are listed on the EU list of non-cooperative jurisdictions or that have a CIT rate of less than 9 per cent). In other situations, the Netherlands takes the position that the Netherlands already has CFC rules in the form of the arm’s-length principle (see Section IX.iii).

iii Transfer pricing
The Netherlands has incorporated the arm’s-length principle into the CITA. It forms the legal basis for the Dutch tax authorities to adjust intercompany transfer prices in cases where related parties have entered into a transaction for a price or conditions that would not have been agreed upon between independent parties. This provision defines the term ‘related parties’ and describes the transfer pricing documentation requirements. Moreover, the provision includes specific rules for financial services companies (e.g., substance and real-risk requirements).

Generally, the Netherlands follows the OECD transfer pricing guidelines and has largely incorporated these guidelines into a transfer pricing decree. It has also incorporated the country-by-country reporting rules into the CITA as of 1 January 2016. These rules correspond to OECD BEPS Action 13 (i.e., applying the three-tiered documentation approach using a country-by-country report, master file and local file).

iv Tax clearances and rulings
The Netherlands is well known for the cooperative and constructive attitude of the tax authorities, and the possibility to discuss the tax treatment of particular operations or transactions in advance (upfront certainty) in an ATR or APA. An ATR provides the taxpayer with certainty regarding the tax treatment of international structures (e.g., the applicability of the Dutch participation exemption). An APA provides upfront certainty in respect of the transfer prices for intra-group transactions.

Both types of ‘settlement agreements’ are concluded by the Dutch ruling team working in close liaison with the Central Point for Potential Foreign Investors. This department provides foreign investors advance certainty on the tax treatment of their prospective investments in the Netherlands. An ATR or APA is typically valid for four years.

As of July 2019, the Netherlands has renewed its ruling practice. To obtain a ruling, there must be enough substance in the Netherlands at the group level (the ‘economic nexus
requirement’) and the requesting entity must have enough substance for the items to be covered by the ruling. Rulings are not granted if the request covers direct transactions with low tax jurisdictions (see Section VI.i).

v  Anti-hybrid rules

The Netherlands has introduced the anti-hybrid rules prescribed by the EU ATAD, effective as of 1 January 2020. Under the anti-hybrid rules, deduction or non-inclusion and double deduction outcomes resulting from hybrid mismatches (hybrid financial instruments, hybrid entities or hybrid permanent establishments) are neutralised by a denial of deduction or an inclusion of the income. The reverse hybrid taxpayer rule enters into effect on 1 January 2022.

X  YEAR IN REVIEW

The 2020 Dutch tax plan, proposed on Budget Day 2019, contained a large number of changes to the Tax Code. At the same time, the Netherlands implemented the EU Anti-Tax Avoidance Directive with respect to hybrid mismatches and the EU Mandatory Disclosure Directive.

The 2020 Dutch tax plan makes the definition of a permanent establishment dynamic as it regards jurisdictions with which the Netherlands has a tax treaty (i.e., reference is made to the tax treaty definition). As it regards jurisdictions with which the Netherlands does not have a tax treaty, the revised (2017 OECD Model Tax Convention) permanent establishment definition applies.

The Netherlands is introducing a conditional withholding tax on interest and royalties paid to low tax jurisdictions (which are listed in the December preceding the calendar year for which the list applies) and in certain abusive situations (e.g., flow-through companies with little substance) effective 1 January 2021.

The CIT rates will be lowered to 15 per cent (lower bracket) and 21.7 per cent (top bracket) by 2021.

XI  OUTLOOK AND CONCLUSIONS

Both the OECD and European anti-BEPS projects continue to be key topics in the Netherlands. Due to pressure from the EU, the Netherlands has taken stricter measures against tax avoidance. However, the Netherlands keeps the business climate in mind when designing the measures against tax avoidance.
I INTRODUCTION

Nigeria’s population of over 200 million and its continuously expanding consumer market have made it an investment destination of interest to foreign investors for some time. Nigeria is the largest economy in Africa, with a GDP of US$397.27 billion as at December 2018. The establishment of democratic structures during the past 19 years and the efforts of the government towards entrenching the rule of law may have improved the country’s political risk profile. Some potential investors may see the country’s relatively low corporate tax rates as a good incentive to do business in Nigeria, in spite of tremendous infrastructure deficits and the multiplicity of taxes at the different tiers of government, which can make running a business in Nigeria quite challenging.

The country is a federation of 36 states and 774 local government areas, each with power to impose tax on specified activities. Lagos State, one of the 36 states, is the fifth-largest economy in Africa.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

The most common form of corporate business organisation is the private limited liability company. This may not have more than 50 shareholders and must restrict the transfer of its shares. There is also the public limited liability company (plc), which can have any number of shareholders starting from two. This is the required form for companies listed on the stock market. The unlimited liability company is also an available form, but is rarely used.

Most enterprises can only be carried on using a corporate vehicle. For instance, banking, and crude oil exploration and production, can only be carried out by registered companies. The company itself (not its owners) is taxed on its profits.

ii Non-corporate

Many small-scale businesses and petty traders carry on as unincorporated enterprises. Besides sole proprietorships, the most commonly used form of non-corporate business entity is the general partnership. Partnerships are not liable to tax – their profits are shared among the partners and taxed in the partners’ hands.

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1 Theophilus I Emuwa and Chinyerugo Ugoji are partners and Jibrin Dasun and Eniye Igbanibo are associates at ÆLEX.
III DIRECT TAXATION OF BUSINESSES

i Tax on profits

There are two corporate income taxes: companies’ income tax (CIT) pursuant to the CIT Act (CITA) and petroleum profits tax (PPT) pursuant to the PPT Act.

**Determination of taxable profit**

CIT is chargeable on the profits of all companies apart from those engaged in oil exploration and production. Expenses are deductible if they are ‘wholly, exclusively, necessarily and reasonably’ incurred in the making of profits. Donations to charities and educational institutions are deductible up to a prescribed limit. Instead of depreciation, capital allowance is allowed annually at specified rates that can be as high as 95 per cent in the first year.

PPT is chargeable on the profits of any company engaged in the exploration and production of petroleum (or crude oil). Under the PPT Act (PPTA), expenses are deductible if they are ‘wholly, exclusively and necessarily’ incurred in the making of the profits. The test for deductibility does not include reasonableness as is the case with companies in other sectors. In addition, instead of depreciation, capital allowance is allowed annually at specified rates. For the purposes of both CIT and PPT, taxable profits are arrived at by aggregating all trading income and then deducting exempt income, allowable expenses, capital allowance and carried-forward losses.

For the purposes of CIT, profits are taxed on an accrual basis. The tax is paid after the tax year (that is, on a preceding-year basis). PPT, however, is paid in advance, in monthly instalments based on forecasts of year-end profits and tax; in other words, PPT is paid on a current-year basis with reconciliation made at the end of the tax year to reflect actual profits made in that year. Profits of a Nigerian company are deemed to accrue in Nigeria regardless of where they arise. Nigerian companies are therefore subject to CIT on worldwide profits. Profits of a non-Nigerian company are taxable in Nigeria to the extent that they arise (or are deemed to arise) in Nigeria – the CITA prescribes various tests for determining this (see Section IV).

The CITA also sets out rules for taxation of a company at commencement of business, change of accounting date and cessation. The commencement rules and change of accounting date may lead to double taxation on a company.

**Capital and income**

Taxable profits consist solely of income or trading profits – these are profits that arise from business or trade. Profits that arise from the disposal of a capital asset are not included in income tax computations but are chargeable to tax under the Capital Gains Tax Act (CGT Act).

**Losses**

A company that makes trading losses is entitled to treat them as tax-deductible and to carry forward unrecovered losses indefinitely, even if the ownership of the company changes. Losses cannot, however, be carried back or offset against capital gains.
Rates
The CIT rate is 30 per cent of profits. Companies engaged in crude oil exploration and production are subject to PPT at rates that vary between 50 and 85 per cent depending on the nature of the taxpayer’s operations. The CGT rate is 10 per cent.

Administration
Corporate taxes are administered by a single tax authority, the Federal Inland Revenue Service (FIRS). Every company is required to file a self-assessment return with the tax authority at least once a year. The filed return must contain the company’s audited accounts, tax and capital allowances computation, and a duly completed self-assessment form. The company may pay the tax due and forward evidence of payment along with its return. For PPT purposes, at least two returns must be filed. The first is filed early in the tax year and is based on forecasts of profit and tax. The second is filed after the end of the tax year and reflects actual profits and tax. If forecasts change during the year, a company may amend the first returns from time to time.

Education tax of 2 per cent of assessable profits is imposed on all companies incorporated in Nigeria. Assessment and payment of education tax are done together with the assessment and collection of the CIT or PPT, whichever is applicable.

The Industrial Training Fund Act requires every employer with a staff strength of 25 or more to contribute 1 per cent of its annual payroll to the fund established by the Act. An employer may be refunded up to 60 per cent of the amount contributed if the Industrial Training Fund Governing Council is satisfied that the employer’s training programme is adequate.

The Employees’ Compensation Act directs every employer covered by the Act to make a minimum monthly contribution of 1 per cent of its monthly payroll. The scope of the Act extends to both the public and private sectors with the exception of members of the armed forces; however, staff of the armed forces employed in a civilian capacity are covered by the Act.

The Niger Delta Development Commission (Establishment) Act mandates every oil or gas company to pay 3 per cent of its annual budget to the Commission for tackling ecological problems in the Niger Delta, where most of Nigeria’s oil is produced.

The National Information Technology Development Agency (NITDA) Act mandates telecommunications companies, cyber-related companies, pension-related companies, banks and other financial institutions with an annual turnover of 100 million naira or more to pay a levy of 1 per cent of their profits before tax to the NITDA Fund. In addition, the Nigerian Maritime Administration and Safety Agency imposes a 3 per cent levy on all inbound and outbound cargo from ships or shipping companies operating in Nigeria.

The FIRS has introduced an integrated tax administration system to enhance tax administration. Thus, taxpayers are now able to file tax returns and pay their taxes electronically. This has significantly reduced the complexity, time and cost of paying taxes.

Tax grouping
Nigerian law makes no provision for the tax treatment of a group of companies as one entity. Each company within a group is therefore taxable in Nigeria on an individual basis. Consequently, losses suffered by one member of a group of companies cannot be utilised to reduce the tax liability of another company within the group, but must be carried forward and set off against the future profits of the company that incurred them.
Other relevant taxes

In addition to income taxes, Nigerian businesses are also subject to other taxes such as value added tax (VAT) under the VAT Act, CGT under the CGT Act and stamp duties under the Stamp Duties Act.

VAT is levied on the supply of all goods and services with a few exceptions. The rate of VAT is 5 per cent, and it is collected by the supplier and remitted to the FIRS, except where the supplier is a foreign company, in which case the purchaser withholds the VAT and remits it to the FIRS. A taxpayer is allowed to recover VAT incurred in acquiring stock-in-trade or inventory, but not VAT incurred on overheads and administration or on capital assets. It remains unclear whether VAT arises on the sale of choses in action (or intangible contractual rights). Lagos State has also introduced a 5 per cent consumption tax on hotels, restaurants and event centres.

CGT is charged on the gains arising on the disposal of an asset at a rate of 10 per cent. Gains that are applied towards replacing business assets are exempted from CGT, as are gains arising from the disposal of stocks and shares, and those arising from the merger of two companies provided that no cash payment is made. On the other hand, gains arising from a demerger or spin-off are not exempted even where assets have been moved to entities under the same control and ownership as the transferor.

The Stamp Duties Act provides for stamp duty to be paid on instruments. The rates are as contained in the Act, and can be as high as 6 per cent of the value of the underlying transaction.

IV TAX RESIDENCE AND FISCAL DOMICILE

Corporate residence

The profits of a Nigerian company are deemed to accrue in Nigeria regardless of where they arise. Nigerian companies are therefore subject to CIT on worldwide profits. The profits of a non-Nigerian company are taxable in Nigeria to the following extent:

a the company has a ‘fixed base’ in Nigeria to the extent attributable to such base;
b the company habitually operates in Nigeria through a dependent agent who conducts business on its behalf, or who delivers goods or merchandise on its behalf from stock maintained in Nigeria, to the extent attributable to such activities;
c all the profit where the company executes a turnkey contract in Nigeria; that is, a single contract for surveys, deliveries, installation or construction; and
d the adjustment made by the FIRS where the foreign company does business with a connected Nigerian company, and the FIRS considers the terms to be artificial or fictitious.

Branch or permanent establishment

In determining the fiscal residence of a non-Nigerian company incorporated in a country that has a double taxation treaty with Nigeria, the applicable concept is that of ‘permanent establishment’, which such treaties define as a fixed place of business through which the business of an enterprise is carried on. However, a permanent establishment will not include facilities used solely for the purpose of carrying on an activity of a preparatory or auxiliary nature, or for the storage, delivery or display of goods or merchandise of a non-resident company. The FIRS directed that all non-resident companies are to file income tax returns taking effect from tax year 2015.
V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

The drive to encourage foreign direct investments in Nigeria has led to the enactment of various pieces of legislation, including the Industrial Development (Income Tax Relief) Act. This Act encourages investment in sectors of the economy that are necessary for the economic development of the country by granting tax relief to businesses. For a business to enjoy relief from corporate income tax under this Act, it must be engaged in one of the industries listed in the Act, or would have to apply and obtain a designation of its activity as a pioneer industry. Relief under this Act is for an initial period of three years extendable up to a maximum period of two years. Dividends are not subject to tax in the hands of the shareholders of the company enjoying the relief. Capital allowances can be carried forward and utilised at the end of the tax relief period. This incentive regime was reviewed in 2017 by the Application Guidelines for Pioneer Status Incentive. The Guidelines have replaced the erstwhile ‘service charge’ of 2 per cent of estimated tax savings with a new annual service charge of 1 per cent of actual pioneer profits.

The Venture Capital (Incentives) Act provides tax incentives to venture capital companies that invest in venture capital projects and provide at least 25 per cent of the total project cost. The incentives include a 50 per cent reduction of the withholding tax payable on dividends distributed by project companies, allowing equity investments in venture project companies to be treated as qualifying capital expenditure, and exempting capital gains on the disposal of such equity from tax.

The Nigeria Export Processing Zones Act also contains certain fiscal incentives for businesses. It provides in Section 8 that approved enterprises within a zone would be exempted from all federal, state and local government taxes, levies and rates. It also provides in Section 18 that such enterprises may repatriate capital, profits and dividends at any time. The Oil and Gas Export Free Zone Act grants similar incentives to approved enterprises operating within the zone.

Capital allowances are another form of tax incentive. Capital allowances are granted on the acquisition of qualifying capital expenditure that is used solely for the purpose of the business. Capital allowances serve to reduce the profits of a company, and ultimately reduce tax liability. Under the CITA, there are initial and annual allowances. The initial allowance can be claimed only in the year in which the asset was acquired, while the annual allowance, based on the remainder after deducting the initial allowance from the cost of the asset, is spread over the tax life (including the first year) of the asset until the cost of the asset is reduced to a book value of 10 naira.

Under the PPT Act, a petroleum investment allowance (PIA), which allows an uplift of up to 20 per cent on qualifying capital expenditure, is available as an incentive to encourage investment in offshore exploration. In addition to the PIA and capital allowances, companies operating production-sharing contracts (PSCs) in Nigeria’s deep offshore and inland basin regions are entitled to either an investment tax credit (ITC) or an investment tax allowance (ITA), depending on when the PSC was signed, which is equal to 50 per cent of annual qualifying expenditure. The ITC operates as a full tax credit, while the ITA is deductible from profits before the calculation of tax. The ITC does not result in a deduction from qualifying capital expenditure for the purposes of calculating capital allowances. There are also special incentives available to oil companies to encourage gas utilisation or the development of gas delivery infrastructure. Most significantly, such companies can offset their gas-related capital
allowance against their oil production profits. Given the difference in tax rates between gas production and oil production (30 per cent versus 85 per cent), this incentive has led to considerable investment in gas utilisation projects.

To stimulate the financial markets, the federal government, in 2012, amended relevant laws to exempt from taxation income earned from debt instruments. Consequently, income from bonds issued by sovereign or sub-sovereign entities and those of corporate bodies are exempted from tax in the hands of the bondholder. Proceeds from the disposal of government or corporate bonds are exempt from VAT. These exemptions for corporate bonds are only for a period of 10 years and will lapse in 2022. In addition, the government has increased the tax relief available to companies that incur expenditure on infrastructure or facilities of a public nature. Such companies will now enjoy a 30 per cent uplift in basis for deductibility of the relevant expenditure.

i  Holding company regimes
Nigeria does not have any special holding company regimes.

ii  IP regimes
Nigeria does not have any special IP regimes.

iii  State aid
No state aid is available.

iv  General
See Section I.

VI  WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i  Withholding on outward-bound payments (domestic law)
By law, where any amount is payable by one company to another company or person as interest, royalty, rent or dividend, the company making the payment shall first deduct tax at a rate of 10 per cent and pay it to the tax authority. This withholding tax is treated as the final tax when the payment is due to a non-Nigerian company. Where a dividend is paid to a Nigerian company, the amount deducted as withholding tax is treated as franked investment income and is not subject to further tax in the hands of the recipient. In all other cases, such withholding tax qualifies as a credit against CIT liability.

ii  Domestic law exclusions or exemptions from withholding on outward-bound payments
Withholding tax exemptions are available on outward-bound payments where:
   a  the payment of a dividend is satisfied by an issue of shares of the company paying the dividend;
   b  dividend is paid by a company exempted from tax under the Industrial Development (Income Tax Relief) Act;
   c  dividend is paid out of profits that have been subjected to PPT;
   d  dividend is paid by an enterprise operating within a free zone; or
interest is paid by a Nigerian company on a foreign loan with a tenor of at least seven years.

In all other cases of outbound remittance of payments, tax withheld at source by the company making the payment will be the final tax.

### iii Double tax treaties
Nigeria has signed a number of double taxation treaties with countries. Residents of these countries enjoy a preferential withholding tax rate of 7.5 per cent on payments of interest, rent, royalties and dividends. While Nigeria’s double taxation treaties mostly employ the credit method for the elimination of double taxation, a few treaties also employ the exemption method.

### iv Taxation on receipt
As a general rule, dividends, interest, rent and royalties brought into or received in Nigeria by a Nigerian company do not qualify for a credit against Nigerian CIT in respect of foreign tax or withholding already suffered. Exceptions include when the income in question is liable to Commonwealth income tax or when the income is brought in from a country with a double taxation agreement with Nigeria that allows for such a credit. In an instance where a credit is not allowed, the ordinary treatment for these types of profits is to aggregate them with business profits subject to tax at the applicable rate of CIT (i.e., 30 per cent); however, such profits will be exempt from CIT if they are brought into Nigeria through a commercial bank.

### VII TAXATION OF FUNDING STRUCTURES
Small and medium-sized businesses are predominantly funded by equity, as most businesses of this size do not have access to long-term debt. On the other hand, most large businesses, including foreign-owned companies, are predominantly funded by debt.

#### i Thin capitalisation
Nigeria does not have thin capitalisation rules. There are no restrictions on debt-to-equity ratios, although minimum equity capital requirements exist, mainly in the financial services sector. There are, however, anti-avoidance provisions under which the FIRS may disallow the deduction of interest and other financing costs that it deems not to be at arm’s length.

#### ii Deduction of finance costs
Generally, finance costs may be deducted, provided that the relevant test for deductibility of expenses is satisfied. However, as group relief or consolidation is not available, it will be difficult to push acquisition debt down to the target except by, for example, the acquisition financiers directly refinancing target company debt or a mechanism such as post-completion merger.
iii Restrictions on payments
A Nigerian company can only pay dividends out of distributable profits, namely, trading profits, revenue reserves and capital gains. A company shall not declare or pay dividends if its directors are of the opinion that doing so will leave the company in a position where it is unable to meet its liabilities as they fall due.

iv Return of capital
A company may cancel paid-up shares that it considers to represent excess capital and return such capital to its shareholders. A resolution for the cancellation of shares for purposes of returning capital, like all other procedures that reduce share capital, must, however, first receive court sanction. At the discretion of the court considering an application for reduction of capital, creditors of the company making the application may object to the reduction. Before making an order confirming a reduction of capital, the court must be satisfied that the consent of every creditor entitled to object to the reduction has been obtained, or that the debt owed to them has been discharged, determined or secured, and that the company's authorised share capital has not, by reason of the reduction, fallen below the statutory minimum.

A court order confirming reduction of capital must be registered with the Corporate Affairs Commission before it can take effect and repayment can be made. The return of capital using this procedure is tax-neutral, because proceeds from a disposal of shares are not subject to either CIT or CGT.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Foreign companies acquiring interests in local businesses usually avoid doing so through a local vehicle, unless the circumstances demand it. Instead, most foreign investors prefer to use an investment vehicle located offshore, usually in a low-tax or double taxation treaty country. It is quite common for acquisitions of this type to be funded by debt or by portfolio investments. Consideration payable to local sellers is usually structured as a cash payment for shares in the local entity. This structure is tax-neutral.

ii Reorganisation
Mergers and other corporate reorganisations that involve the exchange of shares or cash payment for shares are tax-neutral. CGT may be payable where a reorganisation involves the payment of cash for assets.

iii Exit
A foreign investor wishing to liquidate an investment in a Nigerian company may do so by winding up the business or selling its shares in the business. Capital returned in the process of winding up and proceeds from the sale of shares will not be subject to tax in Nigeria.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Various tax laws contain general anti-avoidance provisions. These provisions allow the FIRS to make necessary adjustments to counteract the reduction in tax that would result from transactions it considers artificial. The FIRS may deem any transaction to be artificial if it finds that its terms have in fact not been effected or, where it is a transaction between related parties, if its terms do not reflect arm’s-length dealings.

ii Controlled foreign corporations
There are no rules relating to controlled foreign corporations. There is legislation that empowers the tax authorities to tax undistributed profits of a Nigerian company where the company is controlled by five persons or fewer.

iii Transfer pricing
The Income Tax (Transfer Pricing) Regulations 2018 provide guidance in the application of the arm’s-length principle in related-party transactions. The Regulations allow related parties to adopt any of a number of listed methods as a basis for pricing of controlled transactions. The methods are:

a the comparable uncontrolled price method;
b the resale price method;
c the cost-plus method;
d the transactional profit split method; and
e the transactional net margin method.

With the approval of the FIRS, a method outside of those listed above may be used. The Regulations also allow for advance pricing agreements with the FIRS. The Regulations replace the Income Tax (Transfer Pricing) Regulations 2012 and incorporate the 2017 updates on the Organisation for Economic Co-operation and Development (OECD)’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Companies with related-party transactions of over 300 million naira are obliged to prepare and submit contemporaneous transfer pricing documentation. A transfer pricing declaration form must also be filed with the documentation. The Regulations stipulate punitive administrative penalties for late filing and non-disclosure.

iv Tax clearances and rulings
There are no provisions authorising the FIRS to give tax rulings. In practice, the FIRS does issue circulars and opinions regarding the tax treatment of contentious issues. However, such circulars and opinions have been held to be non-binding.

It is also not possible to obtain an advance ruling from the courts. In Nigeria, the courts will refuse to hear an action based on hypothetical or academic issues. Consequently, the only means of ascertaining the position of the law is to institute an action when a dispute arises between a company and the tax authority.

The parties to a merger, takeover or other corporate reorganisation involving the transfer of business undertakings or assets must obtain directions from the FIRS as to the value at which assets will be transferred. The parties must also obtain clearance from the FIRS in respect of any CGT resulting from the transaction.
X YEAR IN REVIEW

The Federal Executive Council (FEC) approved the Road Infrastructure Development and Refurbishment Investment Tax Credit Scheme in January 2019. The scheme has a 10-year life span and permits participating companies to fund the construction or refurbishment of major road projects in the country. The participating companies will in return get CIT credits.

The FIRS issued the Income Tax (Common Reporting Standard) Regulations (CRS Regulations) effective from 1 July 2019 and the Income Tax (Common Reporting Standard) Implementation and Compliance Guidelines (the Guidelines) to supplement the CRS Regulations. The CRS Regulations give effect to the provisions of the OECD Convention on Mutual Administrative Assistance in Tax Matters, the Multilateral Competent Authority Agreement (MCAA) on Automatic Exchange of Financial Account Information and the Common Reporting Standard, alongside its commentaries, as approved by the OECD. Reporting financial institutions include depository institutions, investment entities, custodial institutions and specified insurance companies.

On 14 October 2019, the President submitted the Finance Bill 2019 (the Bill) to the National Assembly. The Bill introduces vast changes to the CITA, VAT Act, PPTA, Personal Income Tax Act and Stamp Duties Act. It is expected that the Bill will become operational from January 2020.

Some of the changes proposed in the Bill are outlined below.

CITA:

a introduction of digital permanent establishment (PE) for companies with significant economic presence in Nigeria;

b introduction of thin capitalisation rules limiting deductible interest expense on a loan by a foreign related party to 30 per cent of earnings before interest, taxes, depreciation and amortisation (EBITDA); any excess interest expense to be carried forward for a maximum of five years;

c introduction of a specialised framework for the taxation of securities lending transactions;

d 'excess dividend tax', wherein companies pay tax on dividends that exceed profits, to no longer apply to dividends paid out of exempt income or from franked investment income;

e exempting businesses with a turnover of less than 25 million naira from CIT while medium-sized companies with turnover between 25 million and 100 million naira to pay CIT at the rate of 20 per cent;

f eliminating the rules for the taxation of a company at commencement and cessation of business (which typically lead to double taxation);

g permitting insurance companies to deduct reserve for unexpired risks on time apportionment basis and to also carry forward tax losses indefinitely; and

b introduction of a bonus of 2 per cent and 1 per cent, respectively, for early payment of CIT by medium-sized and large companies.

PPTA:

a subjecting dividends declared from profits from the sale of crude oil to 10 per cent withholding tax.
VAT Act:
ea increasing the rate of VAT to 7.5 per cent;
b defining goods and services to include intangibles;
c charging VAT based on the destination principle;
d requiring residents to self-charge and remit VAT on taxable supplies from non-residents even where a non-resident fails to issue a VAT invoice; and
e introduction of a threshold of 25 million naira of turnover for registering for and filing VAT returns.

CGT Act:
a exempting compensation for loss of employment below 10 million naira from CGT; and
b exempting gains realised from the sale of assets by related companies in furtherance of a reorganisation from CGT.

Stamp Duty Act:
a defining stamp to include electronic stamps; and
b imposition of stamp duty of 50 naira on electronic receipt or transfer from 10,000 naira and above (with the exception of own-accounts transfers).

XI OUTLOOK AND CONCLUSIONS

With Nigeria’s tax-to-GDP ratio being at 6 per cent (one of the lowest in the world) and unstable revenue from oil, the federal government’s resolve to increase tax revenue is stronger than ever. The Bill, is, therefore, unsurprising. Further, the government has completed the last step in the implementation of the CRS MCAA by the introduction of the Country-by-Country Reporting (CbCR) Regulations, which would enable the government to receive information from over 100 jurisdictions that have committed to exchanging information under the CRS MCAA.

We, therefore, expect to see aggressive initiatives from the federal government geared towards widening the tax net and curbing tax evasion and profit shifting. We also expect to see increased investments in small and medium-sized businesses when the Bill is eventually passed.
I INTRODUCTION

Norway has a small but robust economy, and with a corporate tax rate of 22 per cent and a participation exemption that is among the most liberal within the European Economic Area (EEA), investors tend to find Norway to be an attractive country to invest in or through.

Norway does not impose withholding tax on royalties or interest in general, or on dividends paid to corporate shareholders in the EEA. Together with a wide range of double taxation treaties with low or no withholding tax, this makes Norway a suitable base for holding companies, especially when investing into the EEA.

To balance out the low rates for corporate taxation, Norway has an extensive anti-avoidance doctrine to control the use of innovative tax-planning techniques. Special tax regimes apply to income from the exploration of petroleum resources, shipping income and income from the production of hydroelectric power.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

There are two main forms of organising a business: entities with limited liability and entities with unlimited liability.

Limited liability companies, where none of the shareholders have personal liability for the obligations of the company, may be incorporated either as a private limited liability company (AS) or a public limited liability company (ASA). Other entities with limited liability include foundations, cooperative societies, stock funds and mutual insurance companies.

The common types of entities with unlimited liability are the general partnership with joint liability (ANS), the partnership with apportioned liability (DA) and limited partnerships (KS and IS).

Entities with limited liability are subject to corporate taxation, while entities with unlimited liability are transparent for tax purposes and taxed at partner level.

i Corporate

The AS and the ASA are regulated by two separate laws but with similar structure, and largely similar content. Key differences between public and private companies are that only public companies may turn to the public to raise capital and be listed on a stock exchange.
Public companies are also subject to stricter rules regarding organisation, the minimum board member requirement and restrictions on share classes. The required minimum share capital for a private limited company is 30,000 kroner and 1 million kroner for a public company.

As a member of the EEA, Norway has adopted the EC Regulation on European Companies (SE companies). SE companies are mainly governed by the same rules that apply to public limited companies.

### ii Non-corporate

Business activities may also be organised as partnerships. In a general partnership, the partners are jointly and severally liable for all the obligations of the partnership. A general partnership can also be organised with proportional liability, where each partner is only liable to the proportional share set out in the partnership agreement.

The limited partnership is distinguished by having one or more general partners with unlimited personal liability, and one or more limited partners whose liability is limited to a set amount.

### III DIRECT TAXATION OF BUSINESSES

Corporate entities incorporated in Norway, and foreign companies with their effective management in Norway, are regarded as tax-resident and liable to corporate tax on their worldwide income, including capital gains (for partnerships, the tax depends on the partner’s tax status).

Non-resident companies and Norwegian branches are taxed on Norwegian source income (see Section IV.ii).

#### i Tax on profits

**Determination of taxable profit**

As a general rule, taxable profit is a net amount based on accounting profit adjusted for differences between the accounting rules and the tax accounting rules.

Income is taxed on an accruals basis. Income derived under contracts will, with the exception of fixed price production contracts, be considered accrued when the taxpayer is entitled to the consideration from the other party under the contract (when the taxpayer has delivered his or her goods or services under the contract).

**Income**

The taxable corporate income comprises all kinds of income, inter alia, interest, dividends, capital gains on the disposal of assets or ownership interests and foreign-sourced income taxable in Norway (i.e., ordinary business income). For resident limited liability companies or entities, the participation exemption is applicable for dividends and gains on shares and partnership interests (see Section V.i).

For partnerships (transparent for tax purposes), the net result of the partnership is calculated as if the partnership were a company and then allocated to the partners and taxed

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3 The profit element of these contracts is recognised as taxable income according to the completed contract principle.
at the partner level. Income and loss covered by the participation exemption (capital gains and dividends from shares) shall not be included. However, 3 per cent of dividends shall be recognised as taxable income.

A limited partner will not be able to deduct partnership losses against ordinary income from other sources. Such losses may be carried forward for deduction against future partnership income or gains upon the realisation of partnership interests. Dividends and gains on shares received by corporate partners will to a large extent be tax-exempt under the participation exemption (see Section V.i).

**Expenses**

When calculating net taxable income, the general principle is that all expenses incurred to acquire, maintain or safeguard the company's taxable income are deductible.

As a starting point, interest on debts is deductible, whether paid periodically or discounted. The deductibility may, however, be limited under the interest deduction limitation rule (see Section VII) or the arm's-length principle.

Expenses unrelated to normal business activities are not deductible (e.g., excessive entertainment expenses, donations and bribes or similar payments).

Dividends distributed and appropriations of profits are not deductible in taxable income for the distributing company.

**Depreciation and amortisation**

The amount of tax-allowable depreciation is determined by the tax legislation and may differ from the accounting rules. There are two alternative methods to determine the deductible amount:

- the declining balance method (which in general applies to tangible assets and goodwill – the rates vary from 2 to 30 per cent); and
- the linear method (which applies to intangibles that are not covered by the declining balance method).

Land and plots are not depreciable.

**Capital gains and income**

Capital gains are considered as ordinary income for tax purposes.

Gains on shares and partnership shares will, however, to a large extent be tax-exempt under the participation exemption (see Section V.i).

**Losses**

Tax-deductible losses may be carried forward indefinitely and set off against future profits. When a company is liquidated, any loss may be carried back for the two preceding years.

The tax position of a loss carried forward will survive a change in ownership unless the predominant motive is to exploit the tax position; for example, through a group contribution. In these cases, the tax position of the loss may be lapsed (see Section IX.ii).

Losses on intra-group loans (between companies where the lender has more than 90 per cent ownership) are not deductible.
In general partnerships, a limited partner will not be able to deduct partnership losses against ordinary income from other sources. Such losses may be carried forward for deduction against future partnership income or gains upon the realisation of partnership interests.

**Rates**
The corporate income tax rate is 22 per cent.

**Administration**
As a general rule, the income tax year follows the calendar year. Companies must file tax returns electronically by 31 May in the year following the income tax year. Companies may apply for a deviating 12-month tax year, but a tax year may never include more than 18 months. Companies must pay advanced tax by 15 February and by 15 April in the year following the income tax year.

The Norwegian Tax Authority is responsible for the administration of all direct taxes and VAT for domestic sales. Complaints against decisions made by the tax authorities may be filed with the Norwegian Tax Appeal Board. Decisions by the Tax Appeal Board may be brought before the courts.

As of 2017, the statute of limitation period for reassessment of the tax return is five years (10 if the taxpayer intentionally or through gross negligence has given misleading or incomplete information about his or her income).

Penalty tax will be imposed where the company gives misleading or incomplete information about its income and this results in – or could have resulted in – an underassessment. The penalty tax will normally be 20 per cent, but is raised with 20 per cent or 40 per cent if misleading or incomplete information was filed intentionally or by gross negligence.

**Tax grouping**
If a resident company (the parent company) holds more than 90 per cent of the capital and votes of other resident companies, the companies will constitute a tax group. Each company within a tax group is, as a general rule, treated as a separate entity, and assets, dividends, interest, income and deductions cannot be moved between companies. However, in a tax group, the participating companies may make tax-deductible group contributions and intra-group transfers of assets without immediate realisation of latent gains (i.e., the taxation is deferred).

A company resident in the EEA may be the parent company in a Norwegian tax group, and a permanent establishment (PE) of a company resident in either the EEA or in a state with which Norway has a tax treaty may also qualify for the tax grouping benefits.

**Value added tax**

**General**
Value added tax (VAT) is payable on domestic sales of most goods and services. In addition, VAT is payable on importation of goods or services and withdrawal.

Because taxation (including indirect taxation) is not explicitly covered by the EEA Agreement, Norway is not required to harmonise its VAT law with European Union (EU) VAT law.
The Norwegian VAT Act of 2009 does not contain any specific provisions with respect to the place of supply of goods and services. As a starting point, transactions taking place domestically within Norway are subject to VAT. However, the VAT Act contains several exceptions. Transactions taking place abroad (outside the Norwegian mainland and the limit of territorial waters) are outside the scope of Norwegian VAT.

**VAT liable supplies and VAT exempt supplies**

The ordinary VAT rate is 25 per cent. Certain goods and services enjoy reduced rates. A reduced rate of 15 per cent applies to foodstuffs, and a lower rate of 12 per cent applies (e.g., to passenger transport, cinemas, hotels and accommodation services as well as admission fees to museums, amusement parks and sports events). The zero rate applies to exports of goods or services, and a number of other supplies, such as supplies of newspapers and books, supplies of or to certain ships, supplies to the continental shelf, aircrafts, transfer of business (TOGC) etc.

A number of services are VAT exempt. Such supplies fall entirely outside the scope of the VAT Act. Businesses that only are engaged in such supplies are not entitled to register for VAT purposes, and are not entitled to VAT deduction. Examples of VAT exempt supplies are financial services, health and social services, educational services, some cultural services (e.g., the right to attend theatre, opera, ballet and concerts). Sale and lease of real estate are also VAT exempt. However, it is possible to opt for a voluntary VAT registration with respect to lease of real estate for use in a VAT liable business by the lessee.

**Exports and imports**

The zero VAT rate is applicable on exports of goods and services from Norway to abroad under certain conditions.

VAT should be calculated and paid on services purchased from abroad, that would have been liable to VAT when sold domestically. The recipient has a duty to calculate and pay the VAT in accordance with the reverse charge principles. VAT liability applies only to those services that can be supplied from a remote location. This means in cases where the provision of the services, by its nature, is difficult to associate with a particular physical location. Examples of remote services are services that can be supplied digitally, consultancy services, administrative services, legal services (with an exception for court cases), accounting services, information services and hiring out of labour. For services that cannot be supplied from a remote location, such as services relating to work on real property or goods in Norway, hiring out of goods etc., the foreign business enterprise must instead register in the Norwegian VAT Register and calculate Norwegian VAT on the supply to the customer.

VAT shall also be calculated on the importation of goods. The reverse charge principles applies to VAT registered businesses.

**VAT deduction**

A business registered in the Norwegian VAT Register is, as a main rule, entitled to deduct input VAT on purchases of goods and services for use in the VAT liable business. A pro-rate key must be used for acquisitions for use in both a VAT liable and VAT exempt business.

Input VAT is not deductible on certain costs. It is also a condition for VAT deduction that incoming invoices contain certain information as set out in the Bookkeeping Regulation, including the VAT number by the supplier.
**VAT adjustment rules: capital goods**

Machinery, fixtures, fittings and other operating assets, for which the input VAT on the cost price amounts to at least 50,000 kroner, are deemed to be capital goods. This limit applies to each individual acquisition. Real estate that has been subject to construction, extension or alteration, for which the input VAT amounts to at least 100,000 kroner, is also deemed to be capital goods.

In general terms, the provisions means that the deduction for input VAT shall be adjusted up or down if the connection between the capital goods and activities liable to VAT change during a period of 10 years (real estate) or five years (other capital goods).

Sale and other transfer of capital goods through mergers, demergers or transfer of business, may trigger VAT adjustment obligations. The same applies when a change in the use of the capital goods results in the purpose no longer being VAT liable. The VAT adjustment obligations could be transferred to the new owner in a VAT adjustment agreement under certain conditions.

**VAT registration**

All companies with annual VAT liable turnovers that exceed a certain threshold (at present, 50,000 kroner) is required to register with the Norwegian VAT Register.

In general, this also apply to non-resident enterprises, making supplies that are subject to VAT in Norway. A foreign enterprise, that does not have a place of business in Norway, must in principle register through a fiscal representative. However, foreign enterprises from other EEA countries can register for VAT without a VAT representative.

A foreign enterprise that is not required to register for VAT purposes in Norway may nevertheless claim a refund of input VAT paid for goods and services for business purposes in Norway. It is a condition that the enterprise would have been required to register for VAT purposes in Norway if the business activities had been carried out in Norway and that the VAT incurred would have been deductible in accordance with the VAT Act.

It is also possible, under certain conditions, to apply for a pre-registration before the supply commences, or prior to the registration threshold have been reached.

Collaborating companies may, at their own request, be regarded as one single taxable entity and form a VAT group provided at least 85 per cent of the capital, in each company are owned by one or more of the collaborating companies. VAT should not be calculated on transfer of goods and services between the VAT group registered companies, as this is not considered as a supply for VAT purposes. All companies within the VAT group are jointly and severally liable for the payment of VAT.

**VAT reporting and filing**

VAT registered businesses are required to file VAT returns (normally bi-monthly) to the tax office. The deadline for filing VAT returns as well as payment of the respective VAT is 1 month and 10 days after expiry of the reporting period.

The company has the right to set off all deductible input VAT in the period against all output VAT in the same VAT period. The net amount output VAT must be paid to the tax authorities. If the input VAT exceeds output VAT, the business is entitled to repayment of VAT from the tax authorities.
iii Other relevant taxes

Stamp tax

The registration of transactions involving immovable property in the Land Registry is subject to a stamp duty of 2.5 per cent of the accepted value of the property at the time of the registration.

There are no other stamp duties in Norway.

Customs duties

Imported goods may be subject to customs duties depending on the country of origin and the type of goods concerned. Customs duties mainly apply to textiles and foodstuffs.

Excise duties

Excise duties apply on a number of goods. As an example, there is electrical power tax, air passenger tax, mineral product tax, NOx tax (tax on emissions of nitrogen oxides in energy production from certain sources), excise duties related to vehicles etc.

Real estate tax

Individuals and companies that own immovable property may be subject to municipal real estate tax regulated by an immovable property tax law.4

The financial activity tax

A financial activity tax was introduced from 2017 for the financial sector. Normally, the financial activity tax is applicable to businesses that are engaged in VAT exempt financial activities.

For enterprises defined as financial institutions, the corporate tax rate will remain at 25 per cent even if the ordinary corporate tax rate is 22 per cent. Financial institutions also have a 5 per cent tax imposed on their total salary costs.

The petroleum tax system

All petroleum-related income on the Norwegian continental shelf is governed by the Petroleum Tax Act; however, the general tax legislation will also apply.

The petroleum tax regime is characterised by a very high marginal income tax rate (78 per cent), which to some extent is offset by relatively generous tax deductions, such as the immediate expense of all exploration costs, fast tax depreciation, an uplift allowance for special tax purposes and a tax deduction for financial costs related to upstream business activity.

Income tax for 2019 comprises the ordinary 22 per cent corporate tax rate and the 56 per cent special tax rate.

There are no field operation ring-fencing arrangements on the Norwegian continental shelf, and all exploration costs may be deducted. Companies may, however, no longer deduct exploration costs abroad from the Norwegian income. Companies in a loss position may choose between a cash refund of the tax value (i.e., 78 per cent) of the exploration costs or

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4 Law of 6 June 1975, No. 29.
to carry the cost forward with interest. When winding up the business on the Norwegian continental shelf, a company will receive the tax value (78 per cent of exploration cost and 22 per cent of all other cost) of any unused losses the company may have.

A norm price, set by a separate norm price board, replaces the actual sales price when calculating the taxable gross income from the sale of crude oil (regardless of the actual sales price being higher or lower).

There is no dividend withholding tax on distribution from profits subject to the 56 per cent special tax.

**Hydroelectric power production companies**

In addition to the ordinary income tax rate of 22 per cent, hydroelectric power production companies are subject to a 37 per cent natural resource rent tax, so that the total tax rate amounts to 59 per cent. An amount equal to the normal rate of return on the investment is shielded against the additional tax. Further, the hydroelectric power production companies are subject to a municipal resource extraction tax of 0.013 kroner per produced kwh.

**Tonnage tax system**

For shipping companies, the tax on corporate profits may be replaced by a tax based on the tonnage operated by a company.

Elaborate ring-fencing arrangements limit the benefit of tonnage tax on the operation of ships, and companies within the regime may not carry on any other business.

**Employers' social security contribution**

The rates range from zero to 14.1 per cent depending on the tax municipality of the employer.

An employer resident abroad is required to pay social security contributions in respect of employees working in Norway, but is subject to a possible exemption under the EEA or other social security treaties.

### IV TAX RESIDENCE AND FISCAL DOMICILE

#### i Corporate residence

Companies, etc., are considered resident in Norway if these are (1) incorporated pursuant to Norwegian company law; or (2) have their de facto management in Norway.

In assessing whether de facto management is in Norway, it must be considered where the board level management and daily management are carried out, but also other circumstances relating to the organisation and business activities of the company must be considered. A company, etc., will nonetheless be considered not resident in Norway if such company is resident in another state under a tax treaty.

#### ii Branch or permanent establishment

Norwegian tax legislation does not define a PE and, as a general rule, a foreign incorporated company conducting or participating in business in Norway will be considered as having a taxable presence in Norway. However, most Norwegian bilateral tax treaties are based on the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention, and with Norway’s extensive network of tax treaties, the PE definition will normally be decisive for a company’s taxable presence in Norway.
The allocation of income between a foreign head office and the taxable presence in Norway, a Norwegian PE or branch should be calculated according to the arm’s-length principle.

Capital gains on shares realised by non-resident corporate shareholders are not subject to taxation in Norway unless the foreign shareholder has a PE in Norway, and the shares are effectively connected to the PE or presence in Norway and are not covered by the participation exemption.

Activities on the Norwegian continental shelf related to petroleum resources will constitute a taxable presence as a PE after a certain number of days of activity, often as little as 30 days within a 12-month period.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

The participation exemption, an extensive network of tax treaties and a tax credit system that allows unused tax credits to be carried forward, ensure the avoidance of double taxation and make the Norwegian holding regime one of the most favourable in Europe.

Participation exemption

Pursuant to the participation exemption, corporate shareholders are exempt from taxation of dividends and gains on shares (except for a clawback of 3 per cent on dividends, if the receiving company owns less than 90 per cent of the shares and voting rights of the distributing company).

The participation exemption comprises dividends and capital gain on shares in companies resident in Norway, and the EEA. Dividends and capital gain on shares in companies resident outside the EEA, but not in a low-tax jurisdiction, are also tax-exempt provided that the shareholder has held at least 10 per cent of the shares and capital for a period of two years. Dividends and capital gains on shares in companies in low-tax jurisdictions outside the EEA are not tax-exempt, and losses on such shares will be deductible.

For dividends, 3 per cent of the dividends received are subject to the 22 per cent corporate tax (effective taxation on exempt dividend is 0.66 per cent). The clawback of 3 per cent does not apply to intra-group dividends within a tax group from companies resident in Norway and that have more than 90 per cent ownership in the distributing company, or within the EEA provided that the shareholder has held at least 10 per cent of the shares and capital for a period of two years.

There are no requirements for participation or holding periods for dividends and capital gains on shares of Norwegian or EEA-resident companies for the exemption method to apply. However, companies resident in a low-tax jurisdiction within the EEA must be genuinely established and conduct genuine business within their state of residency (substantial business test) in order for the participation exemption to be applicable. As a general rule, this implies that the business is organised in a similar way as other local businesses of the same kind, and a tax-avoidance motive is not proven.

Capital gains on a partnership’s shares will, for a corporate partner, be tax-exempt if at least 90 per cent of the partnership’s investments at all times during the past two years have been in tax-exempt shares. Losses on the partnership’s shares will, for a corporate partner, be deductible only if the partnership’s non-qualifying shares have exceeded 10 per cent of the
total value of shares during the previous two years (the tax rules regarding gains and losses on a partnership’s shares are asymmetrical, and the requirements could lead to double taxation if both the shares owned by the partnership that are not tax-exempt and the partnership shares are sold). For corporate partners resident in Norway, this applies irrespective of where the partnership is registered.

Corporate partners receiving distributions from a partnership’s shares are, as for dividends from shares, liable to 22 per cent income tax on 3 per cent of the distributions received (after a deduction for the partner’s tax on the partnership’s share).

With effect from 2016, distributions from companies for which the distributing company has been able to deduct the distribution will not be covered by the participation exemption.

ii IP regimes
There is no special IP tax regime in Norway.

A tax relief may, however, be granted according to the rules of SkatteFUNN R&D tax incentive scheme (see below).

iii State aid
Norwegian authorities offer a wide range of state aid for investments, R&D (see below), and development and exports through a regional development fund (Innovasjon Norge) supporting businesses establishing in Norway and abroad.

iv General
SkatteFUNN is an R&D tax incentive scheme that entitles all enterprises subject to Norwegian taxation to a tax deduction of expenses related to R&D (within certain limits and provided certain conditions are met), provided that the research programme has been approved by the Research Council of Norway.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
Outbound dividends paid to a non-resident shareholder or owner are subject to a 25 per cent withholding tax unless an exemption or lower tax rate applies pursuant to a tax treaty.

There is no withholding tax on royalties, interest or other payments such as service and management fees, rents or lease payments.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
The participation exemption applies (i.e., no withholding tax on dividend distributions) to corporate shareholders within the EEA provided that the shareholder meets the substantial business test (see Section V.i).

iii Double tax treaties
Norway currently has tax treaties covering 94 jurisdictions.
The withholding tax rate on dividends is normally reduced to 15 per cent, and to 5 per cent in parent–subsidiary situations, under a tax treaty. For dividends under the participation exemption (within the EEA) there is no withholding tax. Norway does not impose withholding tax on royalties or interest in general, and some tax treaties, in particular relating to royalties, interest or other payments, provide for a withholding tax rate of zero.

iv Taxation on receipt
Dividends received by, and capital gains from the sale of shares by private and public limited companies and other companies treated equally for tax purposes, are tax-exempt pursuant to the participation exemption.

If the participation exemption is not applicable, dividends will be fully taxable. In such cases, the Norwegian parent company is entitled to a tax credit for foreign withholding tax, and (on certain conditions) may claim tax credit for underlying corporate tax paid by the foreign subsidiary.

Royalties, interest and other payments, such as service and management fees, rents and lease payments, are taxable as corporate income.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
Norwegian tax legislation contains no specific statutory or regulatory prescriptions of thin capitalisation, and as a rule, all interest paid to an unrelated party is deductible. Between related parties, interest deductibility may be limited under the arm’s-length principle or the interest deduction limitation rule, both set out under the Norwegian Tax Act.

Limitation of interest deduction between related parties
The interest deduction limitation rule states that net interest expenses exceeding 25 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA) will be non-deductible for tax purposes. For companies that are part of a group, interest expenses on external and internal debt will be subject to the limitation rule, whereas for companies not part of a group, the limitations only apply to interest expenses on debt to related parties.

For companies that are part of a group, there are, however, two alternative escape clauses providing that the company or group can escape the limitations completely if:

a the relevant company on a stand-alone basis has a debt-to-equity ratio similar to or stronger than the consolidated debt-to-equity ratio in the group that the company is a part of; or

b the Norwegian part of the group has a consolidated debt-to-equity ratio that is similar to or stronger than the consolidated debt-to-equity ratio in the wider group.

Interest deductions will, however, only be limited to the extent that the net interest expenses exceeds certain thresholds. For companies that are part of a group, the limitation rules will only apply to the extent that net internal and external interest expenses exceeds 25 million kroner in total for the Norwegian part of the group.

For companies not part of a group, the limitation rules only apply to the extent that net interest expenses in the company exceeds 5 million kroner. This also applies to companies that are part of a group that has net interest expenses to a related party outside the group.
Parties are considered related when there is ownership or control of 50 per cent or more of one party by another.

External loans guaranteed by a related party of the borrower (tainted debt) will be treated the same way as loans to related parties.

The interest deduction limitation rule applies to limited liability companies, and similar other companies and entities. The rules also apply to partnerships, shareholders in controlled foreign corporations (CFCs) and foreign companies with PEs in Norway. Financial institutions are exempt from the interest deduction limitation rule.

**ii Deduction of finance costs**

Interest costs on business debt (see above), issue expenses and commissions on loans are tax-deductible. The same applies for interest charged for late payment of debt. Even under the participation exemption, companies may continue to deduct interest on debt incurred to finance acquisition of shares giving rise to tax-exempt income.

Excessive interest or business profits paid to the parent company or a related company may, depending on the circumstances, be regarded as dividend distributions and thus not deductible.

Financial acquisition costs may not be deducted from the company’s taxable income, but have to be capitalised together with the cost of the acquired shares.

**iii Restrictions on payments**

Dividends may be distributed several times during the year, but only if the company has sufficient net assets to cover the share capital after the distribution of dividends.

**iv Return of capital**

Paid-in equity may be repaid on a tax-neutral basis through a reduction and return of capital.

### VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

**i Acquisition**

Capital gains on the transfer of shares by corporate shareholders (limited liability companies, etc.) are tax-exempt, and losses are not deductible pursuant to the participation exemption. The acquisition costs are not deductible even if the transaction is aborted, and any allocation of acquisition costs to the target company is regarded as illegal financial aid.

Asset deals are, for tax purposes, regarded as selling the company’s possessions separately, and gains are taxable and losses deductible.

**ii Reorganisation**

Mergers and demergers may, subject to certain conditions, be carried out without triggering taxation if all the companies involved are resident in Norway. One of the crucial conditions for carrying out a merger or demerger without triggering taxation is that it is done with tax continuity on both company level and shareholder level, and thus maintains the tax positions of the parties.

Cross-border mergers between companies within the EEA may be carried out tax-free if the transaction is carried out pursuant to principles for tax continuity applicable in the state where the assigning company is resident. However, if the transferring company is resident
in Norway, the company’s assets will be considered realised for tax purposes upon exit (see below) if moved out of the Norwegian tax jurisdiction. Corresponding rules apply for a demerger of a limited liability company resident in an EEA state if the acquiring company is resident in Norway.

Cross-border mergers and demergers will not be tax-exempt if one or more of the companies taking part in a merger or demerger are resident in a low-tax country within the EEA, and if the company or companies do not fulfil the substantial business test.

iii Exit
A company can relocate by moving the board level management and daily management from Norway (whether on purpose or not).

When the company ceases to be resident in Norway for tax purposes and relocates to a state outside the EEA, or a low-tax jurisdiction in the EEA in which the substantial business test is not met, all business assets and liabilities are regarded as realised at market value, and are subject to tax or tax deduction. If the company relocates to other states, tax on tangible assets except for merchandise may be deferred upon certain conditions.

When assets are moved within the EEA, the tax payable on tangible assets (except for merchandise) may, subject to certain conditions, also be deferred. The exit tax for tangible assets is then annulled if the asset is not realised within five years.

For intangible assets and merchandise, the exit tax is definitive and payable on the day of exit.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION
i General anti-avoidance
Norway has an expansive anti-avoidance doctrine, with both general and specific anti avoidance rules.

The courts have developed a general anti avoidance doctrine that ensures that the tax authorities can cut through structures and dispositions whose primary motive is to achieve tax benefits and are deemed ‘disloyal’ to the tax legislation.

The tax legislation also contains a specific anti-avoidance rule that states that if a company has tax positions that are unrelated to any asset or liability, and the ownership of such company changes by merger, demerger or other transaction with the predominant motive of exploiting that position, the tax position will be void.

ii Controlled foreign corporations (CFCs)
The CFC taxation rules imply that the shareholder of a company is taxed on a yearly basis for its proportionate share of the company’s income, whether distributed or not. The rules apply to shares in companies incorporated in a low-tax jurisdiction controlled by Norwegian shareholders (Norwegian control, directly or indirectly, over at least 50 per cent of the shares or votes).

A low-tax jurisdiction is defined as a country with an effective income tax rate lower than two-thirds of the effective tax rate in Norway for the same type of business (the Ministry of Finance has published a non-exhaustive ‘white list’ and ‘black list’).

The CFC legislation does not apply to companies that are established in an EEA country and that meet the substantial business test (see Section V.i).
If the company is resident in a Norwegian tax treaty country, the CFC legislation only applies if the company’s income is predominantly of a ‘passive’ character (financial or rental income, royalty, etc.).

iii Transfer pricing

Intra-group transactions are to be priced in accordance with the arm's-length principle.

If the income of a Norwegian-resident company is reduced owing to transactions with a related party, the tax authorities may adjust the income of the company in accordance with the arm's-length principle.

Reporting documentation requirements apply, and group companies must, in their tax return, give information on intra-group transactions. The taxpayer must, with some exceptions, be prepared to file transfer pricing documentation (type and volume of the transactions, functional analysis, comparable analysis and a report of the transfer pricing method used) within 45 days of a written notice from the tax authorities.

iv Tax clearances and rulings

Advance rulings may be obtained from the Directorate of Taxes and from local tax inspectors in respect of direct taxes, social security contributions and VAT. These rulings will be binding for the tax authorities, but optional for the taxpayer.

X YEAR IN REVIEW

In a white paper issued in April 2019, it was proposed to implement rules that codify the non-statutory legislation on anti-avoidance (see Section IX.i for a further description of these rules). The proposed rules entered into force from 1 January 2020 and apply for both tax and VAT.

Previously, importation of goods was exempt from VAT and customs duties, under certain conditions, provided the value of the shipment from abroad was less than 350 kroner. However, it has been decided that the VAT and customs duties exemption will be removed with effect from 2020. As a result, VAT and customs duties shall be paid on all imports, as a rule.

The government has also decided establishing a simplified registration and reporting system for calculation and payment of VAT that will involve the foreign suppliers, offering goods to Norwegian private consumers, being responsible for calculating and payment of the Norwegian VAT. Importation of foodstuff, alcohol etc. will not be included in the simplified reporting regime, and must be customs declared at the time of the importation.

Moreover, private individuals will be entitled to import clothes and textiles from foreign suppliers and online shops, without paying customs duties provided the value of the shipment is below 3,000 kroner.

The new registration and reporting system will not apply in connection with imports made to Norwegian businesses and to the public sector.

XI OUTLOOK AND CONCLUSIONS

In 2017, the Norwegian Ministry of Finance issued a public consultation paper regarding amendments to the interest deduction limitation. The proposal relating to this issue was followed up in the government’s proposal of the Fiscal Budget for 2019 and 2020.
Currently, however, no consultation paper to introduce a withholding tax on interest and royalties has been set forth. However, the Ministry of Finance has announced that such consultation paper will be published in due course.
Chapter 24

POLAND

Jarosław Bieroński

I INTRODUCTION

Since Poland joined the European Union on 1 May 2004, Polish domestic law has been harmonised with EU legislation and the case law of the Court of Justice of the European Union (CJEU), and all EU tax directives have been implemented.\(^1\)

In addition, foreign and local income is protected in Poland against double taxation through an extensive network of 92 double taxation treaties (DTTs) that are based on the Organisation for Economic Co-operation and Development (OECD) Model Convention. Whenever such a treaty does not exempt income from taxation, or in the absence of a treaty, the tax credit system applies, including the full tax credit for underlying tax applicable to Polish companies receiving foreign (inbound) dividends from countries outside the EU. As a result, in many such cases, no corporate tax would apply in Poland, as the Polish Corporate Income Tax Law (CITL) sets tax rates of 19 or 9 per cent, which are lower than tax rates in many countries.

Income derived from economic activities conducted in the Polish territory within special economic zones (SEZs) (i.e., areas designated for the purposes of running businesses on preferential terms) is tax-exempt. Furthermore, large and small investments that are crucial to the Polish economy may also find support through a number of government and other state aid programmes aimed at fostering investment or the creation of new workplaces. Flexible thin capitalisation rules also encourage investors to finance local businesses with the use of debt, including intra-group loans.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

In Poland, business activity may be pursued by any person acting either as a sole entrepreneur or a capital (corporate) company or partnership, as envisaged in the Polish Commercial Companies Code. Foreign entrepreneurs with their registered office in the European Union

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1 Jarosław Bieroński is a partner at Sołtysiński Kawecki & Szlęzak.
2 Including Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States, and to the transfer of the registered office of a European company (SE) or European cooperative society (SCE) between Member States; Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States; and Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.
Poland

(EU), European Free Trade Association (EFTA) or European Economic Area (EEA) may perform their business activity in Poland in compliance with the rules and principles set forth for Polish entrepreneurs. In turn, foreign entrepreneurs with their registered office in other countries may perform their business activity in Poland through a limited partnership, a partnership issuing shares, a limited liability company or a joint-stock company only. Foreign entrepreneurs may also perform their business activity in Poland through a local branch.

### Corporate

Corporate companies (i.e., limited liability companies and joint-stock companies) obtain legal personality upon court registration. The limited liability company is most frequently used for doing business in Poland. In turn, a joint-stock company features more advanced corporate instruments, such as convertible bonds, authorised but not issued capital, founders’ certificates and non-voting shares. Its operations and management are subject to more stringent requirements than the operations of a limited liability company. In addition, the value of all in-kind contributions to the share capital of a joint-stock company is subject to a mandatory verification by court experts. The registered share certificates may be issued prior to the full coverage of shares by shareholders. Bearer shares may be listed on stock exchanges and traded on a public market. The form of a joint-stock company is mandatory for the conduct of certain types of activities (e.g., banking or insurance). Joint-stock companies floated on the Warsaw Stock Exchange must comply with additional informational obligations envisaged by pertinent laws and stock regulations.

Corporate companies (even prior to their court registration) and other organisational units, with or without legal personality, including limited partnerships issuing shares (with the exception of other partnerships), are taxpayers liable to corporate income tax (CIT). Corporate taxpayers that have their registered office or place of management in Poland are liable to CIT on their worldwide income. If a corporate taxpayer does not have its registered office or place of management in Poland, the tax is levied only on the income derived in Poland, unless an applicable DTT provides otherwise.

Capital companies may also establish a ‘tax group’ (tax unit) – a group of two or more capital companies treated as a single CIT payer – which must first satisfy numerous conditions.

Owing to attractive tax treatment, foreign and local investors also used Poland-based regulated close-ended investment funds and qualified foreign-regulated mutual investment funds from the EU and the EEA (they must be managed by a company operating under a permit granted by the competent financial sector supervision authority of the country of the fund’s seat), and regulated investment companies from the EU and the EEA operating upon a simple notice of initiation of investment activities. Although Polish investment funds may not conduct operational business activities, they may invest in real property, in shares issued by companies and limited partnerships issuing shares, and in other securities. Such local and foreign regulated funds and regulated investment companies were entirely exempt from Polish CIT on any local and foreign income. However, since 2017, the local general tax exemption of Poland and foreign regulated investment funds is narrowed to income derived by Poland-based open-ended investment funds and qualified foreign-regulated collective investment funds from the EU and the EEA only. In principle, they must have a permit granted by the competent financial sector supervision authority of the country of the fund’s seat, be managed by a company operating under a permit of such authority and have custody. In turn, Poland-based close-ended investment funds and qualified foreign-regulated collective
investment funds from the EU and the EEA operating upon a simple notice of initiation of investment activities, rather than upon a permit of the competent financial sector supervision authority, are also able to apply the local tax exemption, with, however, the exclusion of certain items of their income (in particular, interest, donations and profits paid by local and foreign tax-transparent partnerships, and capital gains from transfers of securities issued by those partnerships). In addition, the new tax exemption for qualified foreign-regulated collective investment funds from the EU and the EEA is limited to situations where Poland may claim an exchange of information from the tax authorities of the country of that fund pursuant to a pertinent DTT or other treaty.

The administrative court also ruled that a Luxembourg investment company operating under Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers is not exempted from CIT in Poland as it is not a collective investment fund such as UCITS, which should operate upon a permit of the competent financial supervisory authority in the meaning of the EU and Polish regulations.

On the other hand, the CJEU and Polish administrative courts have issued encouraging judgments stating that narrowing the tax exemption to income of regulated investment funds only from Poland and other EU or EEA Member States violates Article 56 of the Treaty on the Functioning of the European Union (TFEU). According to Article 56, taxpayers from third countries should be treated equally to taxpayers from the EU, and therefore income of investment funds from countries outside the EU or EEA should also be exempted from CIT pursuant to Article 56 of the TFEU, which may be applied by foreign funds directly. In particular, tax authorities denying that the Polish tax exemption on cross-border income of a US investment fund violates the freedom of movement of capital provisions under the TFEU.

Since 2014, CIT has been imposed at a rate of 19 per cent on profits of limited partnerships issuing shares (general and limited partnerships remain tax-transparent for income taxation). Such partnerships fall under the standard corporate tax rules, including thin capitalisation rules, and should depreciate fixed and intangible assets by continuing to apply the rates and methods they adopted prior to 2014.

ii Non-corporate

Local and foreign investors may conduct business activities through a partnership, which in general may have one of the following forms: civil law partnership, general partnership, professional partnership, limited partnership or limited partnership issuing shares (limited-stock partnership). General and limited partnerships are most commonly used. Limited partnerships issuing shares have also been popular, as they are used by close-ended investment funds for carrying out income tax-exempt business activities. In turn, civil law partnerships are established for small businesses only. All types of partnerships other than limited partnerships issuing shares are income tax-transparent. Therefore, partners are liable to income tax on profits derived through their partnership proportionally to their interests in the partnership’s profits. Creation and liquidation of partnerships are subject to special tax rules, and income from withdrawal of a partner from a partnership or from liquidation of a partnership is tax-exempt under those rules. However, according to a recent court ruling, payments received by a partner in a partnership will not be tax-exempt if that payment represents the income that was not taxed when derived by the partnership.
In general, partnerships may be taxpayers for purposes of other Polish taxes, including value added tax (VAT), excise tax, customs duty, tax on civil law transactions or real estate tax (local taxes).

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

CIT is payable at a rate of 19 (or 9) per cent on all income derived from whichever source of income and on all capital gains derived from certain sources of capital gains, subject to certain exemptions. The 9 per cent rate applies for small taxpayers, with the exception of new taxpayers created via the restructuring of existing businesses; this rate does not apply to capital gains. Taxable income is defined by tax rules as an excess of all items of the taxable income (excluding capital gains from certain sources of such gains) over costs of such income in a given tax year. The taxable income is not equal to an accounting profit. In addition, it may include income from gratuitous services and imputed income. For example, according to interpretative guidelines issued by the Minister of Finance, a surety or guarantee issued by a shareholder without remuneration to secure a payment of debts of its corporate company constitutes taxable income of that company. In principle, income from business activities is taxable on an accrual basis. Expenses incurred to derive taxable income are deductible unless they are listed in Article 16 of the CITL, which enumerates non-deductible costs. Non-deductible costs include expenses for the acquisition of land or perpetual usufruct of land, which may not be depreciated but may be deducted upon the sale of such assets, purchase costs of shares and securities until the day of their sale or redemption, certain expenses for promotion, compensation and contractual damages, any donations, expenses (above certain limits) for the use of cars, costs incurred for tax-exempt income or depreciation write-offs pertaining to know-how contributed in-kind to the stated capital of the company, and other costs. According to the general tax interpretative guidelines of the Minister of Finance, however, deductions of payments for the rental of passenger cars used in business activities are not subject to statutory limitations in terms of expenses incurred during the use of such cars (e.g., the cost of fuel); such rental payments are, therefore, fully deductible. Another general tax interpretative guideline of the Minister of Finance states that the cost of food, beverages, lunches and other meals offered to customers and potential customers are not subject to the statutory limitations regarding expenses for the promotion and representation of a taxpayer; therefore, such costs are fully deductible.

As from 2018, new tax rules exclude from tax-deductible costs expenses incurred directly or indirectly for the benefit of affiliated entities or entities that have their seat in countries deemed to have engaged in harmful tax competition, related to the following (intangible) services, to the extent to which the aggregated expenses of such services exceed 5 per cent of the taxpayer’s earnings before interest, tax, depreciation and amortisation (EBIDTA):

a advisory services, market research services, advertising services, management and control services, data processing services, insurance, guarantee, surety and similar services;

b licence fees for use of copyrights and IP rights, and know-how; and

c shifting a risk of a debtor’s insolvency as regards loans, other than extended by banks and credit and savings unions, including liabilities arising out of derivatives and similar services.
The amount of costs not deducted in a given fiscal year is deductible in the consecutive five fiscal years, within the cap applicable in particular years.

According to case law, company share capital increase is tax-exempt; therefore, costs associated with such increase are non-deductible. However, the costs should be solely narrowed to expenses that are directly connected with such an increase (e.g., notarial or court fees), and not to costs connected with the general functioning of a company or its business activity generating taxable income (e.g., advisory fees), which should be deductible.

Generally, fixed assets (buildings, constructions, machinery and equipment, and vehicles) owned by a taxpayer, acquired or constructed may be depreciated if their projected service life exceeds one year, they are completed and fit for use when they are placed in service, and if they are used for business activities by the taxpayer or a third party on the basis of a rental, lease or similar agreement with the taxpayer.

The following may also be depreciated, regardless of their projected useful life: leasehold improvements placed in service; buildings and constructions developed on land owned by a third party; and buildings, constructions and other assets constituting a separate freehold used by a taxpayer for business activities on the basis of a financial lease agreement.

Taxpayers may also depreciate certain intangible assets such as computer software, copyrights, licences and goodwill.

Interest on loans received to finance acquisitions or to develop depreciable fixed or intangible assets accrued by a borrower before the assets are placed in service is subject to depreciation rather than full deduction. Generally, rates of deductible depreciation write-offs are prescribed by local tax regulations. However, taxpayers may set depreciation rates within certain limits for fixed assets used or improved, and for intangible assets. The minimum depreciation periods for intangible assets are 24 months for licences for computer software, copyrights, films, radio and television programmes, 12 months for R&D costs, and 60 months for goodwill and other intangible assets.

Once established, the depreciation rates for intangible assets may not be changed. Goodwill may be depreciated only in cases of acquisition of an enterprise or its organised part, namely where it is purchased on the basis of a sale agreement; or where the enterprise or its organised part is subject to a financial lease arrangement and is depreciated by the lessee pursuant to applicable rules, or where the enterprise or its organised part is contributed in-kind to a local company under the Privatisation Law.

After a statutory merger or demerger, acquiring companies should continue the depreciation of fixed and intangible assets of the target company on the basis of the same depreciation value, rates and methods. This also applies in cases of the contribution in-kind of an enterprise or its organised part to a company. Depreciation of fixed and intangible assets contributed to partnerships is subject to special tax rules.

From 2018, the minimum CIT will apply on income from commercial properties leased or otherwise made available to third parties: commercial and service buildings (inter alia, commercial centres, department stores) and office buildings classified as an office building in the classification of buildings, where their initial value exceeds 10 million zlotys. The taxable basis is the initial tax value of a building for its tax depreciation decreased by 10 million zlotys. According to a new judgment of the administrative court, only the initial value of the property that is not depreciated constitutes the taxable basis, although it is not stated in the CIT Law explicitly. The tax rate is 0.035 per cent of the table basis per month. The amount of the tax may be deducted from CIT. The tax does not apply to office buildings used exclusively or mainly for the taxpayer’s own purposes.
Capital and income
There is no capital gains tax in Poland. However, certain capital gains from a disposal or redemption of shares in corporation and partnerships, titles in investment funds, derivative instruments and other securities, and from interest on shareholders’ participating loans as well as costs related to such gains should not be aggregated with ordinary income subject to CIT. In principle, capital expenses may be offset only against capital gains, while expenses related to ordinary income may be offset only against ordinary income.

Losses
Where costs of ordinary income exceed total taxable ordinary income, in a given tax year, the difference will represent a tax loss. This loss may be carried forward against ordinary income derived in the next five consecutive tax years. However, in any of those five years, the loss from the given year may be deducted in part not exceeding 50 per cent of that loss. It is not possible to carry losses back, offsetting them against prior year income. Tax losses are linked with the legal entity that incurred them. Therefore, in cases of mergers, acquisitions (including purchases of an enterprise) and divisions, an acquiring entity may not carry forward tax losses incurred by a target business prior to such a transaction. Conversely, the acquiring entity may carry forward its tax losses incurred prior to the transaction.

Capital losses may be carried forward under the same rules applicable to ordinary losses. However, ordinary losses may not be carried forward against capital gains, and capital losses may not be carried forward against ordinary income.

Rates
As previously mentioned, CIT is chargeable at a rate of 19 per cent or, with respect to small taxpayers, at a rate of 9 per cent. In addition, outbound dividends are subject to local withholding tax at a rate of 19 per cent, and outbound royalty and interest payments are subject to local withholding tax at a rate of 20 per cent, unless a pertinent DTT sets out a lower rate. There is no proposed legislation aimed at a change in the CIT rates after 2019.

Administration
The fiscal year is the same as the calendar year, unless a taxpayer selects another period of 12 consecutive months and notifies the tax office by 30 January of a given year.

Polish taxpayers are obligated to pay corporate tax advances on a monthly basis, without, however, an obligation to file monthly CIT returns with the tax office. They may also decide to pay monthly tax advances in a simplified form, in an amount of one-twelfth of the tax due as disclosed in the annual CIT return filed during the preceding tax year. All taxpayers are only obliged to file one annual CIT return within three months from the end of each tax year, and to pay the difference between the tax due and the sum of tax advances paid from the beginning of the tax year.

The taxation system is uniform across Poland (outside small differences in local taxes only). Foreign and local companies and individuals pay the same taxes. The Polish tax system is administered by:

a heads of tax offices, who supervise the collection of taxes in their territories, audit taxpayers and issue individual administrative decisions;
heads of customs and tax offices, who perform taxation and procedural checks on fiscal settlements and conduct fiscal penalty proceedings; they also issue individual administrative decisions to taxpayers as a result of checks of fiscal settlements that were not corrected by taxpayers;

c heads of tax administration chambers, who supervise the heads of tax offices and heads of customs and tax offices: they are empowered to review administrative decisions of tax offices and customs and tax offices;

d the chief of Country Tax Administration, who generally supervises the entire taxation system on the territory of Poland; examines tax cases that require that final tax decisions be declared null and void, or that tax proceedings already closed be exceptionally resumed; and issues tax decisions in tax cases falling under the local general anti-avoidance rule;

e the head of Country Tax Information, who issues private tax rulings in taxation cases upon the request of taxpayers and withholding tax agents; and secures, processes and publishes uniform information that is relevant for taxation and customs;

the Minister of Finance, who is responsible for budgetary policy. He or she, ex officio or upon the request of taxpayers and other entities, issues general guidelines applicable to tax rules that in his or her opinion require uniform interpretation; and

g local self-government authorities, which are responsible for the collection of local taxes.

Taxpayers may, within 14 days, appeal against a tax decision or a private tax ruling of the local tax authority. Afterwards, a complaint against the tax decision or a private tax ruling may be submitted, within 30 days, to the district administrative court, and subsequently to the Supreme Administrative Court of Poland (NSA).

**Tax grouping**

Tax advantages of a few single companies may become apparent in the case of the creation of a ‘tax group’, which may compensate losses of some of its members with profits of the remaining members. The tax group may be formed by corporations that meet the following conditions:

- they are limited liability or joint-stock companies incorporated in Poland;
- the average share capital of the member companies is not less than 500,000 zlotys, excluding the value of the share capitals covered by shareholders’ loans, interest thereon or non-depreciable intangibles;
- in principle, a parent company directly holds 75 per cent of the shares of the subsidiary companies;
- the subsidiary companies do not hold shares in other subsidiary companies being members of the tax group; and
- before joining the tax group, the companies do not have any tax arrears towards the State Treasury budget.

Once the tax group is formed, the following additional requirements must be met: members of the tax group may not be exempted from CIT; the ratio of taxable income of the tax group to its total revenue in each tax year must be at least 2 per cent; and members of the tax group need to price transactions with related entities from outside the group at arm’s length according to Polish transfer pricing rules.
Violation of any of these conditions results in the dissolution of the tax group and its members have to settle CIT on their own for a current tax year and previous two tax years. The group is also dissolved at the end of a period for which it was established.

The parent company and the subsidiaries that establish the tax group need to do so for at least three years under an agreement in the form of a notarial deed to be registered with the tax office.

Each member of the tax group should calculate its profits (capital gains) or losses separately in accordance with the ordinary rules. The taxable income of the tax group is defined as an excess of total taxable profits and capital gains of members of the group over ordinary losses and capital losses of the other members during the tax year. However, tax losses or profits from years before or after the life of the tax group may not be offset against the income or losses of the tax group. The tax group is a taxpayer liable to CIT at the regular rate of 19 per cent, which should be withheld by the parent company, but for which tax all the members of the tax group may be held liable jointly and severally. If the total losses of the members exceed their total profits, such difference represents a tax loss of the tax group. However, in practice, such a situation violates the 2 per cent profitability requirement for the tax group, and triggers the end of the tax group as of the date the group files its annual tax return for its given tax year.

Owing to the required 2 per cent profit-to-revenue ratio, the benefits of creating the tax group are generally seen as rather strict when compared with the potential 'fruits' of the creation of such a group.

**ii Other relevant taxes**

Other taxes in Poland are:

- a VAT;
- b excise tax;
- c stamp duty;
- d tax on civil law transactions;
- e real estate tax and other local taxes;
- f tonnage tax;
- g gambling tax;
- h donation and inheritance tax (which, however, does not apply to legal persons);
- i tax on mines;
- j tax on certain financial institutions;
- k tax on retail sales; and
- l congestion tax.

Polish VAT is in general harmonised with the EU VAT legislation, including Council Directive 2006/112/EC of 28 November 2006 on the common system of VAT. Pursuant to Article 5, Section 1 of the Polish VAT Law, in principle, supply of goods (inter alia, intra-Community acquisitions and supplies of goods) and provision of services against consideration in the territory of Poland are subject to Polish VAT at a rate of 23 per cent. Gratuitous services and supplies of goods without remuneration may be also taxable. For
some goods and services, VAT rates have been reduced to zero,\(^3\) 8,\(^4\) 7,\(^5\) 5\(^6\) and 4 per cent.\(^7\) As of 1 April 2020, a new VAT matrix indicating goods subject to reduced VAT rates will be implemented. The new matrix aims to systematise and unify VAT rates for similar goods and services.\(^8\) Certain services, including education, medical services, insurance, granting and management of loans, dealing in securities and certain other services, are subject to a VAT exemption, and the service provider may not deduct input VAT in such cases.

Pursuant to the above-mentioned EU Directive, Poland has exercised the option that any transfer of an enterprise or organised part of an enterprise is outside the scope of Polish VAT. In addition, input VAT on purchases, importation, manufacturing and use (rent, lease) of passenger cars, and VAT on the purchase of engine fuel, maintenance and other services related to such cars, may be deducted provided that passenger car is used solely for business activities. If a passenger car is used for both business and private purposes, 50 per cent of the input VAT may be deducted. Taxpayers using passenger cars for business activities only should maintain VAT records that include details about the driver, his or her itinerary and mileage.

The VAT Law states that services provided by Polish suppliers to foreign service recipients are not subject to Polish VAT, and are subject to VAT in the country where the recipient of services has its seat or fixed establishment, provided that the recipient is registered for VAT in that country.

Over the past few years, Poland has introduced many measures to tackle the VAT carousel frauds. In 2018 the ‘split payment’ was introduced to the VAT Law. Under this mechanism, the purchaser is eligible to: (1) divide the amount following from the invoice received into VAT part and a net price; (2) pay the VAT part to a special ‘VAT bank account’ of the supplier; and (3) pay the net price to the current bank account or settle it in some other way (e.g., in cash or set off).

As of 1 November 2019, the split payment is mandatory in the case of domestic supplies of certain goods and services,\(^9\) if the gross value of the transaction exceeds 15,000 zlotys and the payment is made via a bank transfer. As a result, all VAT payers trading in these goods and services are obligated to open a bank account in Poland for the purpose of settlements within the split payment mechanism. In addition, invoices documenting these transactions must include the words ‘split payment’. Failure to comply with the new rules may result in imposition of severe pecuniary fines, both for the supplier and the purchaser.

The application of the split payment mechanism to transactions not meeting the above-mentioned conditions is optional. However, in the case of purchase of certain goods and services,\(^10\) the purchaser may be jointly and severally liable with a supplier of such goods

\(^3\) For example, export and intra-Community supplies of goods, sea and air transportation, international transportation and related services.
\(^4\) For example, some groceries, fertilisers and healthcare products; sport, recreation and culture events; some services in agriculture and forestry; and construction services related to the development of public residential buildings and apartments.
\(^5\) For example, farming activities.
\(^6\) For example, printed books and specialist journals, some groceries and ready-made meals.
\(^7\) For example, taxi or cab transportation.
\(^8\) For example, change from three different VAT rates (23 per cent, 8 per cent, 5 per cent) to 5 per cent for cereal products or unification of VAT rate for e-books and paper books.
\(^9\) For example, steel products, waste, electronics, car parts, fuel and construction works.
\(^10\) The same catalogue of goods as subject to mandatory split payment.
for the payment of VAT chargeable on that supply if no split payment was used and the purchaser knows or should reasonably know that the supplier is not going to pay VAT on that supply.

Additionally, as part of the fight against tax frauds, a special register of VAT taxpayers was introduced which include, inter alia, bank account numbers of the VAT taxpayers. Failure to make payment for supply of goods or services to such a bank account of the supplier indicated in the register is subject to severe sanctions.\textsuperscript{11} However, the purchaser may be released from the sanctions provided that the purchaser notifies the tax authorities that the payment was made to a bank account not listed in the register and indicates the number of that bank account.

Similarly, as with VAT, the Excise Tax Act is harmonised with the respective EU regulations. The tax is charged on certain supplies of goods, including intra-Community acquisitions and supplies of goods in Poland.

Excise tax is imposed on certain transactions performed by the taxable entity, such as transactions involving:

\begin{enumerate}[a]
\item import, intra-Community acquisition and first domestic sale of passenger cars that are not registered in Poland; and
\item import, intra-Community acquisition, production or transfer to a tax warehouse, domestic supplies and use of certain engine fuels and gas, heating fats, oils and gas, coal products, other energy products, electric energy, and alcohol and tobacco products listed in Attachment 1 to the Excise Tax Law, including the use of dried tobacco plant or goods exempted from excise tax because of their intended use if they are used contrary to their intended use. As of July 2020, excise duty will be levied also on electronic cigarettes and ‘innovative products’ including tobacco (e.g., heat not burn products).
\end{enumerate}

Excise tax is calculated either as a percentage of the value of taxable goods (or their customs duty value) or as a flat fee per the quantity basis (fee per unit).

Stamp duty is payable in nominal amounts on certain acts and documents, including:

\begin{enumerate}[a]
\item official applications;
\item official acts;
\item certificates;
\item permits; and
\item certain documents (e.g., powers of attorney presented in administrative and court proceedings).
\end{enumerate}

Stamp duty rates are determined in relevant schedules to the Stamp Duty Act, and paid in cash or by a bank transfer.

Tax on civil law transactions is a capital (transfer) tax levied on certain civil law transactions and certain legal acts and their amendments, in particular, on the sale and exchange of goods and property rights agreements, loan agreements, on setting up a mortgage, establishing a corporate company or partnership, and increasing the company’s share capital, additional shareholder payments or loans. The tax is due if related goods are situated or

\textsuperscript{11} For example, denial of the right to treat certain expenses as tax deductible costs, joint and several liability of the purchaser with the supplier for VAT chargeable on the given supply.
property rights are exercised in Poland, or their purchaser has its residence in Poland, and
the transaction itself takes place in Poland. With few exceptions, this tax is not payable if the
transaction is subject to VAT, even when VAT-exempt.

Civil law transactions tax rates are either fixed or ad valorem. The rates include:

a 2 per cent of the market value of the subject of the transaction on the sale or exchange
of real estate, perpetual usufruct right or movable goods;
b 1 per cent of the market value of the subject of the transaction on the sale or exchange
of other property rights, including shares in companies;
c 0.5 per cent of the par value of the share capital on the establishment of a corporation
or partnership or an increase in a share capital; and
d 0.5 per cent of the principal amount of loans.

A number of tax exemptions apply, including a tax exemption on loans extended by a direct
shareholder to its company and by non-residents of Poland conducting business activities
that encompass the extending of loans. In addition, an exchange of majority shares in one
company for new shares issued by another company is tax-exempt. The tax exemption also
applies to an in-kind contribution of an enterprise or its organised part to the stated capital
of a local capital company as well as to mergers or transformations of those local capital
companies. According to a tax ruling issued by the tax authorities, a limited partnership
issuing shares should be treated as a corporation, and that transfer tax exemptions pertaining
to corporate mergers and restructurings should therefore also apply if they refer to a limited
partnership issuing shares.

Local taxes include:

a real estate tax;
b transportation tax (imposed only on lorries and trucks);
c marketplace tax;
d agricultural tax;
e forestry tax;
f dog owner tax; and
g sanatorium tax.

Local self-governments are entitled to establish rates for certain taxes within the limits set
by law. The most important local tax is real estate tax, which is paid annually (in monthly
instalments) by an owner or possessor of real property and constructions, and their parts,
including devices and equipment facilities, connected with business activities. For real estate
used for business, the maximum tax rates in 2020 are 23.90 zlotys per square metre for
buildings connected with business and 0.95 zlotys per square metre of land. In addition to
statutorily defined exemptions, local self-government bodies, at their discretion, may establish
further tax exemptions and their conditions with a view to attracting investors and businesses
to invest in certain regions of Poland. As from 2018, the local self-governments report to the
Minister of Finance on the tax rates, tax base and exemptions applied in their regions.

Tonnage tax is imposed on navigation enterprises rendering international sea ship
services in transportation of goods and passengers, sea tugboat and sea tow services, sea
lifeboat and rescue services, deepening of the sea bottom, as well as certain other services
connected with the foregoing, such as the sale of goods and services on ships, currencies
exchange, management of passenger and cargo terminals, loading, unloading and reloading
of cargo, and ship chartering. Tonnage tax is chargeable to the extent that the navigation
enterprise uses ships with a tonnage gross (GT) capacity exceeding 100GT, and provided that it has selected to be the taxpayer of this tax instead of CIT for 10 years. The tax is chargeable at a rate of 19 per cent on total lump-sum income calculated as an aggregated product of the total net capacity (as determined in the international measurement certificate) of each ship used for the taxable services, and rates decreasing from €0.50 to €0.10 for each 100 tonnes of net capacity of each ship per day. In addition, these ship owners pay tax at a rate of 15 per cent of the gross proceeds from the sale of ships if these proceeds are not reinvested into the purchase, reconstruction or modernisation of ships within three years. They are exempted from CIT.

Gambling tax is imposed on businesses organising gambling activities (casino roulette, card games and gambling, bingo games, various lotteries, mutual bids, slot machines, etc.) under permit, except for promotion lotteries and poker tournaments; it is also imposed on individual participants in poker tournaments. Tax rates differ with respect to each gambling activity and game, and vary from 2.5 to 50 per cent of proceeds from given activities.

Inheritance and donation tax is levied on natural persons only, and depends on the tax bracket, which in turn depends on the degree of relationship between a donor and a donated party. The first two brackets pertain to relatives, and the third to other persons. The tax rates for the first bracket are 3 to 7 per cent; for the second, 7 to 12 per cent; and for the third, 12 to 20 per cent. There also apply tax exemptions regarding certain assets and regarding inheritance or donations of all assets between certain family members.

The tax on mines is imposed on copper, silver, crude oil and natural gas mining. For copper, the tax rate amounts to \((0.033 \times \text{average copper price} + (0.001 \times \text{average copper price})^{2.5}) \times 0.85\), and applies to each tonne of copper mined by a taxpayer or included in copper concentrate produced by the taxpayer. For silver, the tax rate amounts to \((0.125 \times \text{average silver price} + (0.001 \times \text{average silver price})^{4}) \times 0.85\), and applies to each kilogramme of silver mined by a taxpayer or included in silver concentrate produced by the taxpayer. If the average prices of copper or silver drop below the statutory determined thresholds, higher tax rates will apply, with a minimum tax rate of 0.5 per cent of the average price of copper or silver. From 2016, tax is also levied on production of natural gas and production of crude oil. The tax is levied at ad valorem rates of 1.5 to 3 per cent for natural gas and 3 to 6 per cent for crude oil. In addition, a tax incentive rule entered into force according to which the tax may be reduced by 19 per cent of tax losses that could not be deducted for income tax purposes. The tax should be declared and paid to the proper tax office for each month within 25 days of the following month.

In 2016, a new tax on certain financial institutions was introduced. The tax applies mainly to Polish banks, insurance institutions and branches of foreign banks and insurance institutions. The tax is levied on the accounting value of assets exceeding a statutory threshold of 4 billion zlotys for banks and 2 billion zlotys for insurers. The value of assets constituting a tax base is calculated jointly for all affiliated insurance institutions liable to the tax. The tax is charged at a rate of 0.0366 per cent monthly.

In 2016, the new Act on Tax on Retail Sales was adopted by Parliament. The tax applies to the revenues of retailers. A monthly surplus of those revenues over 17 million zlotys is subject to tax at a rate of 0.8 per cent, and a monthly surplus of revenues over 170 million zlotys is subject to tax at a rate of 1.4 per cent. The European Commission held in its decision that the tax was in breach of EU state aid rules and ordered to suspend the application of the tax. Poland appealed that decision to the General Court, which subsequently ruled that the tax did not constitute state aid. The General Court’s verdict was appealed by the
EU Commission to the CJEU and at the time of preparing this publication the case is still pending before the CJEU. The collection of the tax on retail sales has been suspended until 1 July 2020.

Recently the Polish Minister of Entrepreneurship and Technology suggested that it is considering introducing a ‘congestion tax’. As hinted by the Minister, the new tax could be imposed on big-box retailers and its amount would depend not on a turnover but on the degree of disturbance in urban space caused by the operations of a given retailer. The congestion tax should be used as an alternative to tax on retail sales, which is subject to pending proceedings before the CJEU. However, no draft law has been published yet and it is not certain if the Minister will proceed with the implementation of congestion tax.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Companies, other legal persons, limited partnerships issuing shares and organisational units without legal personality (e.g., tax units), except for other partnerships, are taxpayers liable to CIT. Taxpayers having their seat or place of management in Poland are tax residents liable to CIT on their worldwide income. Other taxpayers are non-residents liable only to tax on income derived in Poland unless an applicable DTT states differently. An entity incorporated outside Poland may become a Polish tax resident if its place of management is relocated to the territory of Poland. Conversely, a locally incorporated entity may cease to be a Polish tax resident if its place of management is relocated from Poland to another jurisdiction. To determine under Polish rules where an entity has its place of management, one must look at where the entity is actually managed (namely, where decisions regarding the entity’s matters are actually taken). It is a question of facts rather than law. Any legal deeds or other formal indicators of a place where the entity is managed and where decisions are made (e.g., relevant rules in articles of association or management agreements executed with the entity) may be considered by the tax authorities, but they are neither final nor prevailing in determining the place of management. In practice, however, there exists no tax or court ruling in which local tax authorities would claim that a given entity became or ceased to be a Polish tax resident owing to the relocation of the place of its actual management. Nevertheless, the place of actual management may be effectively moved for tax purposes. In many cases, this movement could not be challenged by the tax authorities of the exit jurisdiction, as many DTTs executed by Poland state that in cases of disputes regarding where a corporate taxpayer is tax resident, it must be considered a tax resident of the contracting state in which it has a place of management.

A company incorporated in any EU Member State, including SEs, may also become Polish tax residents, and a company incorporated in Poland may relocate to another EU Member State by way of a statutory merger between these companies. SEs and SCEs may also move their corporate seat between EU Member States. Another Polish company would have to open a liquidation procedure if it decides to move its seat to another country.

In Poland, no corporate immigration or emigration taxes were levied on entities that became or ceased to be Polish tax residents. However, as of 2019, Poland introduced exit tax, as part of Polish corporate tax. Exit tax is imposed on unrealised gains in cases where, in connection with the following events, Poland would not be able to impose CIT on income that would be realised from sale of assets in the future:
The exit tax should apply at a rate of 19 per cent to a surplus of the fair market value of assets of the CIT payer being relocated from Poland over costs that would be deductible, were such assets sold before their relocation from Poland.

ii Branch or permanent establishment

A foreign entrepreneur has its fiscal presence in Poland and is liable to Polish income tax if it derives income locally through its PE in Poland within the meaning of local definitions or a pertinent DTT. A PE is defined as a fixed place where the business activity of the foreign entrepreneur is conducted, in part or in whole, in Poland. A PE is created, in particular, if the foreign entrepreneur has a place of management, a branch office or a workshop in Poland.

PEs frequently take the form of a local branch office. A locally registered partnership of one or more of its non-resident partners may also constitute their PE. A PE may also be created without such formal presence in Poland, in particular where a foreign entrepreneur seconds to Poland an employee authorised to conclude agreements in Poland on behalf of the foreign entrepreneur, and this individual customarily exercises this authorisation.

In practice, activities of a foreign entrepreneur will create a PE if they are conducted in Poland permanently. Therefore, such establishment does not exist if activities generating local income are performed outside Poland on a permanent basis rather than in Poland. However, neither Polish domestic regulations nor DTTs define the permanency of these local activities; thus, activities conducted for a few months (e.g., six months) may create a PE. For example, pursuant to a court judgment, cross-border advisory and other services of a Japanese company aimed at the implementation in Poland of a licence granted to a Polish company constitute a local PE within the meaning of the Poland–Japan DTT.

Owing to the protection of DTTs executed by Poland, the PE condition may not be enough to tax local income of the foreign entrepreneur. With few exceptions, most DTTs require that tax authorities prove a nexus between the local business activities of the PE and any items of income derived by the entrepreneur in Poland. In the absence of this nexus, no item of local income may be taxed. However, a few treaties, such as the DTT between Poland and Italy, set forth the presumption that one must assume that this nexus exists between the PE and all items of income (if any) derived by that taxpayer in Poland, unless the taxpayer proves the absence of this nexus with a given item of local income.

In addition, DTTs executed by Poland provide which local permanent activities and places may not be considered to be a PE. Although these activities and places differ to some extent, Polish tax treaties are based on the OECD Model Convention; therefore, such definitions are similar in all treaties. In general, a fixed place of business in Poland does not constitute a PE if it constitutes a construction site or installation for a certain period (usually lasting not more than 12 to 18 months), or if the fixed place is designated solely for the storage or delivery of products, or the purchase of goods or gathering of information or for other auxiliary activities (or for the combination of some or all of these). Therefore, in one of its judgments the administrative court stated that assembling cranes from parts manufactured by subcontractors in Poland and downloading software into cranes’ digital devices by a
Finland-based company on the territory of Poland on a permanent basis does not constitute a permanent establishment as this activity constitutes an auxiliary activity in the meaning of the Poland–Finland DTT. In the absence of a DTT, most of these activities would constitute a PE, and any income generated by the taxpayer from these activities would have to be taxed in Poland.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

2018 brought a big change to the Polish system of tax incentives, which until 5 September 2018 were available only with respect to investments located within the territories of SEZs. Since 2018, under the new Act on supporting of new investments and secondary legislation issued on its basis, the entire territory of Poland has become the SEZ eligible for basically the same kind of support (i.e., income tax exemption). This means that the main barrier – the need to locate a new investment in the SEZ – is no longer present. Also, under the new regulations, the investors that have already obtained state aid within the ‘old’ SEZ scheme may still enjoy this aid and utilise the tax exemption granted to them (however, only until the end of 2026, when the SEZs will finally cease to exist).

According to Article 17, Section 1, Item 34 of the CITL, income derived from economic activities conducted in the Polish territory under a ‘decision on support’ (i.e., a decision issued under the new Act on supporting of new investments) is tax-exempt. The main purpose of this new scheme is to encourage investors to invest in new ventures, irrespective of the investment’s location. In return, an investor is permitted to deduct a specific percentage (depending on pertinent regulations, up to 50 per cent) of its qualified investment outlays and costs incurred in the SEZ (eligible expenditures) from the amount of income tax. The investor must obtain a prior decision on support from the Minister of Economic Development, under which the state aid with respect to the new investment is granted. The investor may benefit from the CIT exemption on the ground of costs borne for a new (initial) investment, or on the ground of costs borne for the creation of workplaces for new employees. The CIT exemption may be cancelled as a result of cancellation of the decision on support if the investor ceases to perform the business activity defined in the decision, or flagrantly violates conditions specified in the decision or fails to redress infringements thereof within the deadline set by the Minister. The new regulation provides a list of activities that may not be covered by the decision on support and, consequently, by the tax exemption, including:

a administration and supporting services (such as those related to office administration services, for example preparation and copying of documents, post services such as emails and answering telephones), except for call centre services, which are explicitly authorised to be performed in SEZs;

b professional, science and technical services (e.g., legal and tax advisory, management advisory, head office, advertising and translation services);

c financial, insurance and real estate transactions;

d certain licence services related to books, brochures, maps, magazines, computer games, software, etc.;

e military services;

f film, video and television production;

g waste management services;

h construction services; and

i certain other services that are also excluded from state support.
In addition, costs of investments not successfully closed can be fully deducted by a taxpayer on the date of the sale or liquidation of investments. The disposal of investments should be documented with an invoice or a bill, and the liquidation of investments should be documented with a memorandum (protocol) of liquidation.

In Poland, any foreign income items may also be income tax-exempt under a pertinent DTT. If a tax treaty is silent as to the exemption, or in absence of a treaty, foreign income tax may be credited against Polish tax on the same item of income (see Section VI.iv).

Unlike the SEZ rules, the new legislation introduces additional conditions of applying for state aid: quantity and quality criteria.

Quantity criteria are the minimum amount of investment expenditures that must be reached in order for an investment to qualify for support. This minimum amount of investment varies depending of the unemployment rate in the area where a project is to be located and the type of the investor (lower thresholds are available to small and medium-sized enterprises).

The quality criteria include such aspects of the investment as creation of specialised jobs, employment predominantly on the basis of employment agreements, the research and development component, cooperation with academic and research centres and with industry schools, contributing to the development of industry clusters, and location of investments in the territories that are most in need of support, have the highest unemployment rate, etc.

Only an investment that meets both the applicable quantity criterion and the quality criteria (in a sufficient number, also varying depending on location) can obtain support.

i  

**Holding company regimes**

Inbound and outbound dividends, capital gains, and other local or foreign income derived by local holding corporations or their non-resident shareholders are subject to income taxation at a rate of 19 per cent and, in certain cases, tax exemptions or tax credits. The basic characteristics of a local special holding company tax regime are as follows:

<table>
<thead>
<tr>
<th>Dividends exemption</th>
<th>Yes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum holding in votes or in capital</td>
<td>10 per cent (25 per cent for Switzerland)</td>
</tr>
<tr>
<td>Capital*</td>
<td></td>
</tr>
<tr>
<td>Minimum holding period for dividends</td>
<td>Two years†</td>
</tr>
<tr>
<td>Capital gains tax exemption</td>
<td>No</td>
</tr>
<tr>
<td>Capital loss deduction</td>
<td>Yes</td>
</tr>
<tr>
<td>Deduction of expenses (e.g., interest)</td>
<td>Yes</td>
</tr>
<tr>
<td>Capital infusion tax</td>
<td>0.5 per cent‡</td>
</tr>
<tr>
<td>Withholding tax to parent under domestic law</td>
<td>19 per cent/0 per cent§</td>
</tr>
<tr>
<td>To EU, EEA and Switzerland parent</td>
<td>0 per cent</td>
</tr>
<tr>
<td>To US parent</td>
<td>15 per cent/5 per cent</td>
</tr>
<tr>
<td>Foreign income tax credit</td>
<td>Yes, if foreign income is not tax-exempt locally under a tax treaty</td>
</tr>
<tr>
<td>Foreign income tax credit for underlying tax</td>
<td>Yes, for CIT of foreign subsidiaries from outside the EU, EEA and Switzerland</td>
</tr>
<tr>
<td>Cross-border consolidation</td>
<td>Yes, under certain circumstances</td>
</tr>
<tr>
<td>Controlled foreign companies legislation</td>
<td>Yes</td>
</tr>
</tbody>
</table>
ii **IP regimes**

According to the new rules, a taxpayer is entitled to deduct part of the costs incurred in R&D activities from its taxable income. The expenditures eligible for deduction include 30 per cent of the salaries of employees engaged in R&D activities, and 20 per cent (for small and medium-sized enterprises) or 10 per cent (for other enterprises) of other R&D-related costs (e.g., materials, research data, use of scientific apparatus), including depreciation write-offs. The relief does not apply to taxpayers operating within SEZs. The tax incentive for R&D activities replaces the previous incentive system involving the deduction of costs for the purchase of new technologies available under the legislation that was in force before 2016. The previous incentive entitled taxpayers to deduct 50 per cent of costs incurred in the acquisition of new technologies (e.g., software licence, research data). Taxpayers who obtained a right to the tax deduction under the previous legislation may continue to make deductions until the existing deduction is utilised in full.

From 2019, the Innovation Box tax relief applies, in addition to the existing R&D relief referred to above. Namely, eligible incomes of CIT payers carrying out R&D activities directly connected with creation, development or improvement of the ‘qualifying IP right’ is subject to CIT at a rate of 5 per cent, instead of the standard rate.

The following income is eligible under the Innovation Box:

- licence fees for the qualifying IP right;
- income from sale of the qualifying IP right;
- a value of the qualifying IP right included in the sale price of a product or a service (transfer pricing regulations apply accordingly); and
- compensation for infringement of the qualifying IP right if obtained in the course of litigation, including court or arbitration proceedings.

The taxable base at the rate of 5 per cent is the sum of the eligible incomes from the qualifying IP rights, less direct costs incurred by the CIT payer for purchases of the qualifying IP rights or for R&D activities related to the creation, development or improvement of the qualifying IP rights during a tax year.

Costs of the same R&D works may be deducted simultaneously within the confines of both the Innovation Box and the existing R&D relief referred to above (where the total R&D costs are also deductible from ordinary income taxed at 19 per cent) and, therefore, the tax savings may be even bigger.

The qualifying IP rights comprise the following rights: patents, utility model protection, an industrial design, rights to topography of an integrated circuit, additional rights to a patent for a medical product or a plant health product, rights to new varieties of plants and breeds of animals, and copyrights to software provided that they are subject to legal protection under laws or ratified international agreements in Poland.
A loss on the activities subject to the Innovation Box relief may be carried forward for five consecutive tax years. A loss from a qualifying IP right may reduce incomes derived only from the eligible income derived from the same qualifying IP right, the same type of product or service, or the same group of products or services in which the qualifying IP right was used.

The condition for application of the relief is also to keep accounting records that should allow a CIT payer to determine the eligible income, tax-deductible costs, income (loss), attributable to each qualifying IP right, under pain of payment of 19 per cent tax in the event the records are kept improperly.

### iii State aid

On 5 July 2011, the Council of Ministers adopted the Scheme Concerning Support for Investments of Material Significance to the Polish Economy for the period from 2011 to 2020 (the Scheme), which was subsequently amended several times. On 1 October 2019, the Scheme was materially modified and extended until 2030.

The purpose of the Scheme is to increase innovation and competitiveness in the economy through cash grants awarded to Polish and foreign companies. The cash grants under the Scheme are to be awarded until 2025 for a maximum period of five years, and the Scheme will end in 2030. The Scheme's overall budget is approximately 2.6 billion zlotys.

Under the Scheme, funds may be granted to support:

- **a** strategic investments (of at least 160 million zlotys and at least 100 new jobs);
- **b** innovative investments (of at least 7 million zlotys and at least 20 new jobs comprising of product or process innovation);
- **c** Centres of Advanced Business Services (investment of at least 1.5 million zlotys and at least 250 new jobs with at least semi-advanced processes located in one of the disadvantaged areas listed in the Scheme);
- **d** Centres of Excellence of Business Processes (investment of at least 1.5 million zlotys and at least 150 new jobs with at least advanced or highly advanced processes; in case of location in one of the disadvantaged areas listed in the Scheme the minimum investment and employment threshold are 300 thousand zlotys and 50 new jobs); or
- **e** Centres of Highly Advanced Services (investment of at least 1 million zlotys and at least 10 new jobs for employees with higher education with only highly advanced processes).

The Scheme also provides definitions of semi-advanced, advanced and highly advanced processes.

The aid may be granted either to support the investment or to support creation of new jobs.

To qualify for support for the creation of new jobs, the investor should make at least one of the following investments:

- **a** an investment into a Centre of Advanced Business Services;
- **b** an investment into a Centre of Excellence of Business Processes; or
- **c** an investment into a Centre of Highly Advanced Services with the investment costs of less than 100 thousand zlotys per 1 new employee.

To qualify for support for new investment, the investor should carry out at least one of the following investments:

- **a** a strategic investment;
- **b** an innovative investments; or
an investment into a Centre of Highly Advanced Services with the investment costs of at least 100 thousand zlotys per 1 new employee.

In principle, it is not possible to combine cash grants awarded under the Scheme in an amount higher than 3 million zlotys with other regional cash grants originating from the state budget, CIT exemptions available in SEZs or EU grants, except for cases of cash grants for strategic or innovative investments where the value of these investments equals or exceeds 350 million zlotys or if an investor creates 500 new jobs within the investment into Centres of Advanced Business Services, Centres of Excellence of Business Processes or Centres of Highly Advanced Services. Any deviation from this rule requires the consent of the Polish Council of Ministers.

Additionally, to be eligible for support, all new investments must meet a number of quality criteria related to such aspects as development of human resources, social responsibility, cooperation with scientific and education institutions, etc.

Investors whose investments meet the above criteria may apply on a standard form to the Polish Agency of Investments and Trade (PAIH). The application is assessed by PAIH, the Inter-ministerial Committee for Investments of Material Significance to the Polish Economy and the Ministry of Economic Development. The decision of whether to award cash grants under the Scheme is discretionary; however, the Scheme defines the criteria for assessing the investment parameters for the purposes of calculating available support.

Poland-based companies, either within or outside SEZs, may under certain conditions benefit from horizontal state aid instruments for legitimate purposes (mainly employment and training). State aid for employment is, as a rule, designed to reimburse companies for part of the costs of employment or training of selected categories of persons (namely, employees, unemployed persons delegated by local labour offices, and disabled and disadvantaged persons).

Incentives are granted in Poland in compliance with the EU state aid rules. The maximum regional aid intensity available for investors varies from 15 per cent (in Warsaw) to 50 per cent (mostly in the eastern part of Poland).

iv General

The following all make Poland a very attractive jurisdiction for business development, acquisition and operation:

a domestic tax legislation harmonised with EU tax law;
b the low 19 per cent CIT rate;
c the income tax exemption offered for activities conducted in SEZs;
d the real estate tax exemption offered by local self-government bodies in many areas of Poland;
e broad state aid programmes for new investments;
f the advantageous tax treatment of IP technologies, R&D and unsuccessful investments;
g Poland’s attractive geographical location in central and eastern Europe; and
h the government’s attempts to soften the adverse impact of the economic depression of other countries on Poland’s economy to maintain economic growth.

In addition, the extensive network of DTTs and the attractive foreign tax credit system, including the foreign full tax credit for dividend withholding tax and underlying tax, allow
for the effective elimination or sufficient reduction of the total international and local tax burdens on income derived from Poland-based holding companies and on foreign income derived from Polish companies.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Withholding tax at a rate of 19 per cent applies to outbound dividends and other income from participation in corporate profits, and withholding tax at a rate of 20 per cent applies to outbound interest and royalties. Other income from participation in corporate profits includes income from share capital reductions, company liquidations, redemptions of corporate shares (except for their voluntary redemption via a transfer of shares to a company, qualified as taxable capital gains), and other income from shares (e.g., bonus shares or shareholders’ income from companies mergers and divisions) or other equity titles in legal persons. Payments of profits by limited partnerships issuing shares (which have been taxpayers since 2014) to general partners and shareholders of such partnerships are also subject to dividend withholding tax at a rate of 19 per cent.

Domestic compliance rules for the settlement of local withholding tax on cross-border interest and dividend outbound payments from securities registered on an omnibus account maintained for foreign investors also apply.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Poland has implemented into domestic tax law Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, which sets forth, inter alia, the ‘participation exemption’. Accordingly, payments of outbound dividends and certain other income from participation in corporate profits of a Polish corporation are exempt from local dividend withholding taxation provided that:

a the recipient of the payment is a company that is a tax resident of any EU Member State, Switzerland or EEA Member State, provided the recipient is not entirely tax-exempt as regards its worldwide income, and has a legal form indicated in an attachment to the above Directive or is such company’s PE also located in one of the above-mentioned states;

b the recipient of dividends holds at least 10 (in the case of Switzerland, 25) per cent of shares in the Polish corporate subsidiary for an uninterrupted period of two years, even if this minimum holding period expires after the dividends were paid; and

c prior to the payment of dividends or other corporate profits, a tax certificate is delivered by the recipient of the income to the Polish subsidiary; this certificate must be issued by the former’s pertinent foreign tax authority to confirm that the recipient is a tax resident of an EU Member State or another state referred to above.

Pursuant to a judgment of the local court, the dividend withholding tax exemption may still apply, although the minimum two-year holding period elapses after a merger of a parent company from an EU Member State with its general tax successor (being another EU company referred to in the above Directive). In another judgment, the local court stated that
although a local general partnership is tax transparent and is a permanent establishment of its corporate partners from other EU Member States, dividends paid by a Polish company to this permanent establishment may not be subject to the Polish dividend withholding tax exemption; this exemption requires that dividends be paid to a company holding shares in the Polish company directly, while the corporate partners in the partnership do not hold directly the shares in the Polish company paying dividends.

In limited partnerships issuing shares, the above dividend withholding tax exemption applies only to profits paid to shareholders. In turn, general partners (and not shareholders) may credit the CIT of the partnership (according to their participation in the partnership’s profits) against withholding tax on profits distributed to them within the next five consecutive years.

From 2016, the dividend withholding tax exemption may not apply to dividends and other income from participation in corporate profits if they result from a transaction or series of transactions lacking business reasons and aimed solely or mainly at obtaining the tax exemption rather than at avoidance of double taxation of corporate profits.

Poland has also implemented Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. In particular, payments of outbound interest and royalties are exempt from withholding taxation. The withholding tax exemption as from July 2013 applies to outbound interest and royalties as long as:

a. the recipient and payer of interest or royalties are associated companies where one company holds directly at least 25 per cent of shares of the other company, or another company holds directly at least 25 per cent of shares of both the payer and the recipient of interest or royalties, or the payer or recipient (or both) is a PE of any of these associated companies;

b. the above minimum 25 per cent holding of shares lasts for an uninterrupted period of two years, even if this minimum holding period ends after the payment of interest or royalties;

c. the recipient of interest or royalties is a tax resident of any EU or EEA Member State or Switzerland, provided the recipient is not entirely tax-exempt as regards its worldwide income, or it is such tax resident’s PE located in another EU or EEA Member State or Switzerland; and

d. prior to the payment, the recipient of income delivers its tax residence certificate issued by its pertinent foreign tax authority to confirm that the recipient is a tax resident in the EU Member State or Switzerland, or is such tax resident’s PE that is also located in another EU Member State or Switzerland.

The existing withholding tax exemptions of outbound dividends, interest and royalties, paid mainly to recipients from the EU, the EEA and Switzerland referred to in Section VI.ii are limited to situations where Poland may claim the exchange of information from tax authorities of the country of the foreign recipient of income pursuant to a pertinent DTT.

As of 2019, Poland introduced new exemptions from withholding taxation on cross-border payments of interest from treasury bonds, mortgage bonds and, subject to exclusion of transactions between related parties, bonds with the maturity of at least one year that are admitted to transactions on regulated markets in Poland or other DTT’s countries.
As of 2019, Poland introduced new compliance rules for collection of withholding taxes on cross-border payments of dividends, interest, royalties and intangible services. The new rules provide for some restrictions that impede application of exemptions and reduced rates to payments of withholding tax (WHT), including:

a. keeping the existing principles of collection of the tax in case of cross-border payments not exceeding 2 million zlotys for amounts due to one taxpayer in a given fiscal year;
b. an obligation to collect the tax in the full amount on the aforementioned payments over 2 million zlotys, without applying any exemptions or reduced rates as provided for in DTTs and the CIT Law;
c. the taxpayer or withholding tax agent will be able to apply with the tax authority, through a different procedure, for a refund of the tax withheld; such a procedure will include but not be limited to examining whether:
   • the actual recipient of the payments is a CIT payer in his or her country and carries out a real business activity; and
   • any prerequisites exist to apply the general anti-avoidance rule (GAAR);
d. the tax refund deadline is to be six months and it can be extended; and

e. exceptions to the above full withholding tax at the domestic rate will apply only if:
   • upon the taxpayer’s request, the tax authority issues, within six months, an opinion on application of the WHT exemption by the taxpayer; or
   • under pain of criminal responsibility, the tax withholding agent declares that they have verified the beneficial owner of the payments and have been in possession of proper documents to prove non-collection of the tax or collection of the tax in the reduced amount.

In the case of payments of dividends and other proceeds from participation in corporate profits between domestic entities, analogous rules of collection and refund of the WHT will apply.

### iii Double tax treaties

Local interest and royalty withholding taxation at a rate of 20 per cent, and dividend withholding taxation at a rate of 19 per cent, may be reduced to 10 or 5 per cent, or even eliminated, in compliance with a relevant DTT. Pursuant to a judgment of the local court, after assignment of a loan by a bank to a third-party acquirer of the loan, a typical DDT interest withholding tax exemption for loans extended by banks may still apply to interest paid by the acquirer of the loan provided that the acquirer of the loan is also a bank. A foreign recipient of such payments should deliver a tax certificate from its respective tax authorities to confirm that it is a tax resident of the other contracting state under the meaning of the tax treaty. According to new legislation, this certificate is valid for one year only unless it indicates another period, and the same recipient of income should deliver a new tax certificate for each tax year in which it receives a payment falling under local withholding taxation. According to administrative courts, cross-border interest may be subject to a treaty withholding tax rate provided that a beneficial owner of the interest is a tax resident in a treaty state.

In turn, most of the 92 DTTs executed by Poland provide that Polish income taxation of inbound dividends, interest and royalties may be reduced through foreign tax credits on such income (not higher, however, than the Polish tax due on the same item of income).
iv Taxation on receipt

Dividends, interest and royalties are taxed on a cash basis. Dividends paid between local corporate companies, or by a foreign corporate company tax resident in any EU or EEA Member State or Switzerland, are exempted from Polish income taxation if the Polish recipient of dividends holds at least 10 (25, in the case of a Swiss subsidiary company) per cent of shares in a subsidiary distributing dividends for an uninterrupted period of two years, even if this minimum holding period expires after the payment of dividends. However, foreign income derived from hybrid instruments is excluded from the Polish inbound dividend tax exemption.

The dividend tax exemption may not apply to dividends and other income from participation in corporate profits if they result from a transaction or series of transactions lacking business reasons and aimed solely or mainly at obtaining the tax exemption rather than at avoidance of double taxation of corporate profits.

Any inbound dividends, interest, royalties and other items of foreign income may also be exempt from Polish income taxation if a pertinent DTT provides for such an exemption. Whenever a tax treaty provides otherwise, or in the absence of a treaty, foreign income tax may be credited against Polish tax. This credit, however, may not exceed the Polish income tax on the same income.

Polish companies receiving foreign (inbound) dividends in Poland may credit against Polish CIT foreign dividend withholding tax, as well as foreign corporate tax paid by a foreign corporation on its profits out of which such dividends were paid out (full tax credit for underlying tax). The foreign underlying tax may also be credited against Polish tax on other foreign income, not only dividends. As a result, in many cases there would be no corporate tax in Poland, since the 19 per cent Polish tax rate is lower than tax rates in many countries. The Polish tax credit for the underlying tax, however, applies only with respect to foreign tax of a foreign subsidiary being a tax resident in countries other than the EU, EEA Member States and Switzerland, having a DTT with Poland, and provided that the Polish corporation holds at least 75 per cent of shares in the foreign company distributing dividends for an uninterrupted period of two years, even if this minimum holding period expires after the payment of dividends. The scope of the foreign tax credit referred to above, including the tax credit for foreign dividend withholding tax and underlying tax, is also granted in the case of Polish taxation of foreign income derived through a Poland-based PE of a company from the EU or EEA Member State, pursuant to a pertinent DTT.

The existing tax credit on foreign inbound income referred to here is limited to situations where Poland may claim the exchange of information from tax authorities of the country of the source of foreign income pursuant to a pertinent DTT.

VII TAXATION OF FUNDING STRUCTURES

In practice, local companies are usually financed with a mix of equity contributions (both in cash and in kind) and typical loans from shareholders or third parties, or through bonds issued to shareholders or third parties. Sometimes, companies also obtain ‘additional shareholder cash contributions’, which in principle are required to be paid to cover accounting losses of the company, but may also be used to finance operations of the company in other situations, and may be returned to shareholders to the extent that they are not required to cover company losses.
i Thin capitalisation
Poland abandoned its previous thin capitalisation legislation and from 2018, the new legislation implemented Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, which include restrictions pertaining to deductions of financial expenses (see Section VII.ii).

ii Deduction of finance costs
Interest, discounts and other financial costs are deductible when they are actually paid or capitalised – that is, added to a principal amount of debt without payment. Interest that is not at arm’s length may be challenged by the local tax authorities. Interest and other costs of financing acquisitions of shares and other securities may also be deducted, including situations of pushing debt down, where interest on the parent company’s debts used to finance a purchase of shares in a subsidiary where companies subsequently are merged is deducted, after the merger, from taxable profits generated by the merged subsidiary’s business.

Interest and other costs of financing acquisitions of depreciable fixed and intangible assets accrued until the day of placing a fixed asset into service are subject to depreciation write-offs. Such costs of financing acquisitions of depreciable fixed assets accrued after that day may be deducted according to general rules.

From 2018, CIT taxpayers, including local branches of foreign enterprises, are obligated to exclude from tax-deductible costs a surplus of their all debt financing costs over their interest income (if any), to the extent to which such surplus exceeds 30 per cent of their earnings before interest, taxes, depreciation and amortisation (EBITDA) in a given fiscal year. The new tax rules widely define costs of debt financing as any and all explicit or hidden costs of financial transactions, including interest, capitalised interest, fees, commissions, bonuses, interest-bearing part of a leasing instalment, penalties and fees for delay in payment of liabilities, and costs of securing receivables and payables (including costs of financial derivatives), securities lending and repurchase agreement (REPO) transactions, regardless of who is a beneficiary of financing costs. In turn, they narrowly define revenues as the interest income (only), which will contribute to the increase in the amount of tax non-deductible costs. The limitation of tax-deductible costs also refers to costs of financing payable to either related entities or entities not related to the taxpayer, or to both. The limitation does not apply to: banks, brokerage houses, investment funds and other regulated entities in the financial services market. The amount of costs not deducted in a given fiscal year is deductible in the consecutive five fiscal years, within the cap applicable in particular years.

iii Restrictions on payments
Tax rules do not prevent dividend payments, which are not restricted by corporate law provided that they are not paid from the company’s net assets required to fully cover the par value of the share capital. Dividends may amount to the aggregated company’s profits from the last accounting year and retained earnings from previous years. Dividend payments

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12 From 2018, the new legislation implemented Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market to the extent of the Directive’s restrictions pertaining to deductions of financial expenses and CFC rules.
must, however, be decreased by losses, the equivalent of treasury shares and write-offs from the company's profits to reserve and supplemental capitals, as required by the articles of association or law.

If dividends are formally declared by a company, but not actually paid to shareholders, such dividends, as shareholders' funds deposited gratuitously with the company, may be a source of imputed income equal to interest on a hypothetical banking loan that otherwise would be taken by the company from a bank.

iv  Return of capital

The equity capital may be repaid to the company's shareholders as a result of capital reduction or redemption of (almost) all or some of the shares in the company. In both cases it is tax-neutral for shareholders up to the amount of the share purchase costs; only a surplus is taxable. Whenever new shares were issued in exchange for an in-kind contribution, their purchase costs may not exceed the fair market value of the in-kind contribution. In any case, losses from the capital reduction or redemption of shares are not deductible.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Most frequently, non-local companies acquire local businesses by virtue of acquisition of existing or new shares in a local corporation operating a business. In the former case, a purchase of shares is subject to capital tax (tax on civil law transactions) at a rate of 1 per cent. In the latter case, such tax is payable at a rate of 0.5 per cent by the local corporation. In addition, acquisition of new shares issued by the company in exchange for a cash contribution to the local corporation is frequently used to eliminate tax on capital gains that arises for sellers in cases of purchases of existing shares. In particular, sellers may reduce the share capital or redeem their existing shares in the corporation for a consideration to be paid by the corporation out of cash contributed for the new shares by the investor, instead of selling the existing shares to the non-local purchaser directly. In this case, the consideration for the sellers qualifies as dividend-like income that may be tax-exempt if the seller holds 10 per cent of shares in the corporation for an uninterrupted period of two years ending even after the redemption of old shares. Since 2011, the tax legislation has limited this solution to a reduction of the share capital and certain types of redemption of corporate shares; the transfer of shares to the company for the purposes of their redemption is excluded from this solution.

Acquisitions of shares in local corporations are frequently financed with intercompany or third-party loans, and often these acquisitions are followed by a merger (also cross-border) between the acquiring and target companies. However, interest paid on a banking loan extended for financing share purchase costs should be capitalised and may not be deducted on a current basis. Consequently, after the merger, interest on these loans may not be deducted from the taxable profits of the target company's business.

Owing to attractive tax treatment, foreign and local investors also used Poland-based close-ended investment funds, qualified foreign-regulated mutual investment funds, and regulated investment companies from the EU and the EEA to acquire shares in local businesses. Although these funds or regulated companies may not conduct operational business activities directly, they may invest in real property, in shares issued by local and foreign companies and limited partnerships issuing shares, and in other securities. They were entirely exempt from Polish CIT on any local and foreign income. However, from 2017, this
general tax exemption of qualified foreign-regulated mutual investment funds was narrowed significantly, and their profits paid by local and foreign tax-transparent partnerships are excluded from this tax exemption (see Section II.i). In particular, interest, donations and profits paid to these investment funds by local and foreign tax-transparent partnerships and capital gains from transfers of securities issued by these partnerships or from sale of buildings rented to third parties are excluded from the tax exemption. In addition, the new tax exemption for qualified foreign-regulated collective investment funds from the EU and the EEA is limited to situations where Poland may claim an exchange of information from the tax authorities of the country of such fund pursuant to a pertinent DTT or other treaty.

ii Reorganisation

Poland has implemented Council Directive 133/2009/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States, and to the transfer of the registered office of an SE or SCE between Member States as regards both cross-border and domestic mergers, demergers and other corporate reorganisations determined in the Directive. Accordingly, pursuant to the CITL, a merger of companies from Poland or other EU Member States is tax-exempt for both the merging companies and their shareholders, except for upstream mergers when the acquiring company holds less than 10 per cent of voting rights in the target company. According to a tax ruling issued by the tax authorities, a cross-border downstream merger between a Polish acquiring subsidiary and its German target parent is tax-exempt under local tax rules even if the Polish acquiring subsidiary grants its treasury shares acquired upon merging to shareholders of the target company, instead of issuing and granting its new shares. The same exemptions apply to a company demerger, provided, however, that all assets and liabilities of the demerged company are divided into two or more parts, each representing a separate organised part of the enterprise. Otherwise, a demerger will be taxed as a sale of assets by the demerged company and a sale of shares by its shareholders.

The above tax exemptions apply assuming that the merger or demerger is pursued for justified business (non-tax) reasons, and where tax avoidance is not the main or one of the main merger drivers. Pursuant to the tax authorities, only statutory mergers of capital companies are tax-exempt; therefore, in the event of the merging of a local tax-transparent partnership into a capital company, shares acquired in exchange for the business of the merging partnership by a partner in such a partnership constitute taxable income of that partner.

If a company contributes in-kind a majority of shares in a company to another company in exchange for shares of the latter company, whether as a domestic or cross-border exchange, such an exchange of shares will be exempt from CIT (19 per cent) and capital tax (0.5 per cent) if all such companies are tax resident in Poland or other EU Member States. In addition, in-kind contributions of an organised part of an enterprise are exempt from corporate and capital taxes.

From 2011, an enterprise conducted by a natural person may also be transformed into a corporation in a tax-exempt manner. According to the tax authorities, the transformation of a corporate (capital) company into a local partnership is subject to CIT at a rate of 19 per cent on the retained profits of that company. On the other hand, the transformation of a local partnership into a corporate (capital) company is not subject to CIT.
However, the general tax succession applicable to the tax rights and obligations of the acquired company in cases of statutory company mergers and demergers does not cover protection arising from a tax ruling. According to a recent court judgment, nonetheless, a general tax successor may benefit from a tax ruling issued to an acquired company if the acquired company complied with that ruling before the merger.

iii Exit
A non-local investor may exit from a Polish corporate company by selling shares in such a company. Most DTTs executed by Poland exempt capital gains from that sale from Polish income tax, except for some treaties allowing for taxation if the company holds mainly real properties. Alternatively, the investor may redeem the shares for consideration that in certain cases may be considered dividend income that is tax-exempt or taxed at a lower treaty rate according to rules referred to in Section VI.i to iii. Pursuant to a judgment of the local court, in a case of a transfer of shares to a company against remuneration to redeem the shares, a shareholder who transfers the shares may deduct losses resulting from share purchase costs exceeding that remuneration.

Such an investor may also exit from Poland by relocating a Polish company, including an SE, to another EU Member State by way of a statutory merger with a company in such other EU Member State. The SE may also move its corporate seat between the EU Member States. Another Polish company would have to open a liquidation procedure if it decided to move its seat to another country.

In Poland, as of 2019, exit tax is levied at a rate of 19 per cent on unrealised income of entities that cease to be Polish tax resident or that relocate their assets from Poland to another jurisdiction, transfer them gratuitously to any entity or contribute their assets in-kind to an entity other than a corporation or a cooperative (about exit tax, see also Section IV.i). Income from liquidation of a partnership is tax-exempt under local rules. Therefore, investors holding interests in a local partnership may liquidate it to exit from the partnership’s business in a tax-neutral way.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Anti-avoidance rules are very limited in Poland. Article 199a of the Polish Tax Ordinance sets forth the ‘substance-over-form’ principle. Under this regulation, the tax authorities may ignore tax effects of a given transaction if it is a cover for another transaction (legal act). In such case, the tax effects should be drawn from the hidden transaction. Whenever the intentions of transacting parties cast doubt, the tax authorities should refer to a civil court to judge the existence or non-existence of such a transaction. In principle, Article 199a may apply when a given transaction is executed or performed in an extraordinary manner to achieve tax benefits that would not normally be available if such a transaction were performed in a typical manner.\textsuperscript{13}

From July 2016, Poland introduced a general anti-avoidance rule, according to which tax authorities may disregard tax benefits (e.g., reduction or postponement of tax obligations or an increase of tax losses) resulting from a transaction or series of transactions of a taxpayer.

\textsuperscript{13} As confirmed by the verdict of the NSA of 18 November 2009, No. I FSK 1133/08.

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if that transaction or transactions are completed in an ‘artificial’ manner mainly or solely for purposes of achieving those tax benefits. A transaction is completed in an ‘artificial’ manner if, for example, without reasonable business or economic reasons, it is divided into separate transactions, involves intermediaries or creates risks higher than non-tax business or economic benefits that could be expected from such a transaction. This general anti-avoidance rule does not apply to VAT settlements. A taxpayer may apply for a tax clearance opinion confirming that a given transaction is not completed in the ‘artificial’ manner mainly or solely for purposes of achieving the tax benefits, and that the general anti-avoidance rule shall not apply to that transaction.

Simultaneously, Poland introduced a specific rule outside the above general anti-avoidance rule. According to this rule, the inbound and outbound dividend tax exemptions will not apply to dividends and other income from participation in corporate profits if they result from a transaction or series of transactions lacking business reasons and aimed solely or mainly at obtaining the tax exemption rather than at avoidance of double taxation of corporate profits. A similar specific rule applies to the tax exemption of exchanges of shares, where a majority of shares is contributed in-kind into the share capital of another company and all the companies are residents in the EU Member States or the EEA.

In addition, since 2018, the new legislation implemented Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market. In 2019, the new legislation also implemented rules of the EU DAC 6 directive on mandatory disclosure of certain domestic and cross-border transactions that may qualify as aiming at avoidance of taxation. The domestic legislation imposes mandatory reporting obligations on foreign and local investors and CIT taxpayers with respect to a few transactions that are not referred to in the EU DAC 6 directive.

**Controlled foreign corporations (CFCs)**

Polish CFC rules apply both to corporate and personal income taxpayers shifting profits (i.e., in the form of royalties, dividends and other passive income) to a foreign company, other entity or PE located in jurisdictions with a lower income tax rate. In particular, a Polish CIT payer must incorporate income generated by its CFC (or its foreign PE) into its corporate tax base for a given year and tax it according to the Polish corporate income (personal income) tax law. A foreign entity is deemed a CFC when it is located in a tax jurisdiction applying harmful tax practices as listed by the Polish Ministry of Finance; it is located in a tax jurisdiction with which Poland has not concluded a DTT; or if the conditions referred to below are met jointly:

- a Polish entity, alone or with a related party, holds, directly or indirectly, at least 50 per cent of shares (voting rights) or other rights to participate in profits in the foreign entity or exercises actual control;
- at least 33 per cent of the foreign entity’s income constitutes dividends, capital gains, royalties, income from derivatives, or from receivables, guarantees, surety, interest and income from banking, insurance or other financial services, or other income from related-parties transactions having no value added; and
- a foreign tax actually paid by the foreign entity (less any refundable foreign tax) is below 50 per cent of the Polish CIT that would be paid in Poland if the foreign entity were a tax resident of Poland.
Since 2019, the notion of a CFC has been broadened to also include any entity with or without the legal capacity, a foreign foundation, trust, any nominee relationship or direct or indirect representative. A foreign entity is not a CFC if it is a tax resident of a Member State in the EU or the EEA, and actually performing a substantial business activity in that state. In one of its judgments, the administrative court ruled out that taxable income of a Polish shareholder derived through a CFC entity may be reduced by dividends paid by such entity to the shareholder, regardless of when the company derived profits, out of which those dividends are paid out.

iii Transfer pricing

Transactions between related parties must be priced at arm’s length. Parties are related, inter alia, where one party holds, directly or indirectly, at least 25 per cent of shares in the share capital of the other party, or the same persons are in the governing bodies of those entities. If, as a result of such relations between parties they agree conditions differing from those that would have been agreed by independent entities, and as a result a taxpayer does not show any income or shows income lower than would have been expected should those linkages not exist, taxable income or related costs may be reassessed, and the tax settlement of that entity may be challenged by the tax authorities. In such a situation, the tax authorities determine income on the basis of market prices of similar goods or services, or according to one of the following methods:

a the comparable uncontrolled price method;
b the resale price method;
c the reasonable margin (cost-plus) method; and
d the transaction profit method.

Note that taxpayers conducting transactions (including the execution of partnership deeds, joint-venture or similar agreements) with related entities, or if such transactions trigger payments to entities located in jurisdictions applying harmful tax practices (directly or indirectly), are required to maintain relevant tax documentation describing, inter alia, the functions of the parties, anticipated costs of the transaction, the method and manner of calculating profits and pricing, a business strategy and factors defining the value of the transaction. Taxpayers must present the documentation within seven days of any request of the tax authorities. Should the company fail to provide that documentation, the tax authorities may apply a 50 per cent tax rate to income reassessed by them.

According to the administrative court, the statutorily defined value of transactions that triggers local transfer pricing documentation obligations (€50,000) refers to the aggregated value of all transactions executed by a taxpayer in any given tax year, rather than separately to the value of each transaction.

From 18 July 2013, the scope of a transfer pricing tax audit has been broadened to include restructurings by related parties of their activities, where such restructuring is defined as a transfer between such parties of substantial economic functions, assets or risks.

From January 2017, CIT taxpayers’ transfer pricing reporting obligations increase significantly, and the transfer pricing documentation must be more complex. In particular, for the biggest entities, benchmarking analysis for documented transactions and a ‘masterfile’ documenting a whole group of related taxpayers are required.

In general, the obligation to prepare transfer documentation follows the OECD’s base erosion and profit shifting (BEPS) recommendations and arises for a Polish taxpayer having a
transaction or other event with a related entity, when the accounting revenues of the taxpayer for the previous tax year according to its financial balance sheet exceeded €2 million and the value of the transaction or other event in one tax year exceeds €50,000.

In such a case, the taxpayer should prepare the local file including, in particular:

a a description of the transaction or other event, including financial data, related parties to the transaction and their functions, engaged assets and incurred risks, and methodology and manner of profit calculation with detailed pertinent justification;

b a detailed benchmarking analysis – only if the accounting revenues of the taxpayer for the previous tax year according to its financial balance exceeded €10 million;

c a description of the financial data of the taxpayer;

d information about the taxpayer, including organisation and management structure, subject and scope of business activities, a business strategy, and competitive environment; and

e documents, namely corporate agreements concluded between related entities and advanced pricing agreements.

Furthermore, if the accounting revenues of the taxpayer for the previous tax year according to its financial balance exceeded €20 million, the transfer pricing documentation must also include the master file.

The transfer pricing documentation should be prepared on an annual basis, and the taxpayer is required to confirm in its annual tax return (to be filed by the end of the third month following the given tax year) that all transfer pricing documentation is properly prepared.

iv Tax clearances and rulings

The Minister of Finance, ex officio or upon the request of taxpayers and other entities, issues general guidelines applicable to tax rules governing selected tax issues that in the opinion of the Minister require uniform interpretation. If particular cases require interpretation of the tax rules, an entity (taxpayer, withholding tax agent and certain other entities) interested in securing the certainty of such interpretation may also apply to selected heads of tax chambers, who (representing the Minister of Finance) issue individual tax rulings within three months (tax rulings regarding local taxes are issued by local government tax authorities). If a ruling is not issued within this period, the tax interpretation presented by the entity in its application will become valid for the tax authorities (a silent ruling), which allows taxpayers to avoid unjustified delays in settlements of tax issues in business activities.

An existing tax ruling may be changed by a new one; however, a taxpayer complying with an original tax ruling that is subsequently changed may not be liable to taxation contrary to the contents of the original tax ruling, and if tax referred to in the original ruling is settled periodically (monthly, quarterly or yearly), the taxpayer is exempt from such tax by the end of the tax settlement period during which the new tax ruling was served to the taxpayer, except for cases arising prior to serving the original tax ruling to this taxpayer.

Taxpayers dissatisfied with any private tax ruling may file a complaint with a district administrative court within 30 days, and subsequently with the NSA.

It is not allowed to apply for (or to issue) individual tax rulings pertaining to powers and duties of tax authorities, CFC rules, the general anti-avoidance rule or specific anti-avoidance
rules. A taxpayer may apply for a tax clearance opinion confirming that a given transaction is not completed in an ‘artificial’ manner mainly or solely for purposes of achieving tax benefits, and that the general anti-avoidance rule shall not apply to that transaction (see Section IX.i).

X YEAR IN REVIEW

During 2019, investors and local CIT taxpayers implemented internal procedures for mandatory disclosure of certain domestic and cross-border transactions that may qualify as aiming at avoidance of taxation according to Polish legislation implementing the DAC 6 EU directive. It was the first year when investors and local taxpayers had to report such transactions to the Head of Tax Administration. Investors also continued to use regulated mutual investment funds from other EU or EEA Member States to acquire shares issued by partnerships and other companies, or to invest in other Polish securities directly. However, since 2017 the local general tax exemption of Poland and foreign-regulated investment funds was narrowed to income derived by Poland-based open-ended investment funds and qualified foreign-regulated collective investment funds from the EU and the EEA only.

In turn, the CIT exemption of Poland-based close-ended investment funds and qualified foreign-regulated collective investment funds from the EU and the EEA operating upon a simple notice of initiation of investment activities, rather than upon a permit of the competent financial sector supervision authority, was narrowed with the exclusion of certain items of their income (in particular, interest, donations and profits paid by local and foreign tax-transparent partnerships, and capital gains from transfers of securities issued by those partnerships). Therefore, during 2019 investors conducted various restructuring of business assets, including shares in companies, securities and interest in partnerships held by such foreign investment funds to qualify for the new tax exemption.

CIT taxpayers’ transfer pricing reporting obligations increased significantly, and transfer pricing documentation became more complex from 2018. In particular, for the largest entities, benchmarking analysis for documented transactions and a master file documenting a whole group of related taxpayers are required. Simultaneously, a number of tax audits aimed at scrutinising by the tax authorities of taxpayers’ transfer pricing reporting and tax settlements increased visibly. Therefore, taxpayers concentrated on preparing pertinent documentation and other practices envisaged by those obligations during the year.

In turn, the administrative courts issued the following positive judgments:

- damages paid for an unjustified termination of a lease agreement may constitute tax deductible costs;
- only the value of the property that is not depreciated constitutes the taxable basis for the minimum CIT on income from commercial real properties, although this is not stated in the CIT Law explicitly; and
- compensations paid by an insurance company to a transportation services company to cover damages caused by the latter company in transported goods constitute a refund of its non-deductible costs, which refunds are not taxable revenues according to CIT Law.

In 2019, the tax authorities continued their policy regarding local taxation in several important matters. In particular, the Minister of Finance aimed to increase tax collections and declared the intention to fight against avoidance of taxation according to its general warning letters regarding certain transactions that may be considered as aggressive tax optimisation falling under the general anti-avoidance rule; for example, transferring IP assets to an SPV, which
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increases assets’ depreciation basis and licenses them to related companies; shifting taxable profits by local companies via payments of interest on bonds issued to tax-exempt Polish regulated investment funds; and other warning letters. Consequently, a number of tax audits and tax disputes in cases relating to such transactions increased significantly.

Since 2019, new rules introduced a general principle of due care that requires withholding tax agents to scrutinise and document if DTTs’, or domestic conditions for application of DTTs’ withholding tax rates and local withholding tax exemptions are satisfied with respect to cross-border royalties, interest, dividends and payments for intangible services. As a result, there arose many doubts and discussions between foreign recipients of these payments if such conditions are met. In many cases, cross-border payments were postponed significantly (even by one year) until the conditions are scrutinised and documented properly.

In turn, local tax authorities issued general and individual tax rulings confirming the following:

a) a contribution in kind of a majority of shares in a company in exchange for new shares in another company may not be tax exempt pursuant to the general anti-avoidance rule if those new shares are subject to sale almost immediately after such contribution of the original shares;

b) application of dividend withholding tax exemption requires the withholding tax agent to verify with due care if a recipient of dividends is their beneficial owner who conducts business activities in the country of its tax residency; and

c) the interest withholding tax exemption may not apply and cross border interest payments should be subject to Polish withholding taxation at the domestic 20 per cent tax rate if cross-border interest is received by a UK holder of bonds that is not a beneficial owner of such interest.

Tax authorities also issued many rulings broadening the scope of prohibited deductions of costs spent for management, advisory, marketing and other intangible services rendered between related parties, where expenses paid for these services should be excluded from tax deductible costs to the extent that these expenses exceed 5 per cent of CIT taxpayers’ EBITDA.

XI OUTLOOK AND CONCLUSIONS

From 2020, a number of amendments to the CITL will enter into force, including the following.

The new legislation implements Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market. According to the new rules, taxpayers, including local branches of foreign enterprises, will be obliged to deny deductions of expenses or tax exemptions or other tax incentives relating to income if such expenses or income result from using hybrid (debt and equity) instruments (i.e., instruments qualified differently for taxation in countries of a recipient and an issuer of such instrument).

The new legislation also governs other tax issues, including:

a) obligation to exclude from deductible costs of expenses that were deducted but were not paid if delay in a payment of such expenses exceeds 90 days from the payment deadline;
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b amendments to rules regulating mandatory disclosure of certain domestic and cross-border transactions;

c new rules (to be applicable from 1 July 2020) governing execution of agreements by taxpayers and tax administration for their mutual cooperation in tax matters; and

d rules excluding expenses exceeding 15,000 zlotys from tax deductible costs if such expenses are paid to banking accounts other than the banking accounts published by the tax administration in the special register of VAT taxpayers called the ‘White List of VAT payers’.

I INTRODUCTION

Why is Portugal a top choice for foreign investors? Portugal has put into place important strategies to stimulate its economy, focusing on key sectors such as high-tech industries, R&D, renewable energy, tourism and real estate. The significant reduction of bureaucracy involved in the investment process, a high-skilled labour force and a modern and very attractive tax system have taken foreign investment in Portugal to the next level.

Portuguese tax system surpasses other regimes in many ways, both for companies and individuals, being one of the most attractive regimes in Europe.

Companies benefit from a participation exemption regime on capital gains and dividends, applicable to both EU and non-EU countries that also benefit from a wide network of double tax treaties (about 80), including treaties with Malta, Luxembourg and Hong Kong, as well as from several investment protection agreements, namely with Portuguese-language countries, which ensures the efficiency of cross-border transactions.

The non-habitual resident’s regime applicable to individuals establishes a 20 per cent tax rate for certain Portuguese employment and self-employment sourced income, as well as a tax exemption for most foreign sourced income. The cherry on top? Inheritance tax does not apply to spouses and direct relatives and wealth tax does not apply in Portugal.

We believe it should not be a surprise that Portugal has become a top choice for foreign companies and high net worth individuals.

II DOING BUSINESS IN PORTUGAL – CORPORATE LAW

i Corporate entities

There are different forms for establishing a business in Portugal, from sole trader to several types of companies, as defined in the Companies Code.

Five types of entities are listed in the Companies Code:

a partnerships;
b private limited companies;
c single-member private limited companies;
d public limited liability companies; and
e limited partnerships (simple or limited by shares).

1 Mafalda Alves is a tax partner at SRS Advogados.
The two most commonly used are private limited companies and public limited liability companies. Choosing one of these business entities depends on several factors: the simplicity level, both in terms of structure and operation or the minimum amount of paid-in capital required.

In a public limited liability company, the liability of each shareholder is limited to the value of his or her shareholding. The minimum number of shareholders for the incorporation is five, and the capital is divided into shares. Bearer shares have not been allowed since 2017.

Private limited companies are the most common type in Portugal, especially for small and medium-sized companies, given their great flexibility.

ii Non-corporate entities

A tax transparency regime applies to certain resident entities: (1) civil law companies not incorporated in a commercial form; (2) incorporated firms of professionals; and (3) holding companies the equity of which is controlled, directly or indirectly, for more than 183 days, by a family group or a limited number of members.

A fiscal transparency regime also applies to complementary business groupings (ACEs) and European economic interest groupings treated as resident in Portugal.

III DOING BUSINESS IN PORTUGAL – TAX REGIME

i Tax on profits

Determination of taxable profit

Resident companies’ taxable profit is calculated on the basis of accounting income adjusted according to specific rules contained in the Portuguese tax legislation.

Business expenses are generally tax-deductible provided that they are incurred in generating taxable profits or deemed essential for maintaining the structure of the company. Nonetheless, some expenses are not deductible for purposes of computing taxable profits, even if accounted for as costs or losses in the relevant accounting period. That is the case, for example, of the following items:

a corporate income tax (CIT) paid;
b compensation paid in respect of insurable events;
c daily expense or allowances and payments relating to an employee’s travel using his or her own car, under certain circumstances;
d excessive depreciation and accounting provisions; and
e interest and other forms of remuneration from shareholder loans exceeding certain limits.

Intangible assets without a fixed life cycle acquired on or after 1 January 2014 may be depreciated over a 20-year period (5 per cent per year) counted from the initial recording of the asset in the company’s books.

Capital and income

The CIT Code adopts a wide definition of taxable income. Capital gains are treated as ordinary business profits and taxed accordingly.
Capital gains and capital losses on the sale of a company’s assets are computed as the difference between the proceeds of disposal, net of related expenditure, and the acquisition cost, reduced by any depreciation claimed. However, capital gains may be exempt from tax (capital losses may not be deducted) under the participation exemption regime (see below).

Only 50 per cent of the difference between capital gains and losses are taken into account if, in the year prior to the disposal or before the end of the second following year, the proceeds are reinvested in the acquisition, manufacture or construction of tangible fixed assets or non-consumable biological assets, except for second-hand assets acquired from related parties.

**Losses**

Tax losses may be carried forward for five years (tax losses registered by entities qualifying as small and medium-sized enterprises, as provided by Decree Law 213/2207, of 6 November, may be carried forward for 12 years). In any case, the deduction is limited to 70 per cent of the taxable profit assessed in the relevant tax year.

Losses carried forward may be lost if, between the tax year in which the losses were suffered and the year in which they are used 50 per cent (or more) of its share capital is transferred to different shareholders.

**Rates**

The regular CIT rate applicable to resident companies in Portugal is 21 per cent. The tax rate applicable to the first €15,000 of the taxable income of taxpayers qualifying as small and medium-sized enterprises, as provided by EU Commission Recommendation 2003/361/EC, is 17 per cent. A municipal surcharge is levied in addition to CIT in most municipalities at a rate of up to 1.5 per cent of taxable income.

Corporate taxpayers with taxable income of more than €1.5 million are also subject to a state surcharge of 3 per cent. The surcharge increases to 5 per cent for taxable income exceeding €7.5 million, and to 9 per cent for taxable profits in excess of €35 million.

**Administration**

**Filing tax returns**

CIT assessment returns must be filed by Portuguese-resident entities and permanent establishments of non-resident companies and submitted by 31 May following the end of the calendar year, or five months after the authorised year-end if the company’s tax year does not follow the calendar year. An annual return containing simplified corporate information must also be filed by 15 July or by the 15th day of the seventh month following the end of the tax year.

Following Organisation for Economic Co-operation and Development (OECD) recommendations under the base erosion and profit shifting (BEPS) Action Plan, ultimate parent entities or other reporting entities of multinational groups of companies that register turnover higher than €750 million are required to complete and file a country-by-country report. Entities with tax residency in Portugal integrating a multinational group of companies, subject to the country-by-country report obligation must also communicate to the Portuguese tax authorities by electronic means which entity constitutes the reporting entity of the group, the respective tax jurisdiction, its tax identification number and address.
Taxable persons liable to CIT and their representatives must also file statements in respect of registrations, changes or cancellations on the taxable persons’ registry, and are required to keep a tax documentation file in respect of each accounting period for a 10-year period containing all accounting and tax information.

Tax authorities
Taxes in Portugal are administered by the Portuguese Tax and Customs Authority, which is organised as a vertical structure integrated into the Ministry of Finance and divided into two main services: the Directorate General for Taxation and the Directorate General for Customs and Excise Taxes.

The Tax Authority has competence to carry out tax audit procedures, make additional and late interest tax assessments, and impose penalties and fines on non-compliant taxpayers.

Advance rulings
Taxpayers may request advance rulings regarding their tax affairs, including their eligibility for tax benefits. When advance rulings are issued, the tax authorities may not derogate from such rulings in relation to the taxpayers that requested it, except pursuant to court decisions.

Subject to the payment of a fee, advance rulings may be provided urgently (within 75 days), provided that such request is accompanied by a tax framework proposal. The proposed tax framework and the facts to which the urgent request for an advance ruling relates are considered tacitly sanctioned by the tax authorities if the request is not answered within 75 days.

Non-urgent rulings are delivered within 150 days.

Apart from the advance ruling regime, a taxpayer and the Portuguese Tax Authority may negotiate advance pricing agreements on transfer pricing issues.

Means of appeal
Following a tax audit, the taxpayer is allowed to challenge an additional tax assessment made by the tax authorities, either by means of an administrative claim submitted to the tax authorities, or through a judicial or arbitration appeal to the tax courts or to the tax arbitration court.

Decisions of the tax courts may be appealed to the Central Administrative Court of Appeal or to the Administrative Supreme Court.

Tax group
Portuguese-resident companies that are members of an economic group may opt to be taxed under the special group taxation regime.

The parent must hold, directly or indirectly, for a minimum one-year period, at least 75 per cent of the subsidiaries’ share capital and 50 per cent of their voting rights. All companies in the group must be tax-resident in Portugal (albeit indirectly held, through a European Union (EU) or European Economic Area (EEA) resident company) and must be subject to Portuguese CIT on their worldwide income at the standard CIT rate to benefit from this regime. This regime is also applicable if the parent company has a permanent establishment in Portugal that holds the capital of the subsidiaries, and some other cumulative conditions are met.
Entities with tax losses in the preceding three years are not eligible for this regime, except where their share capital has been held by the parent for more than two years.

**ii Other relevant taxes**

**Value added tax (VAT)**

Portuguese VAT legislation basically follows the EU common system of VAT. It applies to the supply of goods, services, intra-Community acquisitions and imports into the Portuguese territory.

Any person or corporate entity that independently carries out an economic activity, or that carries out a single taxable transaction either in connection with the performance of the above-mentioned activities or that is subject to personal tax or CIT, is liable to charge VAT on every supply (of goods or services) it makes in the scope of its activities, and afterwards to deliver the due amount to the tax authorities.

There are three VAT rates: 23 per cent (standard), 13 per cent (intermediate) and 6 per cent (reduced).

In the autonomous regions of Azores and Madeira, the VAT rates are currently reduced to 18 and 22 per cent (standard), 9 and 12 per cent (intermediate), and 4 and 5 per cent (reduced), respectively.

**Immovable Property transfer tax (IMT)**

IMT is levied on the transfer for consideration of immovable property.

The tax is payable by the purchaser, whether an individual or a company, resident or non-resident. The taxable amount corresponds to the higher of the contractual price or the tax value.

The tax due is assessed as described above at the following tax rates:

- a) rural property: 5 per cent;
- b) urban property and other acquisitions: 6.5 per cent;
- c) urban property for residential purposes: progressive tax rates up to 6 per cent; and
- d) rural or urban property where the purchaser is domiciled in a blacklisted jurisdiction: 10 per cent.

**Municipal immovable property tax (IMI)**

IMI is levied annually on immovable property located in Portugal. Tax is levied on the tax value of the property as of 31 December of each year.

The taxable value of urban property corresponds to the tax value recorded on the tax registry.

The IMI rates are as follows:

- a) rural property: up to 0.8 per cent;
- b) urban property: 0.3 to 0.45 per cent; and
- c) rural or urban property where the owner is domiciled in a blacklisted jurisdiction: up to 7.5 per cent.
**Additional to the IMI (AIMI)**

AIMI is annually due by individuals, companies and inheritances that own residential property or plots for construction located in Portugal and the taxable basis corresponds to the tax value of all above mentioned properties owed or held by each taxpayer (as at 1 January of each year).

The applicable taxable basis is deducted from the amount of €600,000 for individuals and inheritances and €1.2 million in case of married or living in non-marital partnership taxpayers, who opt to submit a joint tax return.

The applicable rates, after deductions provided, are as follows:

- **a** individuals and inheritances: 0.7 per cent; (1 per cent on the part of the tax value ranging between €1 million and €2 million; and 1.5 per cent on the part of the tax value exceeding €2 million, regarding property held by individuals);
- **b** companies: 0.4 per cent;² and
- **c** urban properties owned by entities in blacklisted countries: 7.5 per cent.

**Stamp tax**

Stamp tax is levied on all acts, contracts, documents, titles, books, papers and other taxable events set out in the Stamp Tax Code that are signed or take place in Portugal, provided that they are not subject to VAT.

Loans granted to resident entities, regardless of the nature or place of resident of the lender, are generally subject to stamp tax ranging from 0.04 to 0.6 per cent, depending on the credit or loan term. A tax exemption may be granted to the following transactions provided certain requirements are met: long-term loans qualifying as *suprimentos*³ for Portuguese commercial law purposes, made by the shareholder, provided that the participation exemption requirements are met (minimum participation and detention period); and short-term (less than one year) cash management loans made by parent companies to their subsidiaries.

**IV TAX RESIDENCE**

**i Corporate residence**

Companies are deemed to be resident in Portugal for tax purposes if their head office or place of effective management is located in the Portuguese territory. These two criteria are often met simultaneously, providing consistency under tax law. However, if this is not the case, the place of effective management is the decisive factor.

According to Portuguese case law, the place of effective management is defined as the place where the management decision-making takes place, and where adequate substance (regarding both people and premises) exists.

Resident companies are taxed on their worldwide income. Non-resident companies are taxed on their Portuguese-source income.

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² If the immovable property is used for residence purposes by the shareholders or the members of the statutory bodies of the company (or any related individuals), tax rates established for individuals shall apply.

³ A legal concept for shareholder loans with a deadline for repayment of over one year.
ii Branch or permanent establishment

In general terms, domestic branch profits are taxed on the same basis as corporate income. Nevertheless, there are some differences in their tax treatment (general administrative expenses incurred by the head office may be allocated to the branch, and there may be restrictions on the deductibility of certain expenses charged by the head office to the branch).

All income is included in the tax base of the permanent establishment located in the Portuguese territory, regardless of its geographical source, provided that such income is attributable to the same. All allowable items of expenditure, deductions and credits are also taken into account, regardless of the source of the income to which such items relate, provided that they are attributable to the permanent establishment.

V NON-HABITUAL RESIDENTS REGIME AND OTHER TAX INCENTIVES FOR INWARD INVESTMENT

i Special tax regime for non-habitual residents

The non-habitual residents regime is available for citizens who have become residents in Portugal for tax purposes, according to the criteria defined by the personal income tax (PIT) Code, and who have not been deemed as resident in Portugal in any of the previous five years. The non-habitual residents regime is applicable for 10 consecutive years. If a taxpayer does not meet the requirements to be considered as resident in any year within that period (thus not using the complete period), the taxpayer may continue to benefit from the regime as soon as he or she meets the requirements.

As this regime is based on effective residence in Portugal, the non-habitual resident's income will be subject to tax in Portugal on a worldwide basis. Notwithstanding this, the following will apply:

a Income obtained in Portugal from high value-added activities of a scientific, artistic or technical nature is taxed at a special rate of 20 per cent. These activities are defined in Ordinance No. 230/2019 of 23 July (which amended Ordinance No. 12/2010 of 7 January – still in force for certain cases), and include professionals such as physicians, dentists, teachers, specialists in IT, authors, journalists, creative and performing artists, engineering technicians as well as companies’ general-directors and executive managers, and directors of companies that promote production investment, provided they are allocated to eligible projects and are granted tax benefits under the Investment Tax Code.

b Foreign-sourced income may be exempt from tax in Portugal, provided that some requirements are met (the exemption method for the elimination of double taxation will be applicable on income derived from foreign sources).

ii Tax regime for former tax residents

A new tax regime to encourage the return of former tax residents to Portugal has been established in 2019. The regime applies to individuals who become Portuguese tax residents under Portuguese domestic law in 2019 or 2020, provided that they:

a did not qualify as tax residents during the prior three years;
b have qualified as tax residents in Portugal prior to 31 December 2015; and
c have their tax situation regularised and did not apply for the non-habitual residents regime.
The regime establishes a 50 per cent relief from taxation on employment or self-employment income received after their return to Portugal. This tax relief is applicable to income derived in the first year of residency after the return to Portugal and in the following four years, expiring after this period.

### iii Participation exemption for dividends and capital gains

Profits and reserves distributed to Portuguese-resident companies by their subsidiaries and capital gains and losses arising from the sale of shareholdings in such subsidiaries are not subject to CIT, provided that:

- the Portuguese company holds at least 10 per cent of the share capital or voting rights of the subsidiary;
- the shares have been held for at least 12 months prior to the distribution or transfer of the shares (or if the shares are maintained for that period, in the case of distribution of profits);
- the company distributing the dividends or reserves is subject to and not exempt from Portuguese CIT, similar tax referred to in the Parent–Subsidiary Directive or similar tax provided that its applicable rate is not lower than 60 per cent of the Portuguese standard CIT rate, unless:
  - at least 75 per cent of the profits derive from an agricultural, industrial or commercial activity, or from the rendering of services that are not predominantly targeted to the Portuguese market; or
  - the main activity of the subsidiary does not consist in performing certain activities (including but not limited to banking operations and operations related to the insurance business);
- the company distributing the dividends or reserves, or whose capital is subject to sale, is not domiciled in a blacklisted jurisdiction; and
- the profits or reserves do not qualify as deductible costs in the distributing entity.

The exemption regime will not be applicable to capital gains or losses arising from the transfer of a shareholding in a subsidiary whose assets are composed, directly or indirectly, in more than 50 per cent, of real estate located in Portugal (purchased on or after 1 January 2014), unless these assets are allocated to an industrial, commercial or agricultural activity that does not consist on the purchase and sale of real property.

### iv Patent box

Income arising from the assignment or temporary use of patents and industrial designs registered on or after 1 January 2014 may benefit from a 50 per cent exemption, provided that:

- the assignee uses the industrial property rights in a commercial, industrial or agricultural activity;
- the results obtained by the transferee from the use of the industrial property right do not consist of delivery of goods or services creating deductible costs to the original owner of the industrial property rights, or any other company integrated in the same tax group, whenever special relations are deemed to exist;
- the assignee is not resident in a blacklisted territory; and
the accounting records of the taxpayer are organised in such a way as to allow the identification of the costs and losses directly attributable to the industrial property right subject to the assignment or temporary use.

v State aid

National and foreign companies that intend to invest in Portugal in certain sectors may apply for financial incentives granted by EU structural funds under the Strategic Programme Portugal 2020.

Apart from such financial incentives, eligible productive investment projects set up by 31 December 2020 may also benefit from certain contractual tax incentives under the Tax Investment Code, such as CIT credits, or real estate and stamp tax reductions or exemptions. This regime complies with the EU state aid rules.

vi General

Apart from the exemptions from withholding tax on outbound payments granted under the CIT Code (see below), there are some other notable tax incentives provided in the Portuguese Tax Benefits Statute and ancillary legislation. The following are an example of such incentives.

Madeira free zone

Companies licensed to operate under the scope of the Madeira International Business Centre benefit from extremely attractive tax benefits, such as a reduced CIT rate of 5 per cent until 2027 (except for intra-group services, financial intermediation and insurance), and exemptions from stamp duty and from property transfer tax and municipal property tax in relation to real estate located in Madeira and registered for company business use, depending on the date of the licence. Shareholders of the companies covered by the scheme, both individuals and companies, may benefit from income tax exemption on dividends and interests paid out.

Undertakings for collective investment (UCIs)

Under this regime, Portuguese UCIs only, including securities investment funds (SIFs), real estate investment funds (REIFs), securities investment companies (SICs) and real estate investment companies (REICs), are generally tax-exempt regarding dividends, interest, rental income and capital gains included in their taxable profits.

The taxation of non-resident investors will depend on the type of UCI to which the income relates.

Income arising from SIFs and SICs, including income distributed by these entities, capital gains from the disposal of units or shares, or income arising from the redemption of units, is fully exempt from tax in Portugal.

Income arising from REIFs and REICs, including income distributed by these entities, capital gains from the disposal of units or shares, or income arising from the redemption of units, is subject to a 10 per cent flat rate tax in Portugal. Following similar REITS models implemented in Europe, the Portuguese government has approved, with effect from 1 February 2019, the Decree Law 19/2019 of 28 January, which establishes the regime applicable to Sociedades de Investimento e Gestão Imobiliária (SIGI). SIGI, the so called
‘Portuguese REITS’, intends to promote real estate investment and to develop real estate market, focusing on the letting market. SIGI will be subject to the tax regime applicable to real estate investment companies.

When more than 25 per cent of non-resident entities are directly or indirectly held by Portuguese residents, or are located in blacklisted jurisdictions, they are subject to tax on the income arising from UCIs at a rate of 25 or 35 per cent, respectively.

**Capital gains realised by non-resident entities**

Capital gains from the transfer of shares, warrants and other securities issued by Portuguese-resident entities and realised by non-resident entities are income tax-exempt. This exemption does not apply to the following:

- non-resident entities, at least 25 per cent of whose equity is directly or indirectly owned by resident entities (exceptions may apply depending on the tax residence and tax regime applicable to the non-resident investor);
- entities domiciled in a blacklisted territory;
- capital gains obtained from the transfer of shares in Portuguese companies more than 50 per cent of whose assets consist of real estate located in Portugal or from the sale of shareholdings in Portuguese holding companies that control Portuguese companies 50 per cent of whose assets consist of real property located in Portugal; and
- capital gains arising from the sale of shares of a nonresident company, where the value of those shares at any time in the previous 365 days resulted, directly or indirectly, in more than 50 per cent, from real estate assets located in the Portuguese territory, unless the relevant real property is allocated to an agricultural, industrial or commercial activity that does not consist in the acquisition and resale of real property.

**Conventional remuneration of the share capital**

Under this regime, 7 per cent of cash contributions made by the shareholders, as well as of conversions of shareholder loans made upon the incorporation or at the time of a capital increase, up to a €2 million threshold, may be deductible from the company taxable income.

**Programme seed**

Targeted to attract individuals’ investment in start-ups, the programme allows for a deduction to the investor payable income tax (up to a limit of 40 per cent) of 25 per cent of the cash contributions. Capital gains from the sale of the start-up company shares may be excluded from taxation if the sale price is reinvested in new eligible investments.

**VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS**

**i Withholding on outward-bound payments (domestic law)**

Except in certain circumstances, most income obtained by non-resident entities in the Portuguese territory is subject to withholding tax. Income is deemed to be obtained in Portugal, as a rule, if the debtor is a resident, or has its head office or place of effective management in Portugal, or if its payment is attributable to a permanent establishment in Portugal.

The CIT withholding tax rate is generally 25 per cent.
ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Outbound dividends paid by Portuguese-domiciled companies are exempt from withholding tax, providing that the company receiving the dividends:

a is resident in a Member State of the EU or EEA, or a country with which Portugal has concluded a double tax treaty that includes a provision for administrative cooperation in the field of taxation similar to that existing in the EU;

b is subject to and not exempt from a tax mentioned in the EU Parent–Subsidiary Directive, or a tax that is similar to CIT tax, in other cases, provided that the applicable tax rate is not less than 60 per cent (12.6 per cent) of the CIT rate; and

c has held, directly or indirectly, for a 12-month period prior to the distribution a participation of at least 10 per cent of the share capital or voting rights of the company.

If the 12-month period is not completed, dividends paid will be subject to a 25 per cent withholding tax (which can be recovered after the completion of such period) eventually reduced under an applicable tax treaty.

Under a specific domestic anti-abuse provision (resulting from the transposition of Council Directive 2015/121/EU, of 27 January, which amended the Parent–Subsidiary Directive), withholding tax exemption on dividends is denied in case of an arrangement or series of arrangements the main purpose or one of the main purposes of which is to obtain a tax advantage that defeats the object and purpose of eliminating double taxation on profits, in case such arrangement or series of arrangements is not regarded as genuine, all facts and circumstances considered.

Interest paid by Portuguese-domiciled subsidiaries to a parent company that is a resident in an EU Member State may benefit from a withholding tax exemption under the EU Interest and Royalties Directive.

iii Double tax treaties

Portugal has entered into double taxation treaties with 79 countries to prevent double taxation.

Under these treaties, withholding tax rates on outbound dividend, interest and royalty payments are reduced provided that the beneficial owner of the income sourced in Portugal is a tax resident of the other contracting state. For a detailed list of the tax treaties in force and rates applicable to interest, royalties and dividends, see Appendix I at the end of the chapter.

Portugal is a signatory of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). Under this convention, existing bilateral tax treaties are considered to be modified to include specific rules preventing the granting of treaty benefits in deemed inappropriate circumstances, notably in situations of creation of opportunities for non-taxation or treaty-shopping arrangements aimed at obtaining reliefs for the indirect benefit of residents of third jurisdictions.

The MLI has been ratified by the President of the Portuguese Republic. However, it shall enter into force on the first day of the month following the expiry of a period of three calendar months beginning on the date of the deposit of the instrument of ratification with the Secretary-General of the OECD. It has not been deposited yet.

Therefore, the amendments introduced by MLI to the bilateral treaties are expected to become effective by mid-2020.
VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
The former thin capitalisation rules were abolished in 2013, and replaced by an earnings stripping rule that limits tax deductibility of interest expenses.

Under this rule, net financial costs are only deductible up to the higher limits of €1 million or 30 per cent of the earnings before depreciations, net financing expenses and taxes.

Any exceeding financing expenses may be deductible on the following five tax years after deducting the financing expenses of each year, provided that the above-mentioned limits are not exceeded.

Furthermore, in respect of shareholder loans, deductible interest cannot exceed the 12-month Euribor rate in force on the day the loan was granted, plus a 2 per cent spread or 6 per cent spread for medium-sized enterprises. This limitation does not apply where transfer pricing rules are applicable.

ii Return of capital
Companies may return cash to shareholders by means of a dividend distribution, capital reduction, redemption of shares or liquidation (under the applicable legal limits).

A payment to shareholders in connection with a reduction of capital along with redemption of shares is regarded for tax purposes as a capital gain on any value exceeding the purchase price of the shares.

Liquidation proceeds are deemed to be capital gains or capital losses that are eligible for the participation exemption regime.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Business acquisitions are usually structured as either asset or share deals. Different tax regimes should apply to these operations.

There are various taxes that can be either levied on the acquisition of assets (property transfer tax, VAT or stamp tax) depending on the nature of the assets. However, taxable capital gains are less likely on a sale of shares.

The acquisition of shares of a public limited liability company is not subject to VAT or property transfer tax. The acquisition of shares of a private limited company by quotas, of a general partnership or of a partnership association may be subject to IMT if these entities hold real estate and following to the share acquisition, one of the shareholders holds at least 75 per cent of the share capital, or the number of shareholders reduces into two, with these two individuals being married or unmarried partners.

ii Reorganisation
Restructuring operations such as mergers, demergers, spin-off transactions, transfers of assets and share exchanges may be performed without income tax constraints for companies and shareholders involved under the Portuguese tax neutrality regime.

Exemptions from property transfer tax, stamp tax and notarial and registration fees may also be granted by the Ministry of Finance upon request, provided that certain conditions are met.
iii Exit
When a company transfers its tax residence abroad, it is deemed as liquidated and is subject to CIT on the positive difference between the market value and the book value of its assets, provided that these are not allocated to a permanent establishment of the company in Portugal. The same regime applies on the end of activity of a permanent establishment of a non-resident entity located in Portugal (the transfer outside Portuguese territory, by any act or legal instrument, of assets allocated to that establishment may also be taxed).

The tax payment resulting from the transfer of residence can be deferred where the transfer is made to an EU or EEA Member State, provided that certain conditions are met.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Portuguese general anti-avoidance rules provide for a general principle of substance over form under which the tax authorities may disregard the legal form agreed upon by the parties where a transaction is deemed to be tax-driven (even if not exclusively), and they may recharacterise the facts for tax purposes in accordance with the underlying economic reality.

ii BEPS
Portugal has already enacted several unilateral anti-BEPS measures, notably:

a controlled foreign corporation (CFC) rules;

b an earnings stripping rule to limit interest deductibility based on earnings before interest, taxes, depreciation, and amortisation (EBITDA) levels;

c denial of the participation exemption regime where the dividends received give rise to a deduction for the subsidiary;

d denial of the participation exemption regime on structures that lack economic substance;

e an obligation to disclose aggressive tax planning schemes;

f a revised patent box regime incorporating the nexus approach; and
g adoption of the 2014 EU directive on automatic exchange of tax information and exchange of information procedures under the Common Reporting Standard.

iii CFC rules
Under the CFC rules, profits or other income derived by non-residents in the Portuguese territory and subject to a more favourable tax regime can be attributed, as a rule, to Portuguese-resident shareholders who hold, directly or indirectly, at least 25 per cent of the share capital in proportion to their shareholding.

iv Transfer pricing
Portugal has implemented detailed transfer pricing legislation that broadly follows the methodologies and principles in the OECD guidelines.

Under Portuguese transfer pricing rules, domestic and cross-border inter-company transactions must be at arm’s length, and the Portuguese tax authorities have wide-ranging powers to adjust declared income if they consider that market conditions have not been respected.
Special relations are deemed to exist between two entities where one such entity has the power to exercise, directly or indirectly, a significant influence on the management decisions of the other entity.

All companies undertaking transactions with related entities, even if they are not obliged to prepare a transfer pricing file, have to fill out additional declarations as part of their annual tax reporting obligations.

Additionally, taxpayers with annual net sales and other income equal to or greater than €3 million in the fiscal year prior to the year under consideration are required to prepare a transfer pricing file, which should contain an analysis of all of the aspects of every transaction with related parties.

v Tax clearances and rulings
Upon request, tax and social security authorities may deliver a written confirmation that a company’s tax affairs are in order. These certificates are valid for three and four months.

Binding advance rulings may be awarded in specific situations (see above).

X YEAR IN REVIEW
The tax reforms launched in 2014 and 2015 to foster tax competitiveness have proven to be very effective in the past few years, including 2019.

The modern tax system implemented in 2014 and 2015 allowed the introduction, in 2019, of new foreign investment tax incentives and the implementation of new international standards (namely on tax avoidance) in a way that should not entail major tax changes to be effective.

The long-awaited REITs regime has been introduced in 2019 – the SIGI regime. The SIGI regime provides a special investment vehicle for real estate and aims to develop the real estate market (in particular, the letting market). SIGI will be subject to the tax regime applicable to real estate investment companies (the new tax regime for REIC has also been introduced in 2015).

Moreover, a new tax regime to encourage the return of former tax residents to Portugal has been approved in 2019.

Both measures shows that foreign investment is a rock-solid trend under Portuguese tax policies.

Finally, Anti-Tax Avoidance Directive (ATAD 1, amended by ATAD 2) was partially implemented in 2019. Although its implementation required some tax amendments and obliges the players to keep these rules in mind when performing their business, as the Portuguese legislation had already foreseen most of ATAD 1 measures to avoid tax evasion, we believe that its implementation will not entail a major shift in the playing field for companies in Portugal.

XI OUTLOOK AND CONCLUSIONS
Portugal has managed to improve economic conditions in the past few years and the economy is projected to continue expanding at a stable pace.

According to available provisional data, a budget superavit may be expected for 2019, for the first time in decades.
Besides good economic news, Portugal has a modern and very competitive tax regime, both for companies and individuals who become resident in Portugal.

Foreign investment has been a key focus of tax policy in recent years and 2019 seems to increase this trend.

Corporate tax benefits and a competitive participation exemption regime (on dividends and capital gains) makes Portugal a unique location for corporate investment.

The special tax regime applicable to high-value individuals who transfer their residence to Portugal (and the golden-visa regime) have also been considered exceptional investment opportunities.

In this scenario, we believe the implementation of ‘Portuguese REITs’ (SIGI) in 2019 and the approval of a new tax regime for former residents may take foreign investment in Portugal to the next level, although heavily real estate-driven.

A negative highlight goes to the maintenance of the ‘heavy’ tax rates applicable to ‘regular’ resident individuals.
## Appendix I: Treaty rates for dividends, interest and royalties (per cent)

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Chapter 26

RUSSIA

Oleg Konnov and Sergei Eremin

I INTRODUCTION

In the past few years, the Russian government has taken various measures to reduce adverse consequences of sanctions introduced by the United States, EU and certain other countries and to encourage foreigners to invest in Russia. The measures included major reform of corporate law, simplification of the regulatory framework, subsidies and guarantees, as well as various tax incentives; for example, in relation to industrial R&D, tourism and operation of ports. As of the end of the first six-month period in 2019, direct inward investment into Russia was US$472 million, slightly exceeding investment in the first six months of 2018. This is a relatively small amount, standing at a par with inbound investments in Belgium. The Organisation for Economic Co-operation and Development (OECD) forecasts the growth of the Russian economy to continue at a very moderate pace.

Tax incentives have been neutralised by a gradual overall increase in the tax burden, including an increase in the value added tax (VAT) rate (as of 1 January 2019) and introduction of various quasi-taxes.

Although the role of the state in the Russian economy has been growing constantly, certain mega projects have been completed by private investors. For instance, Yamal LNG, a company majority owned by Novatek (Russia), with Total (France), CNPC and Silk Road Fund (China) as private investors, completed the LNG project well ahead of the plan. Major tax and customs concessions were secured through amendments to Russian law and an intergovernmental agreement was concluded by Russia and China. In the summer of 2019, the Arctic LNG 2 project majority owned by Novatek attracted investment from Total, CNPC, CNOOC (China), and the consortium of Mitsui and JOGMEC (Japan). The final investment decision on the project was made in September 2019.

The valuation of Russian companies remains low, making them an attractive target for investors willing to take on the risk in the current economic and political environment.

At the same time, Russia has been exercising control over investments in certain sensitive industries, such as defence, aviation and nuclear. Russian law also imposes foreign ownership limitations in certain sectors (e.g., transport infrastructure, aviation and the space industry, cryptology, mass media). In some cases, acquisition of real estate by, and issuance of subsoil licences to, foreigners may be subject to restrictions.

1 Oleg Konnov is a partner and Sergei Eremin is a senior associate at Herbert Smith Freehills CIS LLP.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Russian law provides for a wide range of both corporate as well as non-corporate forms of doing business; however, only a few are used in practice. Generally, tax rules do not materially differ depending on the types of corporate entities.

i Corporate

In most cases businesses prefer to invest through corporate vehicles. The two most commonly used forms of entities are the limited liability company (LLC) (shareholders in LLCs are called ‘participants’ and participants’ stakes are called ‘participatory interests’) and the joint-stock company (JSC), which may be public or non-public.

Both vehicles, as a general rule, stand for limited liability of their members provided that the corporate veil may be pierced in certain cases, including bankruptcy. The major difference between these forms is that LLC capital is divided into participatory interests, which are proprietary rights and not securities, while a JSC issues shares. The title to shares and participatory interest is recorded differently, and the rules of the registration of their transfer differ as well.

An LLC is generally perceived as an entity where personal connections between participants matter more that in a non-public JSC. That triggers some other differences: unlike non-public JSCs, an LLC’s charter may prohibit the disposal of participatory interests to third parties; an LLC’s charter may subject the transfer of participatory interest to consent of participants without any time limitation while in non-public JSCs the lock-up period is limited to five years; in contrast to LLCs, where the right of first refusal is granted by default under statute, there is no such right in non-public JSCs unless the charter provides otherwise.

Taxation of LLCs and non-public JSCs is widely similar save for specific distinctions (e.g., application of the capital gains rules).

Generally, the following taxes would normally apply to legal entities: profits tax, VAT, social security charges, property tax, land tax and stamp duties. There is no separate capital gains tax, securities tax or capital tax in Russia. Depending on the type of business they perform, companies may also be subject to mineral extraction tax and various resources-related taxes, export or import duty, excise taxes, transportation tax and state duty. Employers are normally obliged to withhold personal income tax from wages they pay. Finally, corporates may apply a range of special tax regimes available for small enterprises and the like.

ii Non-corporate

While many unincorporated forms of doing business are recognised by Russian law, they are rarely used, except for real estate investments. Examples of non-corporate organisations include the simple partnership agreement, investment partnership agreement and private equity fund.

All three structures are transparent for profits or income tax and property tax purposes. Property tax and profits or income tax (depending on whether a participant is a legal entity or an individual) are payable only by the participant but not by the partnership. Some other taxes may be paid by the managing partner on behalf of the partnership.

The mutual investment fund enjoys profits tax deferral as its main advantage compared to partnership agreements. Thanks to that, private equity funds are commonly used for real estate investment.
Apart from the mutual investment fund, non-corporate entities are not widely used in practice owing to lack of corporate protection of the participants in combination with somewhat ambiguous tax regulation.

III DIRECT TAXATION OF BUSINESSES

Key Russian taxes and their general rates for businesses are the following:

a) profits tax (20 per cent);^6
b) VAT (20 per cent as of 1 January 2019);^7
c) social security charges (to the Pension Fund, 22 per cent for remuneration not exceeding 1.150 million roubles and 10 per cent for remuneration in excess of it; to the Medical Insurance Fund, 5.1 per cent; to the Social Security Fund, 2.9 per cent for remuneration not exceeding 865,000 roubles and zero per cent for remuneration in excess of it; and to the Social Security Fund for insurance for work-related injuries and diseases at rates ranging from 0.2 per cent to 8.5 per cent);^8
d) property tax (2.2 per cent);^9
e) land tax (may not exceed 0.3 per cent of the cadastral^10 value of agricultural and residential land and 1.5 per cent for other types of land);
f) mineral extraction tax;
g) excises;
h) transportation tax; and
i) stamp duty (relatively low in Russia).

i) Tax on profits

Determination of taxable profit

Corporates that are Russian tax residents are liable for profits tax on their worldwide profit (calculated as gross income minus deductible expenses).

Non-resident foreign companies with a permanent establishment in Russia pay profits tax on the taxable profits attributable to that permanent establishment. Given that Russian attribution rules are not sufficiently clear, disputes with the Russian tax authorities as regards attribution are not uncommon. Certain other income deemed to derive from Russian source and not attributable to a permanent establishment may be subject to withholding tax.

Profit is calculated as gross income less deductible expenses. Most business expenses are deductible, provided that they are economically justified (i.e., aimed at receiving profit) and properly documented. Restrictions apply to the deductibility of certain expenses, such as certain advertising expenses and interest.

Generally, profits tax is calculated on an accrual basis subject to certain exceptions. Special accounting rules apply for profits tax purposes.

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^5 Although VAT is an indirect tax, we have included it in this chapter because of its structure.
^6 Special rates may apply; for example, 13 per cent applies to dividends received by Russian shareholders.
^7 Zero per cent applies to export (exemption with credit), 10 per cent applies to certain food, medical goods, goods for children, etc.
^8 Thresholds subject to annual change.
^9 Decreased rates apply for particular types of taxpayers.
^10 Other statutory value used in certain cases.
Capital and income

There is no separate capital gains tax in Russia. Capital gains are subject to the regular profits tax. A separate base may be required in respect of listed and unlisted securities.

An exemption is available for capital gains on the sale of participatory interests and specified in the law shares of Russian companies. To qualify for exemption, a taxpayer should have acquired shares or a participatory interest after January 2011 (in relation to preceding periods, special provisions apply) and have held them for more than five years.

Losses

Until recently loss carry-forward was limited to 10 years yet unlimited by amount. Now, loss may be carried forward indefinitely; however, such loss cannot reduce taxable profit in any year by more than 50 per cent. Loss included in the general tax profits base may be set off against received capital gain from non-negotiable instruments, but not vice versa.

Starting from 1 January 2020, this rule shall not apply to the legal successor in the reorganisation proceedings of the predecessor if the tax authorities find that the main purpose of the reorganisation was to record losses.

Rates

Generally, the profits tax rate is 20 per cent (that is shared between the federal (3 per cent) and regional (17 per cent) budgets). A zero rate applies to medical and educational institutions, regional or municipal museums, theatres and libraries, and to the regional solid waste management operators (provided that the regional authorities introduce a zero rate). In addition, the Tax Code lists certain categories of taxpayers eligible for profits tax incentives (for instance, residents of special economic zones and, recently introduced to the Tax Code, participants of special investment contracts). Starting from 2019, regions are only able to reduce the rate in cases directly provided by the Tax Code, and the existing incentives are gradually falling apart. The reduced rates, which were introduced before 3 September 2018, are valid until the end of 2022 at the most. But the region may change its mind and raise them earlier.

Reduced rates also apply to certain types of income. For instance, dividends received by Russian companies from Russian and foreign subsidiaries are subject to a 13 per cent dividend tax. Furthermore, a participation exemption applies if the recipient has held at least a 50 per cent stake in the subsidiary continuously for at least one year. If the subsidiary is a non-Russian legal entity, it must also not be incorporated in a country that appears on the ‘blacklist’ of offshore jurisdictions published by the Russian government.

Dividends paid to non-Russian residents having no permanent establishment in Russia are subject to a 15 per cent rate unless a lower tax rate is available under an applicable tax treaty. Interest paid to non-Russian residents is subject to a 20 per cent withholding tax. However, this tax may be reduced (and even eliminated) under an applicable tax treaty. Royalties paid to non-Russian residents are subject to a 20 per cent withholding tax. Again, a reduction or full exemption may be available on the basis of a double tax treaty.

11 The validity period of this rule has recently been extended until 31 December 2021.
12 See Chapter 3.5 of the Tax Code of the Russian Federation.
Administration

Advance profits tax returns are filed quarterly (or monthly, in some cases); the final return is filed annually.

All taxes, including profits tax, are administered by the Federal Tax Service, including its regional and local departments. Special tax inspectorates exist (e.g., for major taxpayers, foreign taxpayers, for information technologies).

Tax rulings are available only in limited instances in Russia. However, it is possible to obtain individual guidance from the Ministry of Finance. Action in accordance with such guidance may exempt the taxpayer from fines and late payment interest, but not tax arrears. A taxpayer or tax agent can also request such guidance from the local Tax Service; however, it is unclear if it grants the same benefit. Letters of the Federal Tax Service and letters of the Ministry of Finance addressed to an indefinite number of persons are formally not mandatory, but reflect the general policy of the tax authorities.

Tax assessments may be challenged with the superior tax authority or in court; most decisions are to be challenged with the superior tax authority prior to filing a lawsuit.

Tax grouping

Tax grouping is only available to few major corporations in Russia.

Members of the group can count income and deduct expenses jointly, thus decreasing the tax and administrative burden. Transfer pricing rules are not applicable inside the group.

Currently, companies are prohibited from joining the existing consolidated groups. It is expected that the existing consolidated groups will be terminated by 2023.

ii Other relevant taxes

VAT

VAT is charged on: (1) goods, works and services ‘supplied’ in Russia, and also on property rights; and (2) imported goods.

Goods are deemed to be supplied in Russia if they are located in Russia and not transported or if they are located in Russia at the time of dispatch.

In respect of services, the general rule is that they are deemed to be supplied in Russia if the seller of services carries out its activities in Russia. However, specific rules apply to certain types of services. For instance, consulting, legal, accounting, marketing, engineering and information processing services are deemed to be supplied in Russia if the purchaser or recipient of those services carries out its activities in Russia.

The standard VAT rate is 20 per cent. A 10 per cent rate applies to certain food products, goods for children, certain mass media items (e.g., newspapers) and medical goods. The export of goods is zero-rated (exempt with credit). Certain VAT exemptions are available; for example, the sale of land or residential properties and the import of certain technological equipment that has no Russian equivalent.

A company’s VAT liability is generally calculated as its output VAT invoiced to customers minus input VAT invoiced to the company by suppliers or paid to customs upon the import of goods. Where the amount of input VAT exceeds the amount of output VAT, the difference is usually recoverable.

Starting from 1 January 2020, the successors of reorganised companies will be obliged to reinstate the VAT deducted by their predecessor if they start to use goods (including fixed assets and intangible assets), works, services, property rights in the activity, which is not subject to VAT, or pass to the simplified taxation system, the UTII.
**Personal income tax**

Russian tax residents (generally individuals who, regardless of their citizenship or domicile, are physically present in Russia for at least 183 days in any consecutive 12-month period) are subject to tax on their worldwide income. Non-residents are only subject to tax on income from Russian sources.

In general, employers are required to withhold personal income tax from wages. Personal income tax is withheld at a rate of 13 per cent from most types of income of Russian residents (special rates may apply) and at a rate of 30 per cent from Russian-sourced income of non-residents (although see below in relation to dividends).\(^{13}\) Employment-related income of non-resident individuals who are treated as highly qualified specialists is subject to 13 per cent personal income tax regardless of their residency status.

**Social security charges**

An employer is subject to social security charges payable on its employees’ and individual contractors’ remuneration. Employees are not subject to social security charges.

Employers are required to make contributions to different social security funds in the following amounts (assessed by reference to thresholds that are reconsidered annually):

- to the Pension Fund, 22 per cent for annual remuneration not exceeding 1.150 million roubles and 10 per cent for remuneration in excess of it;
- to the Medical Insurance Fund, 5.1 per cent; and
- to the Social Security Fund, 2.9 per cent for annual remuneration not exceeding 865,000 roubles and zero per cent for remuneration in excess of it.

Additionally, employers are required to make contributions to the Social Security Fund for insurance for work-related injuries and diseases at rates ranging from 0.2 to 8.5 per cent, depending on the types of activities carried out by the employer.

**Property tax**

As a general rule, Russian companies are liable to pay property tax on the average annual net book value (cadastre value for trade and business centres and non-residential premises) of the fixed assets on their balance sheet. However, movable fixed assets acquired after 1 January 2013 (other than those acquired from related parties or in the course of liquidation or reorganisation) are exempt from property tax. This narrows the application of this tax to immovable fixed assets and movable fixed assets acquired before 1 January 2013. As of 1 January 2019, the property tax on movable fixed assets is abolished.

The standard property tax rate is 2.2 per cent. However, regional authorities may reduce that rate or even provide a full exemption for all or certain categories of taxpayers.

Owned land is exempt from property tax and is subject to a separate land tax.

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13 As of the time of writing, we are aware of the plans of the Ministry of Finance to introduce a bill equalising the rate of personal income tax for residents and non-residents at the level of 13 per cent and materially changing the residency determination criteria.
Land tax

Land tax applies to landowners at the rate determined by the municipal authorities. Land tax is assessed on the cadastral (other statutory values apply in some cases) value of the land, which is usually equal or close to its actual market value. Land tax rates may not exceed 0.3 per cent of the cadastral value of agricultural and residential land. With respect to other land plots, the maximum rate is 1.5 per cent of the cadastral value.

Municipal authorities may establish tax incentives.

Businesses leasing land are not subject to land tax. Instead, they are liable for the land lease payments established by federal, regional or local authorities or other landowners.

Mineral extraction tax (MET)

Companies and individual entrepreneurs that extract commercial minerals must pay MET. In particular, this tax is levied on the extraction of coal, peat, crude oil, gas, ferrous and precious metals and precious stones. In certain limited cases, windfall tax is levied on subsoil users.

Excise taxes

Certain activities with respect to alcoholic drinks, tobacco, transportation vehicles and oil products are subject to excise taxes payable by companies and individual entrepreneurs.

Transportation tax

Transportation tax is payable by persons in whose name a taxable transport vehicle is registered and is payable at the rate established for that type of transport vehicle. Regional governments are permitted to establish tax incentives for certain categories of taxpayers. Generally, transportation tax is not a great burden on businesses.

Stamp duty

Relatively small transactional fees apply to, among other things, the notarisation, registration and filing of legal documents and the issue of securities.

Other taxes

Other taxes include water tax and levies for the use of fauna and for the use of aquatic biological resources.

Certain specific tax regimes are available to small businesses.

IV TAX RESIDENCE AND FISCAL DOMICILE

Corporate residence

All companies incorporated in Russia are deemed Russian tax residents. Companies registered outside of Russia may be deemed Russian tax residents if they have a place of effective management in Russia.
ii Branch or permanent establishment

A foreign entity can establish its presence in Russia via a subsidiary, branch or representative office. Setting up a branch or representative office through which business activity is conducted regularly leads to permanent establishment in Russia unless the functions of such office are restricted to ‘preparatory and auxiliary’ activity.

In line with an OECD tax treaty, a ‘dependent agent’ may also lead to a permanent establishment.

As the test for permanent establishment in Russia is not formal but substantial, the only way to avoid its setting up in Russia is not to carry out regular business activity in Russia.

The profits received as a result of activity of a permanent establishment are attributed to this permanent establishment. If there are several permanent establishments, the taxable base for each permanent establishment is normally calculated separately, unless a specific rule allows the taxable base to be calculated on a consolidated basis (e.g., if several permanent establishments are involved in a single technological process).

Most of the double taxation treaties Russia is a party to are OECD-based, and so are the permanent establishment provisions.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

There are no special tax regimes for resident operations outside the home jurisdiction. Worldwide income of residents is subject to taxation in Russia unless a double tax treaty applies.

However, various tax incentives are available for doing business in Russia. Some of them are granted for investing in specific territories (special economic zones, territories of advanced social and economic development), participation in certain investment projects (regional investment projects, special investment contracts) or even redomiciliation from abroad to special administrative zones in Russia. Russian tax law also encourages investment in high tech. Reduced social security charges are imposed on certain IP companies. Profits tax benefits apply in relation to depreciation of assets used in technological activities. Exemption from capital gains tax applies to listed shares of high-tech companies though, as a general rule, such exemption does not apply to listed shares. Favourable tax regimes are available for small businesses.

i Holding company regimes

Dividends are not subject to profits tax if the participation exemption conditions are met. To qualify for this exemption, a Russian company must have held at least a 50 per cent stake in the relevant subsidiary continuously for at least one year. If the subsidiary is a non-Russian legal entity, it must not be incorporated in a country that appears on the ‘blacklist’ of offshore jurisdictions published by the Russian government. Special rules apply to the companies which had redomiciled to Russia.

Exemption from capital gains is also available (see above).

ii IP regimes

There is no special IP regime in Russia, although there are some incentives for R&D and high-tech companies.
iii State aid
No state aid provisions apply in Russia.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
Russian residents are required to withhold tax on dividends, interest, royalties and certain other payments to non-residents.
No withholding tax applies on profit distributions by a permanent establishment to the headquarters.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
As a general rule, such exemptions do not apply.\textsuperscript{14}

iii Double tax treaties (DTTs)
Russia has a very extensive network of DTTs (at the time of writing, there are 83).\textsuperscript{15}
DDTs may reduce local withholding on outward-bound dividends, and reduce or eliminate withholding on interest and royalties.

By way of example:

<table>
<thead>
<tr>
<th>Party to DDT with Russia</th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>5 or 10 per cent</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Netherlands</td>
<td>5 or 15 per cent</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>5 or 15 per cent</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
<tr>
<td>Ireland</td>
<td>10 per cent</td>
<td>Exempt</td>
<td>Exempt</td>
</tr>
</tbody>
</table>

Most of the DTTs to which Russia is a party are based on the OECD model.
Russia is actively renegotiating its DTTs to accommodate recent trends such as source taxation of real estate shares and limitation on benefits.

iv Taxation on receipt
DDTs may provide for set-off of tax withheld on outbound dividends in the source country.
The same applies to other types of income. The set-off amount should not exceed the amount of tax due in Russia.

\textsuperscript{14} Special rules apply to the companies that redomiciled to Russia.

\textsuperscript{15} As of 1 May 2019, Russia has ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI). The MLI modifies or clarifies only some of the provisions of existing DTTs. The text of the MLI contains options for legal solutions to individual cross-border taxation issues; for application subject to the reservations that the states may make when ratifying the MLI. This should be considered when applying the provisions of DTTs after 1 January 2020.
VII TAXATION OF FUNDING STRUCTURES

The most common way to fund business structures are loans, capital contributions and contributions to assets (financing by a shareholder with no capital increase).

i Thin capitalisation

Rules on thin capitalisation apply if a Russian company (A) obtains a loan:

a from a foreign company that is ‘interrelated’ with the borrower on the basis of a 25 per cent direct or indirect ownership interest in the charter capital of the borrower;

b from an affiliate of a foreign company that is ‘interrelated’ with the borrower on the basis of a 25 per cent direct or indirect ownership interest in the charter capital of the borrower; or

c that is guaranteed in any form by the above foreign company or its affiliate.

In these three cases, the thin capitalisation rules only apply if A’s debt-to-equity ratio exceeds 3:1 (12.5:1 for banks and leasing companies).

Interest attributable to the portion of the loan that exceeds the ratio is not deductible for A and is treated for tax purposes as a dividend that is normally subject to higher withholding tax under a tax treaty. The portion of the interest not taxed as a dividend is deductible up to the threshold set out in the Tax Code.

According to the most recent amendments, there are certain exceptions from these rules in respect of interest under loans relating to investment projects. However, it is not yet clear to what extent they will be available to the foreign investors.

Thin capitalisation rules currently do not apply to permanent establishments of foreign companies.

ii Deduction of finance costs

Generally, finance costs can be deducted. However, interest may only be deductible subject to thin capitalisation rules and interest transfer pricing rules.

In relation to interest transfer pricing rules, if the loan is provided by a related party, interest may only be deductible if it is within the range set by the Tax Code. If the interest is higher than the threshold, only the interest up to the threshold can be deductible. This rule works for the assessment of profits tax to the lender as well: if the interest under the loan is lower than the threshold, the lender is subject to tax based on the lowest interest rate of the range provided by law.

iii Restrictions on payments

The right to receive a portion of distributed net profits (in the case of LLCs) or dividends (in the case of JSCs) arises only when the company makes a decision regarding net profit distribution or dividend payment. Profit and dividend distributions are subject to statutory solvency and certain other capital adequacy tests. In a number of situations, profit or dividend distribution is prohibited, such as where the charter capital has not been fully paid up or where the company is close to being insolvent or may become insolvent as a result of the distribution.
Return of capital

Reduction of charter capital is allowed both in JSCs and LLCs. In some cases, such reduction may be obligatory (e.g., in case of insufficient net assets). Capital can be reduced twofold: by a decrease in the nominal value of the shares (participatory interest) or by a decrease in the number of shares (participatory interest). Share capital reduction may be either accompanied by return of capital or not.

When the reduction of share capital is not obligatory and is not followed by a capital return to shareholders then the company receives a taxable gain. Otherwise there are no tax consequences for the company.

As for the shareholders (participants), generally, irrespective of whether they are legal entities or individuals only the share premium is subject to profits tax.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Historically, a typical structure for acquisition involved an offshore company (often located in Cyprus, Luxembourg or the Netherlands) holding interests in Russian operating companies, with a shareholders’ agreement governed by English law. The popularity of offshore vehicles was owing to the greater flexibility in structuring the relationship between investors and the benefit of tax treaties and bilateral investment treaties offered by other jurisdictions.

Reforms to Russian civil law in recent years have increased the availability of Western-style structuring instruments for onshore business structuring.

Typically, relations between co-investors in such entities are governed by a Russian law shareholders’ agreement supported by an English law agreement containing anti-dilution and shareholder information provisions, and an English law deed of indemnity.

Traditional bank financing is the most common source of debt finance for Russian companies. However, sanctions limiting the debt- and capital-raising abilities of many state and state-backed companies have affected their ability to finance transactions. Further, international nervousness around sanctions has made many foreign banks generally cautious about lending money in Russia.

Equity financing via contributions to assets or increases of the charter capital of the company are common, although EU sanctions may limit the ability of EU investors to participate in these. Shareholder loans are also commonly used and tend to be unsecured.

ii Reorganisation

Businesses can merge or demerge freely except for merging with or demerging from a foreign entity. Reorganisation itself is not taxed. All the tax duties are succeeded by the companies that resulted from reorganisation.

However, reorganisation requires completing administrative proceedings which take time. In addition, reorganisation can trigger special rights of creditors aimed at their protection (e.g., the right to demand early performance if the obligation is not duly secured) and an extraordinary tax audit.
iii Exit

Legal entities can freely relocate within Russia. In order to do so, tax authorities should be notified and the charter amended. No tax penalties for relocation exist. Relocation to a foreign jurisdiction is generally not permitted under Russian law.

Recent amendments allowed redomiciliation to Russia from foreign jurisdictions. However, it is only possible to relocate to two areas: the Russian Island (Vladivostok) and the Oktyabrsky Island (Kaliningrad). Special requirements are to be met in order for the redomiciliation to become possible. If the redomiciled companies meet the ‘international holding company’ criteria, they may enjoy various tax benefits, such as the lower ownership threshold for participation exemption purposes (15 per cent as opposed to 50 per cent generally) and for the capital gains exemption; in addition 5 per cent withholding tax applies on outbound dividends to foreign shareholders until 2029 irrespective of application of a tax treaty, as opposed to 15 per cent generally. International holding companies are exempt from controlled foreign corporations (CFC) regulation, including taxation of CFC profit, until 2029.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance regulations (GAAR)

GAAR have been developed in Russia by courts and applied for many years. In 2017, they were incorporated in the Tax Code, which provides that the following cases are considered tax avoidance:

a reduction of the tax burden by misrepresentation of tax accounting and financial statements;
b the main purpose of the transaction is reduction of the tax burden or receipt of a deduction from the budget; and
c an obligation under the transaction or other operation is not fulfilled by the taxpayer’s counterparty or the person to whom this obligation was delegated.

The rule also describes circumstances that do not per se evidence tax avoidance (e.g., the possibility of the taxpayer reaching the same economic results with different means).

A taxpayer is presumed to act in good faith and the burden of proof rests with the tax authorities.

Notwithstanding the codification of GAAR, courts continue to apply the ‘unjustified tax benefit’ notion previously developed by the Supreme Arbitrazh Court.

ii Controlled foreign corporations

CFC rules came into force on 1 January 2015. Under the CFC rules, a CFC is a non-Russian entity (including funds, trusts, partnerships and foundations) that is controlled by a Russian tax resident (a company or an individual). Limited exemptions exist. The rules set out how ‘control’ is assessed and there are certain circumstances in which ‘control’ will be deemed to exist; for example, where a certain minimum level of participation exists.

‘Control’ will not exist where an individual who participates in a foreign corporation through direct or indirect participation in one or more Russian public companies, which, in turn, may participate in such a foreign corporation through non-public companies. However, this rule will not apply until 1 January 2029 if the public companies above are international holding companies.
A controlling Russian resident is now required to (1) notify the tax authorities of the CFC; and (2) calculate the CFC’s profits and remit taxes to the state at the rate of 20 per cent (for Russian legal entities) and 13 per cent (for Russian individuals).

This is an actively developing and improving area of tax law in Russia although there are still a number of questions about how it will apply in practice.

iii Transfer pricing
Generally, transfer pricing control applies to certain transactions between related persons and certain transactions that, for the purposes of transfer pricing control, are treated as being equivalent to transactions between related persons. In particular, all transactions between related persons where one of the parties is a non-Russian person are subject to such control.

Taxpayers are obliged to report to the tax authorities on all transactions that are subject to transfer pricing control. In addition, the tax authorities may conduct transfer pricing control audits.

If the price of a controlled transaction deviates from the market price and this deviation results in a reduction of taxes owed to the state, the tax authorities are able to assess the respective taxpayers for additional tax liabilities. That said, only profits tax, MET and VAT may be assessed as a result of the above control.

X YEAR IN REVIEW
Unfortunately for businesses, the Russian government has taken certain measures resulting in the increase of the tax burden. As mentioned above, as of 2019 the VAT rate has been increased by 2 per cent to 20 per cent. Regions are gradually losing the right to reduce the rate of profits tax payable to the regional budgets.

A new tax on additional income received from hydrocarbon production has been introduced as of 1 January 2019. Taxpayers are legal persons that have licences specified by the law and satisfy certain requirements. The tax is applied to companies engaged in certain other activities in respect of hydrocarbon production. The tax rate amounts to 50 per cent from net profit received from hydrocarbon production reduced by expenses and the MET.

Tightening of anti-abuse rules has been accompanied by the extension of the amnesty of capital rules. In 2019, the third stage of capital amnesty has been launched, which will continue until 29 February 2020.

XI OUTLOOK AND CONCLUSIONS
The main focus of the Russian tax authorities has been on challenging aggressive tax planning arrangements, including in the cross-border context. We expect that this trend will continue in the new year. In particular, the tax authorities have become very aggressive in applying the beneficial ownership concept when taxpayers claim treaty benefits.

Russia has been a strong supporter of the base erosion and profit shifting (BEPS) initiative and expects to further strengthen enforcement as a result of the introduction of automatic exchange of information.

The possible reform of taxation of the oil and gas industry remains on the agenda of the Russian government.
I  INTRODUCTION

Inward investment into South Korea has been thriving in the past few decades and foreign investors have been able to benefit from various tax incentives available to them. Although these incentives are becoming less advantageous and less available, the overall legal, tax and regulatory climate for investment into South Korea remain favourable to foreign investors.

II  COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i  Corporate

The two most common types of legal entities under the Korean Commercial Code (KCC) are the chusik hoesa and yuhan hoesa. The chusik hoesa is the most common form of incorporation and refers to a joint-stock company governed by a board of directors with limited liability to its shareholders. A chusik hoesa with paid-in capital of 1 billion won or more must have at least three directors and one statutory auditor, whereas a chusik hoesa that does not meet the paid-in capital threshold is required to have at least one director and is not required to have a statutory auditor. Other than certain matters conferred by law or in the articles of incorporation of the company (AOI) to the authority of the general meeting of shareholders (GMS), the board of directors may make decisions on all important corporate policies and management matters, except for regular day-to-day business matters that are decided by the representative director. Unless otherwise provided in the AOI, all actions and resolutions of the board are adopted by the affirmative vote of a majority of the directors attending a properly constituted board meeting. The chusik hoesa is typically appropriate for a large enterprise that will need substantial capital, as it is the only type of legal entity eligible to list its shares on the Korea Stock Exchange, or that may issue corporate bonds.

In contrast, a yuhan hoesa is a closely held limited liability company, which can be described as a mixture of a joint-stock company and a partnership. Like a joint-stock company, the liability of each member is limited to the amount of his or her contribution to the company. This form of legal entity is typically appropriate for small or medium-sized businesses owned by a small number of individuals or entities. A yuhan hoesa is required to have at least one director regardless of its size. A yuhan hoesa is also subject to other limitations that a chusik hoesa may not be subject to. Foreign investors have increasingly utilised this structure, mainly for the reason of potential tax advantages in their home countries.

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1 Sung Doo Jang is a partner and Maria Chang is a senior foreign attorney at Bae, Kim & Lee LLC.
addition, a *yuhan hoesa* allows (in comparison to a *chusik hoesa*) greater flexibility in terms of corporate governance. For those foreign investors or persons desiring less public disclosure, the *yuhan hoesa* may be preferred because such companies are not required to publicly disclose their financial information.

The tax implications and liabilities under Korean law for a *chusik hoesa* and a *yuhan hoesa* are nearly identical. Both a *chusik hoesa* and a *yuhan hoesa* are subject to taxation in Korea. The current applicable corporate tax rate is 11 per cent for taxable income up to 200 million won, 22 per cent for income over 200 million won and up to 20 billion won, 24.2 per cent for income over 20 billion won and up to 300 billion won, and 27.5 per cent for income over 300 billion won.

### ii  Non-corporate

In general, non-corporate entities are not as commonly used as corporate entities given that the shareholders are exposed to unlimited liability. A *hapmyong hoesa* is a form of partnership organised by two or more partners who bear unlimited liability for the obligations of the partnership. A *hapja hoesa*, a limited partnership, consists of one or more partners having unlimited liability and one or more partners having limited liability. From a commercial law perspective, *hapmyong hoesa* and *hapja hoesa* are both treated as corporations. From a tax law perspective, *hapmyong hoesa* and *hapja hoesa* are subject to corporate income tax but may elect to be treated as partnerships, in which case these entities are treated as pass-through entities for tax purposes.

Under the Korean tax law, tax is exempt at the level of the partnership and each partner is subject to pay and file taxes on earned income distributed from the partnership. If the partner is a non-resident, income distributed from the partnership will be subject to withholding tax in Korea.

A private equity fund (PEF) is considered a corporation for Korean tax purposes but may elect to be treated as a partnership for tax purposes. A PEF electing to be treated as a partnership is taxed at the level of the members at the time of income allocation. Income allocated to the foreign limited partnerships (LPs) by the PEF will generally be regarded as dividend income regardless of the character of the underlying income.

### III  DIRECT TAXATION OF BUSINESSES

#### i  Tax on profits

**Determination of taxable profit**

Korean corporations are subject to tax on their worldwide income. Corporate income tax is imposed on a company’s taxable income, which is based on the net income after making book to tax adjustments, less deductible expenses and carried forward tax loss. Expenses incurred in the ordinary course of business are deductible, subject to the requirements for documentary support and accrued expenses are not deductible until the expenses are fixed or determined. Depreciation is allowed for tax deduction only when expensed for book purposes.

The tax law allows the following methods for calculating depreciation:

- straight-line or declining-balance method for tangible fixed assets, other than plants and buildings;
- straight-line method for plants, buildings and intangible assets;
- service-output or straight-line method for mining rights; and
South Korea

de service-output, declining-balance, or straight-line method for tangible fixed assets used in mining.

Capital and income

In general, there is no distinction between the taxation of income and capital profit for resident corporations, as capital gains are included in taxable income and taxed at the standard corporate income tax rates. Korean-source capital gains derived by a non-resident are taxed at the lesser of 11 per cent (including local surtax) of the sales proceeds received or 22 per cent (including local surtax) of capital profit.

Losses

Losses may be carried forward for up to 10 years. From 1 January 2019, domestic companies and foreign companies may utilise their tax loss carry-forwards to offset 60 per cent of taxable income for a fiscal year. Small and medium-sized enterprises (SMEs) may be allowed to carry losses back for one year.

Rates

The corporate income tax rates (effective 1 January 2018) are as follows:

<table>
<thead>
<tr>
<th>Taxable income</th>
<th>Tax rate (progressive)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 200 million won</td>
<td>10 per cent</td>
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<tr>
<td>From 200 million won to 20 billion won</td>
<td>20 per cent</td>
</tr>
<tr>
<td>From 20 million won to 300 billion won</td>
<td>22 per cent</td>
</tr>
<tr>
<td>In excess of 300 billion won</td>
<td>25 per cent</td>
</tr>
</tbody>
</table>

In addition, there is a local surtax of 10 per cent on the foregoing rates resulting in the final rates ranging from 11 per cent to 27.5 per cent on the tax base.

Administration

A Korean company is required to pay (1) interim corporate income taxes within two months from the end of the first six months of the fiscal year and (2) annual corporate income taxes within three months from the end of the fiscal year. The company must file tax returns along with the tax payment for the interim and annual corporate income taxes.

Tax grouping

A domestic parent corporation with wholly owned domestic subsidiaries may elect the consolidated tax group scheme for domestic entities. Where two or more wholly owned subsidiaries exist, the tax consolidation scheme must be applied to all subsidiaries. A corporation seeking tax consolidation is required to submit an application for consolidated tax return filing within 10 business days after the beginning of a business year in which the taxpayer wishes to apply tax consolidation. Foreign subsidiaries are not eligible for tax consolidation. Once the consolidated tax grouping scheme is elected, the scheme must be applied for at least five consecutive business years.

Dividend distributions within the tax group do not trigger any tax costs. Donations or entertainment expenses incurred within the tax group are consolidated for tax reporting purposes.
ii Other relevant taxes

Value-added tax is levied at the rate of 10 per cent on the sale of goods and services in Korea, including imported goods, subject to certain exceptions. A business that sells or provides goods or services to its customers is required to, on a quarterly basis, pay to the competent tax office value-added tax (output VAT) received from such customers. The amount of output VAT to be actually paid to the tax office is the sum of the output VAT received from its customers minus the value-added tax (input VAT) that such business paid to its suppliers for the purchase of goods or services (so called ‘input VAT deduction’).

Stamp duty is levied on agreements relating to the creation, transfer or alteration of rights.

A capital registration tax of 0.48 per cent (including local surtax) is levied when a company registers its incorporation or capital increase with the court registry. The capital registration tax rate for a company incorporated in the Seoul Metropolitan Area triples to 1.44 per cent.

Securities transaction tax is levied on the transfer of shares at 0.5 per cent of the share transfer price. The rate is reduced to 0.1 per cent or 0.25 per cent for the transfer of listed shares.

A company owning real property such as land, buildings, ships and aircraft is subject to property tax on these assets at the rate of 0.1 per cent to 4 per cent, depending on the type of property. Comprehensive real estate tax is also levied on real estate.

Acquisition tax is levied on any company acquiring real estate, motor vehicles, heavy equipment and certain other items generally at the rate of 1.1 per cent to 4.6 per cent (including local surtax).

A company is required to withhold taxes on payments to its employees, including wages, salaries, bonus and other amounts received for employment services rendered. An employer is required to make social security contributions for national pension, medical insurance, unemployment insurance and industrial injury compensation insurance to the relevant social security authorities. Social security contribution rates vary depending on the number of employees and the industry.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

A foreign corporation with its place of effective management in Korea may be deemed as a domestic corporation. The place of effective management refers to a location where key management and commercial decisions necessary for business operations are implemented. Key management activities and commercial decisions necessary for the operation of a corporation’s business relate to a corporation’s long-term business strategies, fundamental policies, corporate finance and investment, management and disposal of key properties, and essential income generating activities. The place of effective management of a corporation is determined on a case-by-case basis, by taking into account the location where meetings of the board of directors or other equivalent decision-making body are held, location where the chief executive officer and other officers perform their day-to-day duties, location where senior managers perform their daily management activities and location where accounting records are generally maintained (Supreme Court Decision, 2014Du8896, 14 January 2016).
To avoid becoming fiscally resident in Korea, a foreign entity should ensure that key management activities and commercial decisions are not made in Korea, including holding meetings where key decisions are made or maintaining books or other important business documents of the foreign entity.

ii Branch or permanent establishment
A non-locally incorporated entity is deemed to have fiscal presence in Korea if (1) it has a fixed place of business (a branch, an office, a workshop, etc.) in Korea where the entity's business is wholly or partly carried on; or (2) the employees of the foreign entity provide services in Korea for more than six months during any consecutive 12-month period or the employees render similar types of services continuously or repetitively over a two-year period, even if each of the service periods do not exceed six months in a consecutive 12-month period. A fixed business place of a foreign company does not trigger a permanent establishment (PE) if its activities are of a preparatory or auxiliary nature on behalf of its head office, such as advertising, collecting and distributing information, or market research. On the other hand, preparatory or auxiliary activities that are carried out on behalf of third parties (including affiliated parties) would give rise to PE in Korea.

In addition to the above, a foreign company without a branch office or other fixed presence in Korea may nevertheless be deemed to have a PE in Korea if it conducts business in Korea through a person who has authority on its behalf to conclude contracts (or to negotiate important and detailed terms and conditions of contracts) and regularly exercises this authority. Such persons will constitute 'dependent agents', so long as their role is sufficiently important for the local business of the foreign company. A foreign company that does business in Korea through a dependent agent in Korea is deemed to have a PE in Korea for tax purposes. On the other hand, if a foreign company carries on business through a broker, general commission agent or any other agent of independent status, and the agent acts in the ordinary course of its business, the foreign company would not on that basis be deemed to have a PE in Korea.

An entity deemed to have a PE in Korea is subject to corporate income taxation in Korea with respect to the portion of its business profits attributable to the PE. An arm's-length amount of profit may be allocated in accordance with the arm's-length price determination methods stipulated in the Korean tax law. Given the inherent limitations in allocating an arm's-length price, which may objectively be accepted as being appropriate, issues often arise regarding profit allocation and may eventually lead to a tax imposition.

With regard to dual resident entities, a majority of the tax treaties signed by Korea include a provision that deems the entity to be a resident of a country where effective management takes place. Tax treaties generally allow competent authorities of the treaty parties to reach mutual agreement to resolve dual residency issues.

If the tax treaty between Korea and the country in which a foreign corporation is residing allows the imposition of a branch profits tax, the tax is imposed on the adjusted taxable income of the Korean branch. Where applicable, the branch profits tax is levied in addition to the regular corporate income tax (CIT), at the rate of 20 per cent (or at a reduced rate as provided in a treaty) of the adjusted taxable income of the Korean branch.
V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i  Holding company regimes
A qualified domestic stock-listed holding company that owns a more than 40 per cent share ownership in its domestic subsidiary will receive a 100 per cent deduction for dividends, while a 90 per cent deduction is allowed for share ownership of 40 per cent or less and an 80 per cent deduction is allowed for share ownership of 30 per cent or less. A qualified domestic holding corporation, other than a stock-listed company, will also receive a 100 per cent deduction for share ownership of more than 80 per cent, 90 per cent for share ownership of 80 per cent or less, and 80 per cent for share ownership of 50 per cent or less.

Dividends received from a foreign company are, in principle, subject to corporate income tax in Korea, but the recipient company may be eligible for an indirect foreign tax credit for foreign income tax paid by the foreign company in its country of residence.

ii  IP regimes
Foreign-invested companies that engage in certain high-technology businesses designated by the government or that are located in certain designated areas may apply for exemption of customs duties or local taxes if certain conditions are satisfied. Tax credits are also available for certain qualifying expenditures on research and development, and investments in energy saving, pollution control, vocational training facilities and employee housing.

The Korean tax laws provide various tax incentives to encourage domestic companies to engage in research and development, technology development and job training.

iii  State aid
No state aid is available in Korea. However, certain programmes or business activities may be eligible for certain subsidies. Programmes eligible for subsidies, expense items, rates and amounts of national subsidies available are announced annually during the government budget proposal. Taxpayers seeking subsidies are required to file applications and receive approval from the relevant government agencies.

iv  General
Korean subsidiaries of foreign multinationals that meet certain foreign investment requirements and that engage in qualifying business or industry activities in designated Free Enterprise Zones, Free Investment Zones, or Free Trade Zones may be eligible for various tax exemptions or reductions.

VI  WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i  Withholding outward-bound payments (domestic law)
Korean source interest, dividends and royalties that are not attributable to a permanent establishment in Korea are generally subject to a withholding tax of 22 per cent (including local tax) at the time of payment to the foreign person. The statutory rate of withholding may be reduced or eliminated under an applicable tax treaty.
ii  **Domestic law exclusions or exemptions from withholding on outward-bound payments**

No domestic law exclusions or exemptions from withholding on outbound payments exist in Korea.

iii  **Double tax treaties**

Certain income such as dividends, interests or royalties paid to non-residents (Korea-sourced income) are generally subject to withholding tax at the statutory rate of 22 per cent (inclusive of local surtax) if no relevant treaty between the non-resident’s country and Korea applies. To enjoy the benefits of a lower rate of withholding tax under a particular treaty, the beneficial owner of the Korea-sourced income is required to submit to the withholding party evidentiary documents demonstrating that the beneficial owner is eligible for the lower rate of withholding tax by virtue of an applicable tax treaty.

According to the constitutional law, tax treaties have the same effect as domestic laws in Korea. In case of a conflict between the tax treaty and the domestic law in Korea, the tax treaty takes precedence over domestic laws. As of November 2019, Korea has entered into tax treaties with 93 countries globally. The chart below is a summary of the reduced tax rates for dividends, interests and royalties under the tax treaties that are currently in force. The applicable domestic withholding tax rates, which vary from 2.2 per cent (including local income tax) to 22 per cent (including local income tax) for cross-border payments made to non-resident individuals or corporations without a permanent establishment in Korea, will apply if such rate is lower than the reduced tax rate under the tax treaty or if there is no relevant tax treaty.

<table>
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<th>Dividends (%)</th>
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<th>Royalties (%)</th>
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<td>Country</td>
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### South Korea

<table>
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<tr>
<th>Country</th>
<th>Dividends (%)</th>
<th>Interest (%)</th>
<th>Royalties (%)</th>
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### Taxation on receipt

Non-local dividends and income received from non-Korean sources are generally included in the income tax base of the recipient and subject to tax. Dividends attributable to investors resident in Korea are in principle subject to corporate income tax at progressive tax rates of 11 per cent (for taxable income up to 200 million won), 22 per cent (for taxable income from 200 million won to 20 billion won), 24.2 per cent (for taxable income from 20 billion won to 300 billion won), and 27.5 per cent (for taxable income in excess of 300 billion won). Taxes imposed by foreign governments on income recognized by a resident taxpayer are allowed as a credit within the limit against the income taxes to be paid in Korea, or as deductible expenses in computing the taxable income. The excess foreign tax credit can be carried forward for up to five years.
VII TAXATION OF FUNDING STRUCTURES

Entities are commonly funded through either debt, equity or both. Although dividends are not tax-deductible, interest expenses incurred in the course of borrowing, including guarantee fees and bank fees, may be deducted for tax purposes.

i Thin capitalisation

Interest incurred in the normal operation of a business is, in general, recognised as a tax-deductible expense as long as the relevant loan is used for business purposes. A shareholder loan extended by a foreign parent company to its Korean subsidiary, however, is subject to the thin capitalisation rule, whereby any interest paid on the shareholder loan in excess of two times the paid-in capital of such Korean company contributed by such foreign parent company (in the case where the Korean company is a financial institution, six times the paid-in capital) cannot be recognised as a tax-deductible expense and will be subject to corporate tax. Furthermore, the excess amount of the interest will be deemed as a dividend and subject to withholding tax at the statutory rate of 22 per cent (inclusive of local surtax).

In line with the Organisation for Economic Co-operation and Development (OECD)’s recommendation on the limitation of interest expense deductions (base erosion and profit shifting (BEPS) Action 4), effective from 1 January 2019, interest expense paid by a Korean company with respect to intercompany loan transactions with overseas related parties in excess of 30 per cent of the ‘adjusted taxable income’ (i.e., taxable income before depreciation and net interest expenses) cannot be recognised as tax-deductible expenses and will be subject to corporate tax.

As a result of introduction of the OECD rule on limitation of interest, the rule that imposes a higher tax burden (i.e., recognition of lower tax-deductible expenses) applies between the thin capitalisation rule and the OECD rule.

ii Deduction of finance costs

Interest payments and other borrowing costs are generally tax deductible. Interest incurred in the ordinary course of business is deductible as long as the related loan is used for business purposes. There are, however, a number of exceptions to the general rule, as follows, where the interest payments will not be tax deductible:

a any borrowings from a foreign shareholder, or from a third party under a payment guarantee by the foreign shareholder, that exceed two times (six times for financial companies) the equity of the relevant foreign shareholder; any such excess interest and discount fees are non-deductible and are re-characterised as dividends (thin capitalisation rule);

b net interest in excess of 30 per cent of the adjusted taxable income for all related-party loans will be non-deductible from 1 January 2019;

c debentures for which the creditor is unknown;

d bonds and securities on which the recipient of interest is unknown;

e construction loans and loans for the purchase of land and fixed assets up to the date on which the assets are acquired or completed must be capitalised as part of the cost of the asset and depreciated over the life of the asset, whereas interest incurred after the date of completion or acquisition is deductible; and

f interest on loans related to non-business purpose assets or funds loaned to related parties.
For foreign corporations without a permanent establishment, interest payments and other borrowing costs are not deductible.

iii Restrictions on payments
There are no specific restrictions on payment of dividends. Under the Korean commercial law, however, a company may pay dividends within the limit of the value of net assets stated on the balance sheets after deducting the amount of capital and reserves. In such respects, there is a limitation on the amount of dividends payable.

iv Return of capital
Return of capital is not permitted and equity capital can be repaid by way of a reduction. Reduction on a pro rata basis based on the ratio of holdings by shareholders would generally not trigger any tax implications. If the repurchase price of the shares exceed the initial acquisition price of such shares, the differential between the repurchase price and acquisition price would be deemed as dividends and subject to dividend income taxation. Where shares are held by related parties and shares of only specific shareholders are reduced at lower than fair market value, any gains incurred by a majority shareholder who, together with related parties, hold 1 per cent or more of the total number of shares issued or 300 million won or more in face value of the shares, is subject to gift tax.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Non-local companies acquiring local businesses commonly structure the transaction by using local holding companies as a vehicle for acquisition of the local business. Although buyers may use both debt or equity, or both to fund their investment, investors generally prefer the use of debt, as this allows the local company to deduct any interest expenses incurred on its borrowings against its taxable income within certain limits prescribed under the tax law. In such cases, the interest rates on borrowings from related parties should be set at an arm's-length rate equal to the market rate. Investors should also take into consideration thin capitalisation and interest limitation rules discussed in Sections VII.i and ii.

ii Reorganisation
For a merger that meets all of the following requirements, capital gains or losses on a transfer may be exempt if:

a a merger is conducted between domestic corporations that have continued to operate their business for at least one year as of the registration date of the merger, provided that the corporation is not established solely for purposes of merging with other corporations;
b the value of the stocks of a surviving corporation or the parent corporation of the surviving corporation is at least 80 per cent of the total costs of the merger received by the stockholders of a merged corporation in return for such merger;
c the stocks are distributed in proportion to the equity ratio of each relevant stockholder in the merged corporation;
d the controlling stockholders of the merged corporation hold such stocks until the last day of the business year in which the registration date of the merger falls;
the surviving corporation continues to operate the business succeeded to from the merged corporation until the last day of the business year in which the registration date of the merger falls; and

the surviving company continues to employ more than 80 per cent of the merged company's employees by the last day of the business year in which the registration date of the merger falls.

If wholly owned subsidiaries are merged into a parent company or merged with each other, the merger may be implemented on a tax-free basis even if the above conditions are not satisfied, provided that both are domestic companies.

However, the tax-free benefits for a qualified merger may be 'clawed-back' if assets or shares of the surviving company are disposed of within two to three years after the merger.

iii Exit

There are no specific tax penalties associated with a business relocating outside of Korea. Entities seeking to close their Korean operations would be required to liquidate and dissolve the Korean entity and file final tax returns.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

The Korean tax law provides for a ‘substance-over-form’ rule that allows a transaction that meets formality requirements to be re-characterised based on its substance. Under the ‘substance-over-form’ rule, each transaction under a series of transactions undertaken for no purpose other than tax avoidance may be re-characterised for tax purposes to reflect the substance of such series of transactions.

ii Controlled foreign corporations

Pursuant to the Korean tax laws, a Korean resident who owns, directly or indirectly, 10 per cent or more of the outstanding shares of a controlled foreign corporation (CFC) at the end of each taxable year is taxed directly on the pro rata portion of the distributable retained earnings of the CFC as deemed dividends, even if the CFC does not distribute the income. Where a CFC actually distributes its retained earnings as dividends subsequent to the taxation of this amount as deemed dividends, the distributed amount is excluded from the scope of deemed dividends.

A CFC is defined as a foreign corporation meeting the following conditions: (1) the foreign corporation has a head or principal office located in a country or region in which the effective tax rate on the income actually earned by the corporation is 15 per cent or less; (2) the foreign corporation has a special relationship with a Korean resident; and (3) such Korean resident directly or indirectly owns 10 per cent or more of the foreign company’s outstanding shares at the end of each taxable year.

There are two main exceptions to the CFC rules: (1) the active business operation exception; and (2) the qualified holding company exception. Under the active business operation exception, the CFC rules do not apply if the foreign company has an office, shop, factory or other fixed facility in the foreign country through which it actually engages in business operations. Under the qualified holding company exception, the CFC rules do not apply if the subsidiaries of the foreign holding company, which are located in the same
country or region as the foreign holding company, have held stocks issued by its affiliates for at least six consecutive months as of the date of dividend distribution and the passive income (i.e., dividend and interest income) derived by the foreign holding company from subsidiaries located in the same country or region constitutes 90 per cent or more of the foreign holding company's total income (excluding income derived from the conduct of active business).

iii Transfer pricing

The Korean transfer pricing regulations are based on the arm's-length standard and are generally consistent with the Organisation for Economic Co-operation and Development (OECD) Guidelines. The Korean transfer pricing regulations prescribe transfer pricing methods, impose transfer pricing documentation requirements, and contain provisions for advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

The Korean transfer pricing regulations stipulate that transfer prices should be consistent with the arm's-length standard. The transfer pricing methods stipulated in the Korean tax laws are as follows:

- comparable uncontrolled price method, resale price method or cost-plus method;
- profit split method and transactional net margin method; and
- other unspecified methods.

The most appropriate and reliable method should be adopted among the methods above considering all relevant factors and circumstances.

iv Tax clearances and rulings

Advance tax rulings may be obtained prior to completing a corporate transaction through a formal advance tax ruling system established by the National Tax Service (NTS). When seeking an advance ruling, the party seeking the ruling must disclose its identity and all the relevant facts applicable to the transaction. Although tax clearances or rulings are not required to acquire a local business, a taxpayer conducting international transactions with foreign parties are required to disclose such transactions by submitting a statement of international transactions to the relevant district tax office by the deadline for filing a tax return.

X YEAR IN REVIEW

The Korean tax laws introduced anti-avoidance measures aligned with the OECD recommendations specifically on BEPS Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status), among others, to prevent abusive business structure aimed at decreasing the Korean tax revenue. The measures include the following:

- The PE rules were expanded to bring them in line with the latest OECD guidelines. With respect to dependent agent PEs, a person that plays a principal role leading to the conclusion of contracts may constitute a PE, even if such person does have the authority to conclude contracts. Moreover, rules were introduced to counter artificial avoidance of a PE through fragmenting business activities to take advantage of PE exemptions for activities of a preparatory and auxiliary nature.

- The foreign investment tax incentive scheme, which provided tax exemptions for foreign-invested companies in new growth sector businesses, was repealed as a result of being identified as being harmful and resulting in the brief inclusion of South Korea in the EU’s list of non-cooperatives jurisdictions.
The loss carry-forward offset limit for branches of foreign corporations in South Korea was reduced from 80 per cent to 60 per cent from 1 January 2019 in line with the measures already implemented for domestic corporations.

The introduction of new rules to treat an overseas investment vehicle as the beneficial owner of Korean-source income if at least one of the following conditions are met:

- the investment vehicle is subject to tax in its jurisdiction of residence and the investment vehicle was not established with the purpose of evading Korean tax;
- the investment vehicle is unable to disclose its investors or only partially discloses, in which case the investment vehicle may be considered the beneficial owner in respect of income attributed to the investors not disclosed (treaty benefits denied when this condition applies); or
- the investment vehicle is considered the beneficial owner under the provisions of an applicable tax treaty.

The transfer pricing rules are expanded to provide that in determining whether a transaction is at arm’s length, the tax authority must accurately delineate the transaction in consideration of the commercial and financial conditions between a resident and its foreign related party, and where a transaction lacks commercial reason, the tax authority must disregard or recharacterise the transaction.

**XI OUTLOOK AND CONCLUSIONS**

The 2019 tax revision bill issued in July 2019 focuses on boosting the economy and supporting industrial innovation, pursuing inclusiveness and fairness and broadening the tax base and improving the tax system. The bill contains various tax incentives aimed at promoting investments, primarily those involving small and medium-sized companies and start-ups. Various tax reduction measures are aimed at encouraging research and development. These measures are expected to provide more leverage for smaller businesses to benefit from tax incentives for various investments made. The tax authorities seek to also improve the tax system as a means for broadening the tax base and increasing tax revenue.
I INTRODUCTION

With more than 90 double taxation agreements and one of the best tax regimes for holding companies in the world, Spain has evolved from a purely inward investment country to a tax-attractive platform jurisdiction.

Indeed, the holding regime together with the extensive participation exemption make Spain the best gateway for two main regions: (1) Latin America, as, owing to its cultural links, Spain is surely the best platform for investing in that region and many multinational groups are using Spain; and (2) Europe, as, given the favourable tax regime for holding companies, many groups could get access to the European single market without almost any tax burden.

Spain is a business-friendly jurisdiction with highly skilled and sophisticated tax authorities that are in favour of giving certainty by means of advance tax rulings and pricing agreements.

Aligned with base erosion and profit shifting (BEPS) Organisation for Economic Co-operation and Development (OECD) and European Union (EU) principles, Spain is involved in, and leading some of, the international initiatives aiming to promote transparency and implementation of anti-avoidance provisions such as those provided by the Anti-Tax Avoidance Directive and the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Business can be developed by way of corporate entities, most commonly in the form of joint-stock companies (SA) requiring a minimum share capital of €60,000 or limited liability companies (SL) requiring a minimum share capital of €3,000. The responsibility of the shareholders is limited in both cases.

From the tax viewpoint, corporations, generally speaking, including not only SA and SL, but also other types of commercial companies, are subject to corporate income tax (CIT) regulations, which are levied on all legal entities resident in Spain.

Certain entities, mainly public entities and certain income of non-profit organisations, can be exempt from CIT.

1 Raúl Salas Lúcia is a partner, Elena Ferrer-Sama and Pilar Vacas Barreda are directors and Ladislao Palacios Navarro is an associate at Roca Junyent.
ii Non-corporate

There are non-corporate entities that could operate in businesses, such as the civil partnership or private equity funds.

CIT rules are also applicable to non-corporations, such as partnerships or lying heritages, provided they have a business purpose. Otherwise, in the event they do not have a business purpose, their income will be allocated (transparent) to their partners or co-proprietors. This is also the case regarding economic interest groupings, where profits or losses are taxed at the level of their co-proprietors.

Increasingly, individuals carrying out business activities – although taxed under personal income tax (PIT) – will apply, under certain cases, CIT rules when determining their business taxable income.

III DIRECT TAXATION OF BUSINESSES

i CIT

Determination of taxable profit

The taxable profit is the company’s gross income for the tax period, less certain deductions. Its determination comes from the annual financial statements prepared under Spanish generally accepted accounting principles (SGAAP), as adjusted under certain statutory tax provisions.

The tax authorities are legally authorised to modify accounting results to determine tax results if they consider that the accounting results have not been calculated according to the SGAAP.

All necessary expenses and costs connected to producing income may be deducted from gross income to arrive at a taxable income determination. Additionally, the Spanish CIT Law provides for certain items that are never deductible (permanent differences) or are deductible in a different year (timing differences).

The standard tax rate is 25 per cent, although different rates may apply depending on activity and legal form (e.g., 30 per cent for banks).

Regarding costs, although all expenses incurred by the company will depress accounting profit, not all such expenses will be allowed for tax purposes. To be deductible, an expense must be correlated with the company’s income. However, some expenses are considered non-deductible by the CIT Law: penalties, gifts, gambling losses, losses from intra-group sales, financial expenses with the group for intra-group acquisitions.

Capital gains and income

Capital gains are normally considered as ordinary income taxable at the standard CIT rate (generally 25 per cent) in the tax period they arise.

As explained below, participation exemption applies to capital gains arising on the transfer of shares when at least 5 per cent participation (or a participation value of over €20 million) is held for an interrupted period of at least one year, the transferred entity is an operating entity and certain other requirements are met.
**Losses**

Tax losses may be carried forward indefinitely, although any deduction is limited to 70 per cent of the positive taxable income before the application of the tax benefit for the capitalisation reserve and other specific items. Tax losses of at least €1 million can always be offset without limitation.

There are additional limitations for large companies and tax groups. When their turnover in the previous 12 months to the taxable period commencement reaches:

a. €20 million: tax losses offsetting cannot exceed 50 per cent of the yearly taxable income before capitalisation reserve and tax losses are offset; and

b. €60 million: tax losses offsetting cannot exceed 25 per cent of the yearly taxable income before capitalisation reserve and tax losses are offset.

The CIT Law provides anti-avoidance rules to prevent tax losses being utilised when there is a change in the control.

**Rates**

The standard CIT tax rate is 25 per cent and it applies to most companies, although there are other specific rates:

a. special tax rates apply to certain activities such as banking, mining, oil and gas that are subject to a 30 per cent tax rate;

b. non-profit entities are subject to a 10 per cent tax rate; and

c. investment funds and UCITs are taxed at 1 per cent.

Apart from that, there is a special 15 per cent rate for newly created companies, applicable to the first tax period in which profit is obtained and the following period.

**Administration**

The tax year for CIT purposes matches with the accounting financial period, which may be other than a calendar year, but cannot exceed 12 months.

Corporate taxpayers must file tax returns within 25 days after six months following the end of the tax year.

Companies must make three advance payments on account of CIT during the first 20 days of April, October and December, calculated as follows depending on the turnover of the previous 12 months to the start of the taxable period and on the applicable tax rate (all below rates only apply to those companies subject to the 25 per cent CIT rate):

a. companies with a turnover under €6 million must pay 18 per cent of the gross tax due liability of preceding tax year generally;

b. companies with a turnover over €6 million and under €10 million must pay 17 per cent of the taxable income for the year to date; and

b. companies with a turnover over €10 million will make an advance payment resulting from the higher of the following amounts:

- 24 per cent of the taxable income for the year to date, reduced by withholding and current year payments in advance; or
- 23 per cent of the positive accounting profit for the same period reduced by current-year payments made in advance.
The statute of limitations for an assessment is four years as from the end of the voluntary filing period.

**Tax grouping**

The Spanish CIT Law allows Spanish tax resident companies and Spanish permanent establishments (PEs) belonging to a Spanish or multinational group to be taxed as a single group and, therefore, apply a special tax consolidation regime for CIT purposes.

To apply this regime, the main requirements are as follows:

a. the Spanish companies should be owned (directly or indirectly) by the same parent company (either resident or non-resident);

b. the parent company (either resident or non-resident) of the tax group must hold a direct or indirect minimum holding of 75 per cent (70 per cent for quoted companies) and the majority of voting rights in the Spanish companies belonging to the group;

c. the above participation should be maintained during the whole taxable period; and

d. the parent company cannot be tax resident in a tax heaven.

The main characteristics of the tax consolidation regime are described below:

a. the taxable income results from the sum of all the taxable incomes of each Spanish tax resident company of the tax group, corrected as established in the following points;

b. tax losses of any of the companies of the tax group can be offset against any company tax profits;

c. tax profits generated from intra-group transactions are deferred and only included in the consolidated taxable income when:
   - they are carried out with third parties;
   - one of the intra-group companies that is part of the transaction ceases to form part of the group; and
   - the consolidation regime is no longer applied;

d. specific limitations apply concerning the offsetting of tax losses or the application of tax credits generated by the group companies before they formed part of the tax group; and

e. no withholding applies on payments made at intra-group level.

**Advance price agreement (APA)**

Taxpayers and the Spanish tax authorities may negotiate APAs on transfer pricing issues. The Tax Agency is quite favourable to the use of APAs because they can provide certainty for both parties, out of the context of a tax audit.

Although legally the length of an APA is not supposed to be longer than six months, its negotiation always takes longer. The APA cannot cover longer than four years, although it can have retroactive effect to years within the statute of limitation.

The documentation provided to the Tax Agency in the course of an APA cannot be used in a tax audit.

**Alternative dispute resolution**

Spanish taxpayers also have access to ‘the competent authority procedure’ provided in the tax treaties signed by Spain following the OECD Model Tax Treaty and the Arbitration Convention (90/436/ECC Convention of 23 July 1990) concerning the elimination of double taxation that may arise in intra-group transactions within companies residing in EU countries.
Finally, Spain is yet to implement Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, which as a Directive is in force as of 1 July 2019, but is yet to be implemented in the domestic legislation.

Means of appeal

After a tax audit, taxpayers are entitled to appeal the claim if they do not agree with it. Additionally, taxpayers might obtain suspension of the tax due under the claim, which in most cases would require a guarantee from the taxpayer.

With regard to appeals, taxpayers have two alternatives: (1) appealing before the same body issuing the tax claim; or (2) appealing to an economic-administrative tax court.

Decisions issued by the Economic Court could be appealed to the Courts of Justice: to the Regional Courts of Justice or the High Court, depending on the amount of the claim.

Afterwards, there might be another tier of appeal to the Supreme Court, but only when the case may create precedents, so the likelihood of accessing the Supreme Court is very limited.

Lastly, the appeal could reach the Court of Justice of the European Union (CJEU), although the taxpayer cannot directly request its involvement, but only through the Spanish tax court, if the court decides so.

ii Other relevant taxes

Value added tax (VAT)

Spanish VAT regulation implements the EU directives on VAT.

VAT is levied on the supply of goods and services provided by entrepreneurs and professionals, intra-community acquisitions and imports of goods into Spain.

The concept of entrepreneurs and professionals includes a large number of assumptions, but basically refers to those persons (physical or legal) who carry out business or professional activities, meaning those that involve the commissioning of material and human factors of production, or one of them, for their own account to intervene in the production or distribution of goods or services.

The territory of application of the tax is the peninsula and the Balearic Islands. In the Canary Islands, Ceuta and Melilla other indirect taxes are applied (IGIC and IPSI, respectively). The operation of IGIC is similar to that of VAT with some differences with regard to exemptions. On the other hand, the IPSI is a basic sales tax.

There are three different rates of VAT: 21 per cent (general rate applied to regular deliveries of goods and services); 10 per cent (reduced rate applied to basic needs); and 4 per cent (super-reduced rate applied to basic needs other than those classified in the reduced rate). The ordinary rate of the IGIC is 6.5 per cent, and the other rates are zero per cent, 3 per cent, 9.5 per cent, 13.5 per cent and 20 per cent.

VAT group

When a Spanish parent company owns at least 50 per cent of one or more Spanish subsidiaries (dependent), all of them taxable in Spain, they could opt for the VAT group regime.

Within this special regime there are two forms of taxation: (1) basic level: the result of VAT tax returns of all members is aggregated and, if so, compensated; or (2) advanced level: the group is taxed like a single entity and internal operations do not generate VAT.
Regarding capital goods, their cost must be fully imputed within the period of regularisation of the quotas corresponding to the aforesaid goods.

**Property transfer tax (TPO)**

TPO applies to transfer of goods and rights when the transferor is a private individual. It also applies to real estate transfers and real estate leases when the seller is an entrepreneur but the operation is exempt from VAT.

Transfer of shares is exempt from both VAT and TPO, but when the transfer is aimed at dissimulating the transfer of real estate owned by the company, the actual taxation of transfer of real estate is applied.

TPO tax rates are 6 per cent for the transfer of real estate, as well as for the constitution and transfer of rights _in rem_ over them; 4 per cent in the case of the transfer of movable property and livestock; and 1 per cent in the case of constitution of rights _in rem_ of guarantee, pensions, bonds or loans.

The above rates may change from one region to another, as regional authorities have competence to increase those tax rates.

**Tax on financial transactions**

In October 2018, the government announced a draft of a law that would establish a new tax on financial transactions; this tax would apply to acquisition of shares in traded Spanish companies when they have a market capitalisation above €1 billion. The tax amounts to 0.2 per cent of the consideration paid exclusively for the shares and the taxable person is the intermediary acting in the operation.

The above-mentioned draft law requires parliamentary approval.

**Tax on certain digital services**

Also in October 2018, the government announced another draft law whereby the ‘Google Tax’ is enacted. The tax requires parliamentary approval.

This tax applies to companies with worldwide turnover of over €750 million or Spanish income subject to this tax of over €3 million. The tax rate amounts to 3 per cent of income resulting from rendering digital services as defined in the draft of law.

**Local property tax**

This tax is a direct municipal tax, periodic, real and mandatory in all councils, which taxes the value of real estate. The rate of taxation will vary depending on the city council, ranging from 0.3 per cent to 1.1 per cent of the cadastral value.

**Stamp tax**

Stamp tax (document duties and registration fees) is levied on notarial instruments and records documenting transactions that need to be registered in public registries. The tax rates range from 0.5 per cent to 1.5 per cent of the operation value.

**Net wealth tax (NWT)**

NWT is levied on all assets and rights of economic content held by an individual.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
In general terms, an entity is deemed to be resident in Spain for tax purposes if at least one of the following requirements is met:

- it has been constituted under Spanish law;
- the registered office is located in the Spanish territory; and
- the effective management (direction and control of the activity) is located in the Spanish territory.

Under certain conditions, Spanish tax authorities can assume that an entity, located in a tax haven or a country with no taxation, is a tax resident in Spain. In order for this assumption to be applicable, the main assets and rights of the entity must be, directly or indirectly, located in Spain.

ii Branch or permanent establishment
Branches or PEs of foreign entities that are located in Spain are subject to CIT on their worldwide income.

However, a limitation in the deductibility of some of their expenses is imposed on PEs, such as payments (in the form of royalties, interests or commissions) made to its parent entity or any of its other branches as remuneration for technical assistance services or the transfer of goods and rights.

Nevertheless, administrative and management expenses derived from the parent entity might be deductible under certain conditions.

As regards the allocation of profits of PEs, reference is usually made to OECD guidelines and principles.

In practice, operating in Spain through a PE leads to uncertainty situations in terms of income allocation, as it is more difficult to be supported and sustained before the tax authorities than operating through a clearer frame (basically, resident subsidiary).

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
The holding companies regime can be applied by entities, with material and personal means, whose corporate purpose includes the administration and management of participation in foreign entities.

Under this regime the distributions made by holding companies, of profits derived from exempt foreign-source dividends and capital gains, to foreign shareholders are not subject to withholding tax in Spain.

Additionally, the capital gains derived from the transfers of shares of holding companies that correspond to exempt dividends and capital gains are not taxed in Spain.

This regime will not be applicable if the shareholder of the entity applying the holding companies regime is located in a tax haven or a no-taxation country.
**Participation exemption for dividends and capital gains, and capital losses**

Dividends obtained by Spanish entities either from resident or foreign entities may be exempt from taxation under the participation exemption regime. Both domestic and foreign entities’ dividends will be generally exempt when the following conditions are met:

- the recipient either owns at least 5 per cent of the distributing entity or has an acquisition cost higher than €20 million; and
- such stake has at least one year's seniority (the one-year seniority could be fulfilled afterwards).

In the case of a foreign subsidiary, an additional condition is required. In order for the exemption to apply, the foreign subsidiary should be effectively subject to (and not exempt from) a tax similar to CIT at a nominal rate of at least 10 per cent; this requirement is understood to be met when a tax treaty is applicable and it includes an exchange of information clause.

Specific requirements are demanded in case of indirect participation through a holding entity.

Furthermore, capital gains resulting from the sale of shares in both Spanish and foreign entities would be generally exempt from taxation when requirements for participation exemptions are fulfilled. In case of sale of foreign subsidiaries, the minimum taxation requirement must be met during all the years in which the participation has been held.

Capital losses from shares that could benefit from the participation exemption are not tax allowed, unless they come from liquidation with certain requirements.

**Patent box**

A partial exemption can be applied to the income obtained by entities from the transfer of the right to use or exploit certain assets (patents, utility models, registered advanced software, complementary certificates for the protection of medicines, phytosanitary products and legally protected designs), that have been generated by research, development and technological innovation activities. This partial exemption can amount to a maximum of 60 per cent of the income.

This partial exemption can also be applied to capital gains generated from the transfer of the above-mentioned assets to third parties. If the transaction is carried out between related parties, the partial exemption will not apply.

**Capitalisation reserve**

Entities that are taxed under the general and increased tax rates (25 per cent and 30 per cent, respectively) can apply a special reduction to their positive taxable base in an amount equal to 10 per cent of the increase in its net equity. The following conditions must be met to apply this reduction:

- there must be an increase in the entity’s net equity that must be maintained during a five-year period; and
- reserve for the amount of the reduction must be booked separately in the account balance. This reserve should be recorded as restricted reserves for, at least, a period of five years.
However, this reduction cannot exceed 10 per cent of the entity’s positive taxable base prior to certain adjustments. The excess over the aforementioned limit can be carried forward for application in the following two years.

ii State aid
Spanish internal regulations establish certain tax incentives to promote investment by foreign companies in Spain, which reduce the tax burden in the field of taxation on company profits.

However, state aid is forbidden by the EU.

Start-up companies
In Spain, a series of incentives for start-ups were introduced in 2013 with the aim of boosting business creation and encouraging job creation. They consist in some measures on CIT and PIT that are applicable during the first years of an activity.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding outward-bound payments (domestic law)
Provided that a double tax treaty (DTT) is applicable, the terms of such DTT should be observed. If there is no applicable DTT or a limit of taxation is not envisaged in the relevant DTT, payments made by a Spanish taxpayer to a non-resident entity will subject to withholding tax in Spain at the following general rates:

- the general rate is 24 per cent, except for 19 per cent for tax residents in the EU and European Economic Area (EEA);
- 19 per cent on dividends and interest;
- 19 per cent on royalties paid to residents in the EU, Iceland and Norway, and 24 per cent in all other cases; and
- 19 per cent on capital gains.

For the application of a reduced rate or one of the exemptions described below, the taxpayer must be in possession of a tax residence certificate issued by the tax authorities of the country of the recipient.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Dividends
According to the domestic law, dividends paid by a subsidiary to its EU parent company are exempt from withholdings when:

- the parent company holds at least a minimum holding of 5 per cent in the Spanish subsidiary (or alternatively, the acquisition cost exceeds €20 million) and the interest in the Spanish subsidiary has been held for at least one year before the dividends distribution (or will be held up to completing the one-year period);
- both the entity paying the dividends and the beneficial owner are subject to and not exempt from one of the corporate taxes mentioned in Article 2(c) of the Council Directive 2011/96/EU of 30 June 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States;
the payment is not a consequence of the liquidation of the subsidiary; and
both the entity paying the dividends and the beneficial owner have one of the legal forms listed in the Annexes to the Council Directive 2011/96/EU of 30 June 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

This exemption will not be applicable if the majority of voting rights of the receiving entity are directly or indirectly owned by non-residents in the EU, unless it is proven that the incorporation of the receiving entity is because of valid economic reasons and sound business reasons.

**Interest**

Interest paid to a resident in the EU will be exempt of withholding. This exemption does not apply when the recipient is tax resident in a tax haven.

**Capital gains**

Capital gains from alienation of movable goods (including shares) by tax residents in the EU are exempt from withholding, except in the following cases:

- the transferred shares are issued by a Spanish company whose main asset or assets are (directly or indirectly) assets located in the Spanish territory;
- the non-resident selling the company is a private individual that has held (directly or indirectly) at least a 25 per cent holding in the Spanish company at any time during the 12 months prior to the transfer; and
- when the transferor is a non-resident entity, the exemption will only apply if the domestic participation exemption requirements (described above) are fulfilled. This requirement aims to equalise the treatment of both residents and non-residents.

**Royalties**

Royalties paid to an EU Member State would be exempt from withholding when the following requirements are met:

- both the entity paying royalties and the beneficial owner have one of the legal forms listed in the Annexes to the Council Directive 2003/49/EC of 3 June 2003;
- both the entity paying royalties and the beneficial owner are subject to and not exempt from one of the corporate taxes mentioned in Article 3(a)(iii) to the Council Directive 2003/49/EC of 3 June 2003;
- both entities are resident in the EU and none of them is resident in a third country in accordance with a DTT;
- both entities are associated companies (i.e., (1) one has a direct minimum holding of 25 per cent in the capital of the other, or (2) a third company has a direct minimum holding of 25 per cent in the capital of both entities). This holding should be held for a minimum holding period of one year that may be completed after the payment; and
- the entity that receives those royalties should receive them for its own benefit and not as an intermediary, such as an agent, trustee or authorised signatory, for some other person and, when the recipient is a PE, the received royalties should effectively be connected with that PE's activity and it should be a taxable income for the PE.
This exemption over royalties will not apply when the majority of voting rights of the receiving entity are directly or indirectly owned by a non-resident in the EU unless it is proven that the incorporation of the receiving entity is because of valid economic reasons and sound business reasons.

### iii Double tax treaties
Currently, Spain has entered into DTTs with more than 90 countries, the main aim of which is to eliminate double taxation and provide for reduced rates of withholding taxes of dividends, interests and royalties. DTTs concluded by Spain are generally compliant with the provisions set forth by the OECD.

A certificate stating that the taxpayer is a resident in another contracting state is required for a non-resident to benefit from the provisions of a treaty. Certificates of residence are valid for one year.

**Taxation on foreign-sourced income**

Dividends from foreign subsidiaries might benefit from the participation exemption as described above.

Profit from foreign PE of Spanish companies could benefit from income exemption, as could dividends.

Other income from abroad might benefit from double taxation relief (credit method), which in certain cases could be more beneficial than the exemption method.

### VII TAXATION OF FUNDING STRUCTURES

#### i Thin capitalisation

Thin capitalisation rules were replaced by rules preventing earnings stripping.

#### ii Deduction of finance costs

As a general anti-avoidance rule, interest paid to a group entity incurred to acquire shares or increase equity interests in other group members is wholly non-deductible (tainted financial expenses), unless the operation might pass a business purpose test.

Remaining net finance cost (this is the net amount of financial income and cost, excluding the above-mentioned tainted financial expenses) is deductible up to an amount equal to 30 per cent of the operating profit defined as the accounting operating profit eliminating the effect of (usually increasing):

- the amortisation of fixed assets;
- the subsidies for non-financial fixed assets and others; and
- the depreciation for impairment of fixed assets as well as the gains or losses derived from the transfer of fixed assets.

The resulting amount should be increased with dividends derived from entities when the stake represents at least 5 per cent of their share capital, or, alternatively, has an acquisition cost exceeding €20 million. This rule will not apply to dividends from subsidiaries that have been acquired from other companies of the group with group debts generating tainted non-deductible financial expenses referred to above.
Net financial cost above 30 per cent of operating profit could be carried forward and deducted in the following tax years (with no term limitation) within the same limit of 30 per cent of the annual operating profit.

Conversely, if net financial cost is below 30 per cent of operating profit (e.g., capacity excess) that excess of capacity may be carried forward to deduct more financial cost in the following five years.

The above limitations do not apply when:

a net financial cost does not exceed €1 million;
b the entities are incorporated under the legal form of insurance or financial entities; or
c in case of entities belonging to a tax unit or tax consolidation group, all the above calculations (net financial cost, operating profit, etc.) would be referred to the whole group.

**Leveraged buyout operations**

There is a special rule for interest allowance in case of leveraged buyout operations (LBOs) whereby the above-mentioned 30 per cent operating income limit should exclude acquired entities operating income provided that the latter has been merged into the acquiring entity (or acquiring entity’s tax unity) within four years following the target company acquisition.

Two considerations should be made in relation to this LBO additional limitation:

a this limitation does not prevent the general interest barrier rule from being applied; therefore, the rule that determined the lower amount of interest will be the applicable one; and
b the LBO specific limitation rule will not apply if the interest-bearing debt does not exceed 70 per cent of the purchase price of the shares and is proportionally reduced during eight years following the acquisition, until the debt reaches 30 per cent of the purchase price.

**iii Restrictions on payments**

**Dividends**

Spanish corporate law provides that dividends or distributions of the earnings for the financial year are decided by shareholders at general meetings on the basis of an approved balance sheet.

Dividends may only be drawn on the year’s profits or freely available reserves if:

a the requirements laid down by law and in the by-laws are met; and
b the value of the corporate equity is not, or as a result of such distribution would not be, less than the company's capital.

Regardless of the above, dividends distributions are subject to the following additional limitations:

a the dividend distribution should not entail a direct or indirect distribution of any profit directly allocated to equity;
b in the event of losses in preceding years that reduce corporate equity to less than the company’s capital, profits shall be used to offset such losses; and
c profit distribution shall likewise be prohibited if the amount of the distributable reserves comes to less than the sum of the research and development expenses shown as assets on the balance sheet.
When there is an adverse tax treatment for dividend distribution, an alternative to be considered could be the purchasing (back) of shares by the company, which could be done with certain limits. Share buy-backs are not deemed a distribution of dividends, but a sale of shares that accordingly generates capital gains or losses to the shareholder.

**Board of directors’ retributions**

Despite being quite a controversial issue, any retribution paid to a director (including salaries when together with their position in the board the director also acts as senior management of the company) should be expressly provided in the company by-laws, as otherwise retributions are not tax deductible.

**Financial assistance**

Spanish companies must also be aware of an issue called financial assistance, which is designed to stop a target assisting by any means in its own transfer.

iv **Return of capital**

Shareholder contributions can take three main forms: share capital, share premium and equity contributions. As a general principle, it is advisable to contribute as little capital as possible and as much share premium as possible because share premium is equity (solvency) but it gives the shareholder more flexibility when it comes to capital reduction, losses or dividend distributions.

Repayment of capital should be approved by the general meeting and it is subject to approval by a qualified majority of the shareholders, the reduction of the capital should be executed in a public deed and sometimes it is also required to be published.

From the tax perspective, when the capital repayment is executed by means of a shares cancellation, 1 per cent stamp duty applies to the equity refunded to shareholder; where shares are bought back usually no transfer tax applies.

**Anti-hybrid provision**

As of 2015 there are two limitations in connection with the hybrid structure. First, there is a limitation on interest payable with respect to a profit participating loan (PPL) that will not be deductible where the lender and the borrower belong to the same group. PPLs are a type of loan regarded as equity in situations where the borrower is in an unbalance situation. Second, participation exemption will not apply to the income that is regarded as dividends in the recipient entity but that generates a deductible cost in the paying entity.

Finally, Spain is about to implement the anti-hybrid rules included in the Anti-Tax Avoidance Directive (ATAD).

**Secondary adjustment and substance over form principle**

As of 2008, SGAAP mostly follow International Financial Reporting Standards; hence, the principle ‘substance over form’ has become of great importance. According to that principle, when there is an operation without an arm’s-length value between a shareholder and a company, it should be understood that there is an equity contribution or an equity distribution depending on the party taking advantage of the lack of retribution. If the shareholder is not
the single owner of the company, it is understood that there is an equity contribution or
distribution on the ownership percentage but a taxable income or a non-deductible gift for
the remaining share capital owned by another shareholder.

The same rules apply when there is a tax transfer pricing adjustment and the Spanish
tax authorities consider that the conditions applied are not market conditions.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

In Spain, the acquisition of a business activity could be done by means of an asset deal or a
shares deal. While an asset deal is generally advisable from the acquirer point of view, the sale
of shares is more beneficial from the seller point of view.

Asset deal

From the seller point of view, generally, an asset deal triggers a capital gain or deductible taxable
loss; the capital gain may be offset with carry-forward losses, within the legal limitations.

Conversely, the buyer might recover the price paid by taking advantage of the step up
resulting from the sale. Besides, an asset deal may determine a limitation of the tax liability
shifted to the buyer. Special attention should be paid when the asset deal involves real estate,
because the indirect taxation could be worse than in a share deal, as VAT does not apply to a
transfer of a branch of activity and, then, real estate will trigger TPO, which would result in
a higher acquisition cost (non-recoverable) for the buyer.

Shares deal

Provided the sold entity is a business operating entity, the share deal will not likely result in
a tax burden for the seller.

The buyer, however, will not take advantage of the assets step up (and accordingly does
not uplift the basis for depreciation or amortisation and future capital gains) and the entity
will be fully liable for past contingencies.

When a foreign investor acquires a Spanish entity through a special purpose vehicle
(SPV) a fiscal unit (tax group) should be considered between the acquiring entity and the
Spanish target company, subject to certain requirements. Accordingly, interest expense on the
acquisition debt at the level of the SPV could be offset against the profits of the target entity
(when the debt does not exceed 70 per cent of the price and it is proportionally reduced
during eight years following the acquisition, until the debt reaches 30 per cent of the purchase
price, as described above).

ii Reorganisation

The Spanish CIT Law offers many ways for reorganisation, such as merger, divisions, spin-off,
system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares
concerning companies of different Member States, those operations could be done without
tax costs under the neutrality regime, avoiding most direct and indirect tax costs.
However, to apply the neutrality regime, companies participating in the operation should be able to demonstrate that the operation is not tax-driven and it is done mainly for valid business reasons.

The neutrality regime is based on deferral and the assets acquiring entity would subrogate (for tax purposes) in acquisition value and date of the transferred assets.

Cross-border reorganisation might be tax neutral if assets of the Spanish resident participating company are allocated to a Spanish PE.

### Exit

The transfer abroad of either the tax residence of a Spanish entity or its legal seat is allowed by Spanish law.

When it comes to the transfer of legal seat, some obstacles might appear depending on the country of destination.

For tax purposes, the transfer of tax residence will trigger a capital gain or loss for the difference between the company’s assets (and liabilities) market value and their historical tax value, triggering the exit tax.

The exit tax could be either avoided or deferred:

- it would be avoided if the assets are allocated to a PE of the foreign entity (formerly tax resident in Spain) in Spain; or
- alternatively, it could be deferred if (1) the tax residence of the company or the PE is transferred to an EU Member State or to an EEA country with effective exchange of information with Spain; and (2) the taxpayer asked for that deferral, constituting the relevant guarantee until the assets are transferred to third parties, when the tax will eventually become payable. Late payment interest will accrue along that period.

In October 2019, the government announced a draft law where ATAD is implemented, amending the current exit tax regime, introducing some situations where the exit tax also applies (i.e., when a PE ceases its activities) and providing that the exit tax cannot be deferred sine die, but it has to be paid in five instalments. This draft law needs parliamentary approval.

### IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

#### i General anti-avoidance

The Spanish General Tax Law provides several General Anti-Avoidance Rules (GAAR) that would allow Spanish tax authorities to tackle situations where the taxpayer artificially avoids the payment of taxes:

- the substance over form or requalification rule;
- a rule for conflicts in the application of the law; and
- rules for simulated schemes.

According to ATAD, EU Member States have to implement GAAR. However, because Spain already had such rules and there would not be a need to introduce new rules, no modification would be required.

Additionally, Spanish legislation has numerous Specific Anti-Avoidance Rules (SAAR), the most frequently applied being the following:

- the transfer pricing anti-avoidance rule;
- limitation of financial interest paid to group entities deductibility;
the anti-abuse rule for mergers, spin-offs and exchange of shares; and
a rule preventing the transfer of companies with carry-forward tax losses.

ii Controlled foreign corporations (CFC)
CFC legislation applies to all resident taxable entities holding a participation in foreign entities located in low-tax jurisdictions other than EU and EEA Member States and whose income is passive income or, despite the nature of its income, the subsidiary does not have any substance, as defined in the law.

For CFC rules to be applicable, the following requirements should be met:

- the Spanish entity, together with other related parties, should have at least 50 per cent participation in the foreign company;
- the foreign participating entity does not have any substance or the subsidiary income is passive as defined in the law; and
- the income tax paid by the entity is lower than 75 per cent of the tax payable in Spain.

When CFC rules apply, the Spanish taxpayer owning the foreign subsidiary should allocate (transparent) the latter’s income in the proportion the taxpayer participates in the subsidiary.

CFC rules do not apply when: (1) the foreign subsidiary is tax resident in an EU Member State; and (2) it is demonstrated that the foreign entity was incorporated for sound business reasons.

In October 2018, the government announced a draft law that will modify the CFC rules to implement CFC rules provided by ATAD.

iii Transfer pricing
Spanish companies and PEs must value their operations with related parties in accordance with the arm’s-length principle. This principle applies both for accounting and tax purposes. In both cases, the burden of proof is on the taxpayer’s side. It is important to keep in mind that, according to the Spanish income tax, the number of people and entities that are regarded as related parties (the ‘related parties perimeter’) is larger than in most countries.

Apart from the related parties’ perimeter, Spanish transfer pricing rules are totally aligned with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and EU transfer pricing regulations.

Transfer pricing documentation
As of 2008, transfer pricing documentation should be prepared. Documentation obligations are based not only on the EU Joint Transfer Pricing Forum Code of Conduct, but also on the OECD Transfer Pricing Guidelines.

Documentation obligations stipulated by the transfer pricing regulation can be divided into:

- group documentation to which the taxpayer belongs (master file); and
- specific documentation for the taxpayer (local file).

These new documentation requirements are applicable for tax periods beginning from 1 January 2016.
Spain

**Tax penalty regime since 2015**

The Spanish CIT Law establishes a specific tax penalty regime as follows:

<table>
<thead>
<tr>
<th>Fulfilment of documentation obligations</th>
<th>Fulfilment of the obligation to apply market value</th>
<th>Penalties</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>€1,000 for each data or €10,000 for each set of data</td>
</tr>
<tr>
<td>Yes</td>
<td>No</td>
<td>No (Only for those cases in which the valuation applied can be deduced from the documentation)</td>
<td></td>
</tr>
<tr>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>15 per cent of the adjustment</td>
</tr>
</tbody>
</table>

It is important to point out that the penalty regime is aimed at the taxpayer fulfilling formal documentation obligations rather than fulfilling the obligation to apply market value.

**iv Tax clearances and rulings**

Taxpayers may obtain certainty in advance mainly by two means:

- asking for an advance tax ruling: this type of ruling is requested from the General Directorate of Taxes and, when obtained, is binding for tax agencies in connection to the taxpayer asking for it (other taxpayers might also benefit from the ruling’s criteria, in terms of avoiding penalties); and
- APAs, as described in Section III.

**X YEAR IN REVIEW**

2019 has been a peculiar year owing to an unsteady political situation, including a change of government, which is expected to trigger significant changes in the Spanish tax picture, but not before the end of 2019. This has meant, somehow, a quieter year in terms of tax changes than usual.

In terms of the changes planned for 2020, Spanish tax legislation is likely to introduce new measures to increase revenues and reduce the public deficit:

- a new tax on financial transactions;
- a new tax on certain digital services;
- the implementation of the ATAD; and
- limitation of participation exemption: limitation to 95 per cent of the current (100 per cent) exemption on dividends and capital gains.

In any case, the above measures are still in the preliminary stages and will need parliamentary consensus to be approved.

**XI OUTLOOK AND CONCLUSIONS**

On 7 January 2020, a new Prime Minister was elected with the support of the Socialist party and the far-left UP with the support of many minority and regionalist parties. The new Prime Minister announced that he will form the first coalition government in recent Spanish history.
A manifesto has been published with several principles and measures that the new government might approve, some of them aiming to amend the Spanish tax system. The most relevant tax measures are set out below.

A new Law on Measures to Prevent and Combat Tax Fraud will be approved, which will strengthen the means dedicated to the fight against fiscal fraud, update the list of tax havens and prohibit tax amnesties. In this regard, control over UCITs will be shifted from the Security Exchange Commission to the Tax Agency.

The current legal and tax regime of the Spanish Real Estate Investment Trust will be amended.

With regard to CIT, the following measures should be noted:

- establishment of a minimum level of taxation of 15 per cent to large corporations (18 per cent for financial institutions and oil companies);
- reduction of the participation exemption for dividends and capital gains. The exempted amount will be reduced to 95 per cent of the dividend amount or the capital gain. This means dividends and capital gains will support an effective rate of 1.25 per cent; and
- reduction of the tax rate applicable to small and medium-sized enterprises down to 23 per cent (instead of 25 per cent).

There are also changes in PIT, increasing by 2 and 4 percentage points the rate applicable to income above €130,000 and €300,000, respectively. The rate applicable to income from capital over €140,000 will also be increased by 4 percentage points.

Other measures announced refer to the establishment of a tax on financial transactions and the ‘digital rate’ (or ‘Google tax’).

The entry into force of these measures will therefore mean a significant modification of the current tax system. Consequently, their effects should be examined in detail and developed by jurisprudence and administrative doctrine.
Chapter 29

SWEDEN

Carl-Magnus Ugga¹

I INTRODUCTION

The tax and legal environment in Sweden is a traditional civil law system, based on statutes rather than case law. However, since joining the European Union on 1 January 1995, case law has become an increasingly important part of the legal environment. Sweden has, as of 1 January 2019, a flat rate of 21.4 per cent corporate tax (expected to be lowered to 20.6 per cent as of 1 January 2021), a generous participation exemption regime and one of the most extensive tax treaty networks in the world.

Foreign investment in Sweden is promoted by the government through, inter alia, the Invest in Sweden Agency and the Swedish Trade Council, which seek to assist foreign enterprises interested in investing or conducting business in Sweden.²

Sweden has no foreign exchange controls and no currency restrictions. As a general rule, there are no requirements to obtain an operating licence to conduct business in Sweden (exceptions in specific sectors do apply). Enterprises must, however, register for tax, etc.

This chapter contains an overview of certain Swedish tax rules regarding companies, and to a limited extent the taxation of foreign legal entities in Sweden. The descriptions are not exhaustive.

This chapter does not cover the taxation of natural persons.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

The vast majority of organisations for commercial activities in Sweden are organised as limited companies. Limited companies may be public or private. Only public companies may turn to the general public to raise capital. To a limited extent, cooperative economic organisations are also used for commercial activities.

The share capital of private companies must total at least 50,000 kronor (there is currently a proposal to lower the minimum amount to 25,000 kronor as of 1 January 2020), while share capital of public companies must be at least 500,000 kronor.

Limited liability companies and cooperative economic organisations constitute tax subjects, and are subject to national income taxation scheduled as business income (lowered from 22 per cent to 21.4 per cent as of 1 January 2019 and expected to be lowered to 20.6 per cent as of 1 January 2021).

¹ Carl-Magnus Ugga is an international tax partner at Bird & Bird Advokat KB.
ii  Non-corporate
Organisations for commercial activities may also be organised as partnerships, limited partnerships or unregistered partnerships. Unregistered partnerships are seldom used for sizeable commercial activities.

Partnerships and limited partnerships are, unlike unregistered partnerships, legal entities that can acquire assets and assume rights and liabilities.

The partners in a partnership have unlimited liability for the debts of the partnership, while in a limited partnership, only the general partner retains unlimited liability for the partnership’s debts. The limited partners’ liability is limited to their financial contribution to the company.

Partnerships are, from an income tax perspective, transparent, but may be liable to VAT, real estate tax, payroll taxes and taxes on pension costs for employees. In addition, partnerships may be responsible for handling social contributions and for withholding preliminary income tax for employees.

III  DIRECT TAXATION OF BUSINESSES
i  Tax on profits

Determinaion of taxable profit
The profit or loss of a limited company is (somewhat simplified) as a general rule calculated in accordance with Swedish generally accepted accounting principles. To determine the taxable result, certain tax adjustments are made; these include transfers to and from certain untaxed reserves, group contributions with fiscal effect, and non-taxable and non-deductible income and costs, as specified in the Income Tax Act. Examples of non-taxable income include dividend distributions and capital gains covered by the relevant participation exemption rules and write-ups on financial assets. Examples of non-deductible costs include general taxes, write-downs on financial assets, certain interest expenses, association fees and, in principle, all business entertainment.

Furthermore, depreciation of machinery and equipment and real property is subject to special tax rules. A deduction for depreciation of machinery and equipment is allowed at an annual rate of 20 per cent of the original acquisition cost or 30 per cent of the remaining non-depreciated value. An alternative 25 per cent declining balance method without correspondence to the books also exists. These rules also apply to the depreciation of, inter alia, concessions, patents, licences, trademarks, leases, acquired non-share-related goodwill and similar rights acquired from another party.

In respect of real estate, deductions for depreciation of buildings are allowed at various rates between 2 and 5 per cent annually, depending on the type of building. For new rental buildings, an additional 2 per cent per annum may, as of 1 January 2019, be deducted over the first six years. Land is a non-depreciable asset.

Capital and income
Income earned by a limited company is subject to a national corporate income tax rate of 21.4 per cent (expected to be lowered to 20.6 per cent as of 1 January 2021). The tax rate is applicable to all taxable income, including capital gains (tax-exempt gains exist: see Section V). Income earned by a partnership, including capital gains, is taxed at the level of its owners, and the tax rate is dependent on their tax status.
Losses

Tax losses are as a main rule carried forward indefinitely (no carry-back exists) and may be offset against any taxable income. However, losses on real estate and shares not tax-exempt under the participation exemption regime may only be offset against gains on the same type of assets.

Losses carried forward may be restricted following a direct or indirect change of control of a company. Where there are such changes, an amount limitation rule implies that all tax losses carried forward exceeding 200 per cent of the purchase price are permanently forfeited. For the purpose of this calculation, the purchase price must be reduced by capital contributions made to the loss company during the current and two financial years preceding the change of control.

Under an offset restriction rule, tax losses carried forward that are not forfeited by the application of the amount limitation rule cannot be offset against profits in any company belonging to the buyer’s group during the year in question and for five years following the year of acquisition. The offset restriction applies not only to an acquisition of a company with losses carried forward, but also when a group containing such a company acquires another company.

When the change of control concerns companies that prior to the change of control were in the same group, the offset restriction rule is normally not applicable. Furthermore, the amount limitation rule is normally not applicable when a controlling company, prior to the change of control, was in the same group as the loss-carrying company.

The above described amount limitation rule may also be applicable in mergers unless the absorbing company has the decisive influence over the dissolved company. Furthermore, unless the companies are entitled to exchange group contributions with fiscal effect the year prior to the merger, the losses carried forward that are not forfeited as a result of the application of the amount limitation rule cannot be utilised against the absorbing company’s own profits or against group contributions during the year in which the merger is completed and for five subsequent years (merger restriction).

Rates

As noted above, income earned by a limited company is subject to a national corporate income tax rate of 21.4 per cent (expected to be lowered to 20.6 per cent as of 1 January 2021). Income earned by partnerships is taxed at the level of its owners.

Administration

Limited liability companies normally pay income tax on a monthly basis based upon a preliminary declaration of income. After the close of the book year, the company submits a tax return to the Swedish Tax Agency that establishes the company’s final income tax for the year. The filing date is dependent on when the book year ends.

<table>
<thead>
<tr>
<th>Book year ending</th>
<th>Filing date</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 January, 28 February, 31 March or 30 April</td>
<td>1 November, if filed on paper; 2 December, if filed electronically</td>
</tr>
<tr>
<td>31 May or 30 June</td>
<td>15 December, if filed on paper; 15 January, if filed electronically</td>
</tr>
<tr>
<td>31 July or 31 August</td>
<td>1 March, if filed on paper; 1 April if filed electronically</td>
</tr>
<tr>
<td>30 September, 31 October, 30 November or 31 December</td>
<td>1 July, if filed on paper; 1 August if filed electronically</td>
</tr>
</tbody>
</table>
The Tax Agency’s decision regarding income tax may be appealed to an administrative court. Such an appeal should be sent to the Tax Agency, not the court, at which point the Agency will make an obligatory reassessment of its decision. If the Agency does not find a reason to overturn its decision, the appeal will be forwarded to the court.

The administrative court’s decision may be appealed to the administrative court of appeal. The administrative court of appeal’s decision may then be appealed to the Supreme Administrative Court. For the Supreme Administrative Court to hear the case, a review dispensation is required, because the Supreme Administrative Court establishes precedent and generally only hears cases in which the appeal is important as guidance for the application of the law.

Tax subjects may ask the Tax Agency for a written response to tax questions. Such written responses are not formally binding. However, according to the Tax Agency, it is intended that it will treat them as binding provided that the tax subjects involved have provided all relevant information and are not using the answer for tax planning purposes, and unless the Supreme Administrative Court delivers case law demonstrating that the Tax Agency’s interpretation was wrong.

The Swedish tax system also provides for the possibility to obtain a formally binding advance ruling regarding a specific tax question. Such a ruling is delivered by the Council for Advance Tax Rulings, an independent public authority. Both the Tax Agency and the taxpayer may appeal the advance ruling to the Supreme Administrative Court without review dispensation.

The statute of limitation for the Tax Agency to review taxpayers’ tax returns is normally six years, but can in most situations be shortened to two years by filing open disclosures.

On 15 January 2019 the government presented a report (SOU 2018:91) on the possibility to introduce a requirement to provide information regarding tax arrangements in Sweden. During the investigation that led to the report, Council Directive (EU) 2018/822 of 25 May 2018 amending mandatory Directive 2011/16/EU on mandatory automatic exchange of information in the field of taxation in relation to reportable cross-border arrangements (DAC 6) was adopted. DAC 6 came into force on 25 June 2018 and entails an obligation for Member States to impose rules with an obligation to provide information regarding certain cross-border arrangements in the tax area. It also imposes an obligation on Member States to exchange information on such arrangements with one another automatically. The report includes proposals to implement DAC 6 in Swedish law. However, the proposed regulations in the report go beyond what follows from DAC 6 in that they also include purely domestic arrangements. The report suggests that the proposed rules come into effect on 1 July 2020. The report was subject to a consultation round that ended on 24 April 2019. The consultation answers were generally, with one exception (Swedish Tax Agency), critical to the proposed rules. It has consequently been speculated within the legal community that the domestic part of the proposal will not be enacted as is because of the criticism, but no such indications have yet been provided by the government. We are currently awaiting a proposal to the ‘Council of Legislation’, which is the next preparatory step, prior to a government bill being created and submitted to the Swedish parliament for a vote. Until such a bill is presented, it is difficult to draw any conclusion regarding the Swedish implementation of DAC 6.
Sweden

**Tax grouping**

Consolidated balance sheets are not recognised for tax purposes in Sweden. Instead, a tax consolidation system is used (i.e., a method of group contributions with fiscal effect between companies within the same corporate group where the ownership chain exceeds 90 per cent of the share capital). When these rules are applied, transfers of taxable income within an affiliated group are enabled. The group contributions are taxable in the receiving company and tax deductible in the paying company, which means that taxable profits can be shifted to a loss company in the same group to be offset against the tax losses.

The group contributions require that there are enough distributable reserves in the providing company, as group contributions are considered dividends for company law purposes. In profitable companies with no negative equity, this should not present a problem as long as no more than the yearly profit is contributed.

**ii Other relevant taxes**

The Swedish VAT system is harmonised with the EU rules. A general VAT rate of 25 per cent is chargeable on most goods and services. Reduced rates apply to a few goods and services, such as foodstuffs, restaurant meals, and non-alcoholic or low-alcohol drinks (12 per cent), as well as to the transport of passengers, books, newspapers and most cultural events (6 per cent). Most financial and insurance service providers are exempt from VAT, and this is normally also the case for healthcare, dental care, social care and schools. VAT returns are filed, and tax is paid monthly, quarterly or yearly depending on turnover.

As a member of the EU, Sweden is also part of the customs union enforcing the Community Customs Code. Most EU customs duties are calculated as a percentage of the value of the goods being imported. All imported goods must be classified according to the EU customs tariff, and the duty rates applied depend on the ‘economic sensitivity’ of the goods. The actual duty rate to be applied also depends on, inter alia, the country of origin of the product and free trade agreements.

Sweden levies a real estate transfer tax (stamp duty) on most transfers of real estate. Most legal persons pay 4.25 per cent; natural persons and tenant owner associations pay 1.5 per cent tax on a base that consists of the higher of the consideration paid or the tax assessment value of the real estate. Real estate transfer tax on an intra-group transfer of real estate may usually be deferred provided the real estate, the buyer and seller remain in the same group. Real estate transferred through a merger, a demerger or real estate reallocations are currently not subject to real estate transfer tax.

Real estate tax on commercial properties totals approximately 0.2 to 2.8 per cent of the tax assessment value (normally 1 per cent) depending on the type of property. The tax assessment value is supposed to equal 75 per cent of a conservative estimate of the fair market value.

Social security charges payable on remuneration to employees (or by the self-employed) are normally levied at 31.42 per cent. Social security charges are deductible for corporate tax purposes.

Pension benefits beyond the mandatory system are customary in most Swedish employers. A special salary tax is normally levied at a rate of 24.26 per cent on these additional pension premiums and commitments. These taxes are deductible for corporate tax purposes.

Sweden does not impose taxes on gifts, and net wealth and inheritance tax do not exist.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Swedish limited companies have unlimited tax liability in Sweden unless otherwise stated in special rules.

ii Branch or permanent establishment
A foreign enterprise is liable to pay income tax in Sweden if it is determined that it has a permanent establishment in Sweden. If the enterprise has a permanent establishment in Sweden, it will be taxed for business income (21.4 per cent; expected to be lowered to 20.6 per cent as of 1 January 2021). An ‘enterprise’ can be a sole trader or a legal person.

A general definition of permanent establishment is found in the Swedish Income Tax Act, which also contains rules regarding when a permanent establishment can be created by a person acting on behalf of an enterprise (e.g., an agent).

A permanent establishment is defined in accordance with the general definition as a fixed place of business through which the business of an enterprise is wholly or partly carried on. Three conditions must be met for the creation of a permanent establishment: (1) a distinct ‘place of business’; (2) which must be ‘fixed’, as in having a certain degree of permanence; and (3) the business of the enterprise must be carried out through that fixed place of business.

The general definition also contains a list of examples of what a permanent establishment may be constituted by: a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resources, a building site or construction or installation project, or real property that is a current asset in a business operation.

The definition mainly conforms to the permanent establishment definition found in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and Capital.

If Sweden has an agreement for the avoidance of double taxation (a tax treaty) with the jurisdiction from which an enterprise originates, a permanent establishment must be present both in accordance with the Income Tax Act and the tax treaty for the enterprise to be liable to pay income tax. In accordance with the Income Tax Act, foreign enterprises have a permanent establishment in Sweden if they carry on business wholly or partly from a fixed place of business in Sweden. A business operation is usually considered to be ‘fixed’ through having a certain degree of permanence when it is carried on for a six-month time period. In most tax treaties that Sweden has entered into with other states, building sites, construction or installation projects are considered to be fixed (have such a degree of permanence) when they are carried on for more than 12 months.

A foreign enterprise may have a permanent establishment in Sweden even when there is no fixed place in Sweden that the business operations are carried on from. This may be the case when the business operations in Sweden are carried on through a dependent agent.

A foreign enterprise is required to submit a tax application to the Tax Agency if it has a permanent establishment in Sweden, is an employer in Sweden or conducts business for which it is liable for Swedish VAT. The Tax Agency may then approve the enterprise as a tax subject conducting business, and decide whether the enterprise must pay, inter alia, preliminary income tax, special salary tax on pension costs, pension yield tax or real estate tax.
A foreign enterprise’s business operations in Sweden may be carried on through a branch. The enterprise must register the branch with the Swedish Companies Registration Office.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
There are no rules that apply specifically to holding companies as such, but the participation exemption rules in practice constitute a very favourable holding regime.

There is a capital gains tax exemption for Swedish corporate entities on gains related to the disposal of shares ‘held for business purposes’. Shares in Swedish corporations and participations in partnerships, as well as in foreign companies, can qualify as shares held for business purposes, and thus be divested tax-exempt.

Unlisted shares will in principle always be considered as held for business purposes. Listed shares are considered held for business purposes if the company has a holding corresponding to at least 10 per cent of the voting rights or, in certain situations, if the shares are held in the course of the business. An additional condition regarding listed shares, not applicable to unlisted shares, is that the shares must be held for a period of at least one year.

An exception from the capital gains tax exemption applies for the sale of shares in a ‘shell company’, which is a company or partnership where the fair market value of cash or liquid assets, shares and other marketable instruments (other than shares held for business purposes), and similar assets, exceeds 50 per cent of the consideration paid for the shares. The sale of a shell company results in punitive taxation where the entire consideration, and not just the gain, is taxed. The tax can be completely avoided by filing a shell company tax return within 60 days of signing or closing.

The participation exemption rules also apply to dividends received on shares held for business purposes and on qualifying holdings via partnerships.

ii IP regimes
There are no specific tax advantages in respect of holdings of IP rights, etc., but costs for research and development are deductible provided that the expenses are significant, or can be projected to have, significance for the business. Costs for the acquisition of, inter alia, patents and know-how may, as mentioned above, be deducted in accordance with the rules concerning the depreciation of machinery and equipment.

iii State aid
State aid is not provided in the shape of tax benefits. However, the government takes part in the financing of growth companies by providing venture capital through, inter alia, Industrifonden, Fouriertransform and ALMI Invest.

iv General
There are no specific tax incentives in Sweden for corporations. However, some generally applicable favourable regimes exist. For example, Sweden has an accruals reserve regime. The accruals reserve regime allows for a tax-deductible appropriation for corporations of 25 per cent of the taxable profit before appropriation to a reserve. Each year’s appropriation
forms a separate untaxed reserve that must be reversed to income no later than the sixth year following the appropriation. Standardised interest income is imposed on former years’ appropriations at 72 per cent of the interest rate on governmental debt notes.

Furthermore, considering the generous rules regarding tax exemptions for dividends and capital gains on shares, Sweden is a suitable country to establish holding companies (as discussed above).

As of 1 January 2018, new favourable tax rules for employee stock options granted by start-ups were introduced. Several requirements are set out for the rules to apply; for example, the company must in the year of grant have a maximum of 50 employees on an average, revenues of a maximum 80 million kronor and it must have operated its business for less than 10 years. The total value of all stock options granted cannot exceed 75 million kronor and the value of each employee’s stock options may not exceed 3 million kronor. Certain types of start-ups, such as banks or financial companies, insurance companies, real estate companies and companies providing tax or auditing services are ineligible to apply the new rules. Employees holding these employee stock options will be subject to capital income tax (effective rate 25 per cent) when the underlying shares are sold instead of salary income tax (progressive rate 29–60 per cent; the highest margin income tax rate will be lowered with 5 per cent as of 1 January 2020) when the stock options are exercised. However, if the company is a closely held company with qualified shares, gains on such shares are taxed at 20–60 per cent (20–55 per cent as of January 2029).

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Sweden imposes withholding tax on dividend paid from a Swedish limited company to foreign investors. The tax rate is 30 per cent, but is often reduced or completely omitted.

Sweden does not impose withholding tax on interest payments from a Swedish limited company to a foreign creditor.

A foreign legal entity that receives a royalty from a Swedish company or from a permanent establishment in Sweden may be deemed to have a permanent establishment in Sweden to which the royalty is attributed. However, in some situations this royalty may be exempt from taxation in Sweden.

In 2017, the Swedish government announced that it has commissioned a review of the Withholding Tax Act. The assignment was originally to be reported by 15 December 2018, but given an extension until 31 March 2019. After a delay, the review has now been completed and an internal (non-public) report has been issued. The Ministry of Finance is currently processing the conclusion of the report. Considering the fact that as of the time of writing nothing has been made public, it is highly unlikely that the review will lead to changes that will affect transactions carried out in 2020.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

A reduced withholding tax rate (or no withholding tax at all) is applied on dividend distributions from a Swedish limited company to a foreign legal entity in accordance with applicable tax treaties. No withholding tax is applied when a foreign legal entity domiciled in the EU holds at least 10 per cent of the shares in the Swedish company paying the dividend,
and that company satisfies the conditions in Article 2 of the EU Parent–Subsidiary Directive; and a foreign company that is the equivalent of a Swedish company holds shares in a Swedish company, and the shares are held as a capital asset, provided the shares are not listed or, if the shares are listed, the holding of shares represents at least 10 per cent of the voting interests in the company and the shares have been held for at least one year.

A foreign company deemed to have a permanent establishment in Sweden because it receives royalty payments from Sweden may be exempt from such tax on these payments under rules based on the EU Interest and Royalties Directive.

iii Double tax treaties
Sweden has one of the most extensive tax treaty networks in the world. With a few exceptions, the treaties follow the OECD Model Tax Convention on Income and Capital. Withholding taxes are generally reduced or completely omitted under the treaties.

iv Taxation on receipt
Dividends from foreign companies are generally treated the same way as domestic dividends, and thus are often tax free under the participation exemption rules (see Section V).

Other cross-border income is generally subject to taxation in Sweden. To the extent a Swedish company has paid tax on income in another jurisdiction, such tax is normally deducted from or credited against Swedish tax paid on that income.

VII TAXATION OF FUNDING STRUCTURES
i Thin capitalisation
There are currently no formal thin capitalisation or debt-to-equity rules in Sweden. Compulsory liquidation will, however, be triggered under the Swedish Companies Act if the equity falls below 50 per cent of the registered share capital unless the equity is immediately restored to an amount corresponding to at least the entire registered share capital. Hence, it is often recommended to keep the registered share capital limited compared to the amount of share premium or free equity.

Furthermore, as of 1 January 2019, Sweden has introduced earning stripping rules. The rules are based upon the EU Anti-Tax Avoidance Directive (ATAD), which in turn is based upon base erosion and profit shifting (BEPS) Action 4. The new rules limit interest expense deductions to – much simplified – net interest expenses of up to 30 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA). This limitation only applies – also much simplified – to net interest expense exceeding 5 million kronor (in a group). Equalisation of interest deduction capacity within a group is possible, provided the companies qualify for Swedish tax consolidation. Negative net interest not possible to deduct in one year may be carried forward for up to six years, but is forfeited in the event of a change of control.

ii Deduction of finance costs
Interest accrued on third-party loans is generally tax deductible provided the interest is not related to profits or distribution of profits.

Interest between affiliated parties must be at arm’s length to be deductible. Interest paid between affiliated companies that are in excess of an arm’s-length interest rate is not
tax deductible to the extent it exceeds an arm’s-length interest rate. Provided the interest on intercompany loans is properly benchmarked and documented, interest costs are normally deductible.

There are interest deduction limitation rules in Sweden covering intercompany loans between affiliated companies and interest costs on such loans. Expenses related to such a loan will only – much simplified – be tax-deductible if the beneficial owner of the interest is taxed at a level of at least 10 per cent, and the loan was not exclusively, or as good as exclusively (at least 90 per cent), put in place for tax reasons.

The scope of the interest deduction limitation rules covers all loans from affiliated companies regardless of the purpose of the loan. Companies are considered to be affiliated if they could be seen as predominantly jointly managed, or if one of the companies, directly or indirectly, has significant influence over the other company.

A company is defined as a legal entity or as a Swedish partnership. Foreign equivalents also fall under the definition in the Swedish Income Tax Act of a company if the association has the ability to acquire rights and undertake obligations; the ability to institute legal obligations before a court and other authorities; and separate partners cannot freely dispose over the association’s assets.

Finally, an interest deduction restriction in the form of anti-hybrid rules was also introduced as of 1 January 2018. The rules target related-party debt in cross-border situations where a company in another state obtains a tax deduction for the same interest expense or when the corresponding interest income is not subject to tax owing to the classification of the income for tax purposes. There is currently a proposal to broaden the scope of the anti-hybrid rules to also cover tax effects of, for example, disregarded entities and permanent establishments, certain hybrid financial instruments and ‘double dips’ (i.e., costs being deductible in more than one jurisdiction). This is likely to come into force as of 1 January 2020.

**iii Restrictions on payments**

Dividend distributions (including a reduction of the share capital for repayment or other transfers benefiting the owners) or other transfers not of an entirely commercial nature for the company must be fully covered by the company’s restricted equity after the transfer. Furthermore, the transfer must be defensible taking into consideration the requirements imposed by the nature, scope and risks of the business.

**iv Return of capital**

A distribution to shareholders in connection with a reduction in the share capital without a reduction of the number of shares is taxed as a dividend. A reduction in the share capital in connection with a reduction of the number of shares is, as a general rule, taxed as if the shares have been divested. Exceptions apply to certain closely held companies and with regard to taxation of foreign shareholders insofar as a reduction in the share capital in connection with a reduction of the number of shares is treated as a dividend for tax purposes.

As a main rule, companies are not allowed to acquire their own shares. Certain exceptions apply to listed companies.
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Local Swedish acquisition vehicles are usually established as limited companies. The acquiring company is normally financed through a combination of equity, external loans and shareholder loans. As previously mentioned, Sweden does not have thin capitalisation rules, so generally equity is kept fairly low. Interest deduction limitations rules (including the new earning stripping rules) may, however, limit the tax deduction of interest paid; see Section VII.

The acquisition vehicles and the target company are often merged to get the acquisition financing into the target company. Should this not be done, the financing costs may still be set off against the taxable income in the target company in subsequent years using group contributions with fiscal effects; see Section III.

ii Reorganisation
Swedish tax law provides for a number of tax-neutral restructuring measures.

Under a merger, one or more limited companies transfer all of their assets and liabilities to another company and are subsequently dissolved without liquidation; or two or more limited companies transfer all of their assets and liabilities to a newly formed company and are subsequently dissolved without liquidation. Correctly structured, a merger should in most situations not trigger any adverse tax consequences. Cross-border mergers are possible, but only tax-exempt if the transferred business remains taxable in Sweden (i.e., is allocated to a permanent establishment in Sweden).

Under a share-for-share exchange, a company acquires shares in another company in exchange for payment in the form of shares in itself. Correctly structured, a share-for-share exchange does not trigger any immediate tax consequences. For the seller, the tax base of the sold shares is transferred to the new shares while any cash payment is taxed in its entirety.

A demerger occurs where one limited company transfers all of its assets and liabilities to two or more limited companies and is subsequently dissolved without liquidation. Correctly structured, a demerger should in most situations not trigger any adverse tax consequences.

An intra-group sale below fair market value occurs when a limited company transfers assets at a price below fair market value to another limited company within the group. Correctly structured, an intra-group sale below fair market value does not trigger any adverse tax consequences. Cross-border sales are possible, but only tax-neutral if the transferred assets remain taxable in Sweden (i.e., are allocated to a permanent establishment in Sweden).

A ‘Lex Asea dividend’ is when a listed limited company transfers all of the shares in a subsidiary to the shareholders through a dividend distribution. Correctly structured, a Lex Asea dividend does not trigger any adverse tax consequences. For the shareholders, the tax base of the shares is apportioned between existing shares and the new shares received.

iii Exit
Exits are usually structured though a tax-exempt sale of Swedish shares; see Section V. Capital gains in an asset sale constitute taxable income.
IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Substance over form

The substance over form concept is somewhat unclear in Swedish tax law. It is sometimes called recharacterisation, relabelling or general assessment. It is not clear if substance over form is to be seen as a label to be used for all of these ‘principles’. When applying these ‘principles’, there is, however, one common denominator: legal actions are recharacterised and taxed accordingly.

It is our interpretation that a substance over form view means that legal actions are analysed from a civil law point of view. Should the true meaning of the legal action be other than the one suggested by the involved parties, the courts may recharacterise the legal actions and, thus, tax them according to their true substance. According to this interpretation, no special substance over form view exists for tax purposes; instead, the civil law substance of actions taken should determine the fiscal effects.

Furthermore, when the concept of substance over form is examined, discussions sometimes tend to focus on chains of transactions that are pre-planned, preordained, or both, where some of the transactions have no real meaning or seem pointless unless all of the transactions are viewed as a whole. The fact that a chain of events is pre-planned is generally not enough to recharacterise the events using a substance over form view as long as each transaction entitles the parties’ true rights (or duties) for a certain period of time.

Tax Avoidance Act

According to the Tax Avoidance Act, legal action should not be considered if:

- the legal action, alone or together with other legal actions, is a part of a procedure resulting in a substantial tax benefit for the tax subject;
- the tax subject has directly or indirectly taken part in the legal action or actions;
- the tax benefit, considering the circumstances, can be assumed to be the main reason for the procedure; and
- taxation on the basis of the procedure would be in conflict with the purpose of the law, as clear from the tax rules’ general design and from the rules directly applicable or circumvented by the procedure.

The Tax Avoidance Act is only applicable if all of the above prerequisites are fulfilled. If fulfilled, taxation should be made as if the legal actions had not been undertaken. If the procedure, considering the economic outcome, appears to be a detour in comparison to the procedure closest at hand, then the tax subject will be taxed as if the tax subject had chosen that procedure instead.

The rules in the Tax Avoidance Act, its preparatory works and the relevant case law are considered exceedingly difficult to interpret and very vague, foremost because it has to be determined whether something that cannot yet be derived from the applicable laws shall be considered to be encompassed by the purpose of the law under the general design of the law. In the preparatory works of the Tax Avoidance Act, it is emphasised that it is first and foremost the general design of the laws, and not their preparatory works, that shall be used when interpreting the law.
ii Controlled foreign corporations (CFCs)
A Swedish taxpayer directly or indirectly controlling at least 25 per cent of a foreign legal entity's equity or voting interest may be taxed for the foreign company's taxable result if the foreign legal entity is low-taxed (CFC taxation).

Income is considered to be low-taxed if the net income, calculated on the basis of the rules that would apply to taxation if the entity was Swedish, is subject to less than approximately 11.8 per cent tax. The net income is not deemed to be low-taxed if the foreign legal entity is domiciled and subject to taxation in a country identified on a 'white list'. Furthermore, CFC taxation within the European Economic Area (EEA) is limited to financing and insurance of risks encountered by associated companies.

A legal entity domiciled in a state within the EEA that conducts commercially motivated activities from an actual establishment is excluded from CFC taxation.

As of January 2020, the CFC rules will be further tightened. Several jurisdictions will be deleted from the ‘white list’, and further exceptions from the remaining ‘white list’ will be introduced for insurance and financial business in certain jurisdictions, for example.

iii Transfer pricing
Cross-border transactions between companies that are associated must be carried out on an arm's-length basis. Otherwise, the Swedish company will be taxed as if the transactions had been carried out on market terms.

The Swedish transfer pricing rules are, essentially, worded in accordance with the corresponding provisions in the OECD framework.

As of 2007, Sweden implemented transfer pricing documentation rules. Hence, the pricing mechanism of all cross-border transactions between related parties must be appropriately documented. In October 2016, the government submitted a proposal to extend these rules by incorporating country-by-country reports based on the OECD BEPS project and EU Directive 2011/16/EU (DAC 4). The new rules came into force in 2017 and are applicable to companies that are part of a multinational group with a turnover exceeding 7 billion kronor.

iv Tax clearances and rulings
See Section III.

X YEAR IN REVIEW

During 2019, the total tax pressure has been slightly reduced from 44.4 to 43.8 per cent of gross national product. The most significant change in 2019 was the introduction of earning stripping rules (and other adaptations to ATAD) and the reduction of the corporate income tax from 22 to 21.4 per cent. There was also a minor reduction on tax on pensions.

XI OUTLOOK AND CONCLUSIONS

Going forward, the most notable change in 2020 will arguably be that the highest margin tax rate for tax on salary income and capital income from closely held companies will be lowered from 60 to 55 per cent as of 1 January 2020. Other changes that will, or are expected, to
come into force in 2020 are stricter hybrid rules and stricter CFC rules: DAC 6 will also need to be implemented. Corporate income tax is expected to be lowered from 21.4 to 20.6 per cent as of 1 January 2021.

It is also likely that the government investigation into withholding tax will eventually lead to certain changes, but it is too early to speculate when and how.

Finally, on 31 August 2019, finance minister Magdalena Andersson held a press conference in which she stated that the government intends to introduce a new ‘bank tax’ in 2022. There is currently no information available on how such a tax will be shaped.
I INTRODUCTION

Switzerland is a federal democracy. As such, corporate taxes are levied on the federal, cantonal and communal levels.

Switzerland is a stable, liberal country with a business-friendly environment, relatively low corporate income tax and an extensive double tax treaty (DTT) network.

Previously, Switzerland had special cantonal statuses for holding companies and administrative companies. However, these special cantonal statuses were abolished as of 1 January 2020, when the Tax Reform and Social Security Funding Act (the Tax Reform Act) entered into force. To keep Switzerland attractive to businesses, the Tax Reform Act provides other benefits, such as IP boxes, and most cantons lowered their ordinary corporate income tax rates.

Additionally, tax rulings allow businesses to secure a specific tax treatment prior to relocating to Switzerland. Additionally, tax rulings may inform businesses of the tax consequences related to specific transactions.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

The most common corporate structures in Switzerland are the company limited by shares and the limited liability company (LLC). However, large companies, with the exception of US multinational enterprises (MNEs) (check the box), generally do not use LLCs.

Companies limited by shares require a minimum share capital of 100,000 Swiss francs, while LLCs require a minimum share capital of 20,000 Swiss francs.

Although less common than the two aforementioned types of companies, Swiss law also permits partnerships limited by shares.

Companies are legal persons, and thus are subject to Swiss taxes. Direct corporate taxes include federal and cantonal corporate income tax and cantonal capital tax. Companies are also responsible for collecting withholding tax on dividend distributions.

ii Non-corporate

Non-corporate entities include general partnerships and limited partnerships. They are rarely used by large businesses, because general partners must be individuals.

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1 Frédéric Neukomm and Floran Ponce are partners at Lenz & Staehelin.
Collective investment schemes include investment companies with variable capital (open-end), fund contracts (open-end) and limited partnerships for collective investments (closed-end).

The above structures are transparent for income tax purposes (except for real estate funds), so the assets and income derived therefrom are attributed to the partners or fund participants based on their share of the partnership or fund; Swiss collective investment schemes must pay withholding tax on the income they realise (irrespective of whether that income is distributed or accumulated).

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Corporate taxpayers are subject to corporate income tax on worldwide income, with the exception of income from foreign immovable property, permanent establishments and business enterprises. Corporate income tax is levied on the net profit.

In principle, the taxable income is the same as the profit listed in statutory financial statements, which is determined on an accrual basis. Generally, all expenses are deductible, provided they are commercially justified. Corrections are allowed when tax law stipulates that a value different from that in the books of account should be used. For instance, if the tax authorities consider depreciations or provisions excessive, they will be reduced or denied.

Companies may record depreciations using either the declining-balance method or the straight-line method, but for tax purposes certain minimum rates must be respected (e.g., for industrial buildings, 3–4 per cent using the declining-balance method and 1.5–2 per cent using the straight-line method, for intangibles, 40 per cent using the declining-balance method and 20 per cent using the straight-line method).

A provision for one-third of the inventory value is permitted for federal and cantonal tax purposes. Further provisions for liabilities and dubious receivables are allowed if commercially acceptable. The standard amount is 5 per cent for Swiss receivables and 10 per cent for foreign receivables.

If a company concludes a contract with a shareholder or related party, it must be at arm’s length. If not, consideration in excess of the arm’s-length consideration is reclassified as a constructive dividend. Amounts reclassified as constructive dividends are not considered justified expenses, so they cannot be deducted from the company’s taxable profit. Additionally, withholding tax (35 per cent) may be levied on the constructive dividend.\(^2\)

Capital and income

As a rule, both income and capital profit are subject to federal, cantonal and communal corporate income taxes.

However, income (e.g., dividends) from and capital gains on qualifying participations benefit from participation relief.

Participation income is eligible for participation relief if the receiving company owns at least 10 per cent of the equity in the distributing company, if the participation is worth at least 1 million Swiss francs (for dividends) or if the receiving company is entitled to at least

\(^2\) See Section VI.i.
10 per cent of the distributing company’s profit and reserves. Participation relief is granted for capital gains if one of the above conditions is fulfilled and the participation has been held for at least one year.

Additionally, some cantons levy a separate real estate capital gains tax on gains arising from the sale of real estate in lieu of ordinary cantonal and communal corporate income tax.

**Losses**

Under Swiss tax law, losses may be carried forward for seven years; there are no provisions for carry-back. Losses must be carried forward using the first in, first out (FIFO) method.

Older losses (more than seven years) may be carried forward during a financial restructuring due to insolvency, if carrying forward said losses will allow the company to balance its books of account.

Losses survive changes in ownership. Additionally, in the event of a merger, the losses from both companies may be carried forward, except in the case of tax avoidance or abuse of a right (e.g., merger with a company that has liquidated most or all of its assets).

**Rates**

The federal corporate income tax rate is 8.5 per cent on profit after tax; cantonal and communal corporate income tax rates vary.

Many cantons reduced their corporate income tax rates when the Tax Reform Act entered into force on 1 January 2020. For instance, the new effective rates are: 13.04 per cent in Basle; 13.99 per cent in Geneva; 13.79 per cent in Lausanne (Vaud); 11.91 per cent in Zug; and 18.19 per cent in Zurich (federal, cantonal and communal taxes included).

**Administration**

The federal tax authority is the Federal Tax Administration (FTA). The FTA is responsible for federal taxes, including withholding tax. Each canton has its own tax authorities; the cantonal tax authorities are responsible for income tax, including federal income tax.

Taxpayers are required to file an annual tax return during the three months following the close of the business year; extensions may be requested.

Both the tax authorities and the taxpayer participate in the tax assessment process; taxes are assessed based on the tax return submitted by the taxpayer.

The tax authorities are responsible for determining relevant facts and applicable legal provisions. They are allowed to conduct investigations, including inspections of the books of accounts and any supporting documents. The tax authorities determine the taxes due; this decision is communicated to the taxpayer in writing and includes the tax basis, tax rate and taxes due.

Tax assessments can be challenged before the tax authorities (formal complaint). If the dispute is not resolved, the taxpayer can appeal; the matter then goes to court (federal or cantonal, depending on the matter being appealed). The Swiss Federal Supreme Court is the highest Swiss court.

Tax rulings are very common in Switzerland. However, certain types of rulings are now subject to spontaneous exchange under spontaneous exchange of information agreements and in accordance with the base erosion and profit shifting (BEPS) rules.
Tax grouping
Swiss tax law does not allow for tax consolidation (except for VAT). Companies that are part of a group are taxed as individual companies, subject to ordinary tax rules.

ii Other relevant taxes

Capital tax
Capital tax is a direct tax that is levied on companies’ net equity (paid-up capital, as well as open reserves and taxed hidden reserves). Capital tax is levied annually and rates vary (0.001–0.525 per cent) between cantons. Some cantons permit corporate income tax to be credited against capital tax, meaning capital tax is levied only if it exceeds the cantonal corporate income tax due. There is no federal capital tax; it is only levied by the cantons.

In the event of thin capitalisation, the part of the loan reclassified as equity is subject to capital tax.3

Issuance stamp duty
Issuance stamp duty is levied on capital contributions from shareholders to Swiss companies, meaning it is levied on both the initial creation of share capital as well as subsequent increases of share capital and contributions without issuance of new shares. Stamp duty is levied at 1 per cent. The first 1 million Swiss francs in share capital is exempt from stamp duty. Exemptions are also granted following a merger or similar restructuring.

Transfer stamp duty
Transfer stamp duty is levied when there is a transfer against consideration of a security subject to stamp duty and the transfer involves a Swiss securities dealer. Securities subject to stamp duty include Swiss and foreign bonds, shares, participation certificates, dividend rights certificates and units in collective investment schemes. A Swiss securities dealer is defined as a bank, securities trader or professional intermediary (individual or legal person) or a company holding over 10 million Swiss francs in taxable securities. Transfer stamp duty is levied at 0.15 per cent for securities issued by Swiss residents and 0.3 per cent for foreign securities.

VAT
The ordinary VAT rate is 7.7 per cent. VAT on accommodation is 3.7 per cent and VAT on essential goods is 2.5 per cent.

Payroll taxes
A social security contribution of 10.25 per cent is levied on employment income; half is paid by the employer and half is paid by the employee (via withholding). Unemployment insurance is also levied on employment income.

Additionally, employers are required to levy tax at source on salaries paid to employees not resident in Switzerland or to foreign employees without a long-term resident permit.

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3 See Section VII.i.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence
Companies with either their statutory seat or their place of effective management in Switzerland are considered Swiss tax residents for tax purposes.

A company is considered to have its place of effective management in Switzerland if its economic centre is located in Switzerland.

In determining the economic centre, the tax authorities consider a variety of factors and the presence of multiple connecting factors with Switzerland is sufficient to consider that the place of effective management is in Switzerland. The predominant factor is the place where management is carried out (i.e., the day-to-day actions required to carry out the company's statutory purpose). Secondary factors include the place where fundamental decisions are made and the place where administrative work (e.g., accounting, correspondence) is carried out. A passive company's (e.g., a group financing company) place of effective management is where its strategic decisions (e.g., decisions about refinancing, loans and loan conditions) are made.

The place of effective management for companies created by individuals for asset management purposes is the jurisdiction in which the controlling individual or individuals reside.

ii Branch or permanent establishment
Non-resident companies are liable to Swiss corporate income tax and capital tax on income and capital allocated to a Swiss permanent establishment.

For Swiss direct tax purposes, the definition of permanent establishment is similar to the definition in the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital (the OECD MC). It is defined as a 'fixed place of business through which the business of an enterprise is wholly or partly carried on' (Article 51, paragraph 2 of the Swiss Federal Income Tax Act of 14 December 1990). Examples include branches, factories, dependent agents with a fixed place of business and construction projects lasting at least 12 months.

Switzerland has an extensive network of DTTs, most of which follow the OECD MC, which provide allocation rules for permanent establishments.

Swiss tax rules stipulate that the direct (objective) method should be used when determining a Swiss permanent establishment's profit. The Swiss permanent establishment's profit is thus based on its books of account and is independent of the entity's total profit.

Switzerland does not levy branch profit tax. Consequently, the remittance of branch profits to a foreign company with its place effective management outside of Switzerland is not subject to Swiss withholding tax.
V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
Previously, holding companies were exempt from cantonal and communal corporate income taxes, with the exception of income and capital gains from Swiss real estate. However, when the Tax Reform Act entered into force on 1 January 2020, the special cantonal statuses (i.e., holding companies and administrative companies) were abolished. Nevertheless, companies will continue to benefit from participation relief for qualifying participations.

Federal corporate income tax participation relief
As explained above, qualifying participation income and capital gains on qualifying participations benefit from participation relief.4

ii IP regimes
Previous IP regimes included mixed companies, principal companies and holding companies, which were abolished by the Tax Reform Act. The Tax Reform Act includes a mandatory cantonal patent box regime as a replacement measure for the elimination of the special tax statuses. The patent boxes are limited to patents and similar rights; copyrighted software is not included.

The cantonal patent boxes use the OECD-compliant modified nexus approach, which requires a direct nexus between the income taxed at the preferential rate and the activity that generated that income; the patent boxes allow for an uplift of qualifying expenditure. The cantonal tax boxes may provide tax relief for up to 90 per cent of patent-related income. For instance, the cantons of Basle-City, Zug and Zurich grant tax relief for 90 per cent of patent-related income, while the canton of Geneva grants tax relief for only 10 per cent; the canton of Vaud has yet to publish its patent box provisions. However, total tax relief from Tax Reform Act deductions (e.g., patent box, R&D deductions, step up) is limited to 70 per cent of a company's taxable profit.

iii State aid
State aid is granted in the form of federal and cantonal tax holidays. The Swiss Federal Act on Regional Policy provides federal tax incentives for creating or preserving jobs in certain regions of Switzerland. Tax relief is limited to an annual amount of 95,000 Swiss francs per job created or 47,500 Swiss francs per job preserved, for a maximum of 10 years. The companies profiting from such tax relief and the number of jobs to be created or preserved are made public.

Cantal tax holidays are granted for up to 10 years, but contrary to the federal tax holidays, cantonal tax holidays are not restricted to specific economic sectors or geographical areas. Cantonal tax holidays are based on the nature of the planned investment, its economic importance to the canton and the number of new jobs the company will create. Tax relief can take the form of a full or partial exemption from cantonal and communal corporate income and capital taxes.

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4 See Section III.i.
Manufacturing and industrial businesses typically qualify for tax holidays. Other businesses (e.g., commercial, finance, services) may qualify if they complement existing local business and industries and create significant new employment opportunities.

### iv General

Switzerland has relatively low corporate income tax rates and, currently, businesses relocating to Switzerland can benefit from the aforementioned special cantonal statuses. On 1 January 2020, when the Tax Reform Act entered into force, the special cantonal statuses were abolished, but most cantons lowered their corporate income tax rates as compensation.

Further, Switzerland’s extensive DTT network eliminates many instances of double taxation, and dividends paid by Swiss resident companies are often eligible for a full or partial refund under a relevant DTT.

Additionally, the Tax Reform Act includes a step up for foreign companies relocating to Switzerland; companies will be able to disclose their unrealised gains without Swiss tax consequences and additional depreciation deductions will be granted during the initial few years following relocation to Switzerland.

### VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

#### i Withholding on outward-bound payments (domestic law)

Swiss companies must levy a 35 per cent withholding tax on profit distributions (including constructive dividends and liquidation proceeds) to shareholders or related parties, irrespective of whether the beneficiary is a Swiss tax resident.

Although interest on bonds and other debt certificates issued by Swiss companies is subject to Swiss withholding tax, generally, withholding tax is not levied on interest paid on private loans.

Under the 10/20/100 non-bank rule, loans from 10 non-bank lenders with identical terms (loan debentures) and loans from 20 non-bank lenders with variable terms (cash debentures) are treated as bonds, provided that the financing exceeds 500,000 Swiss francs. Exceptions exist for intercompany loans.

Further, a company shall be deemed a bank for withholding tax purposes if it has at least 100 non-bank lenders or private placements, or both, and its financing or placements, or both, exceeds 5 million Swiss francs. Interest paid by banks is subject to withholding tax; some exceptions apply.

Royalty payments are not subject to withholding tax.

#### ii Domestic law exclusions or exemptions from withholding on outward-bound payments

Swiss taxpayers (companies and individuals) may request a withholding tax refund. The refund will be granted if certain conditions are fulfilled (e.g., the taxpayers have fulfilled all of their reporting obligations).

Non-resident taxpayers may claim a partial or total refund of Swiss withholding tax if there is a DTT between Switzerland and their country of residence.

A simplified notification procedure can be requested for intra-group distributions to Swiss parent companies or to parent companies resident in a DTT country.
iii Double tax treaties

Switzerland has an extensive network of DTTs, most of which closely follow the OECD MC. Switzerland has concluded treaties with over 80 jurisdictions, including most European countries, the United States, Russia, Japan and China. On 17 July 2019, the United States Senate ratified the 2009 Protocol to the DTT between Switzerland and the United States.

Additionally, an agreement between Switzerland and the European Union eliminates withholding tax if the parent company has directly held 25 per cent or more of the subsidiary’s share capital for at least two years.

To qualify for treaty benefits, certain conditions must be met. The foreign parent company must be the beneficial owner of the dividend income. Further, the withholding tax refund will not be granted if the FTA determines that there is DTT abuse. In assessing whether a structure is abusive, the FTA examines whether there is sufficient capitalisation (30 per cent) and whether the parent company has substance (personnel and premises) in its country of residence. Generally, holding companies must demonstrate that they hold multiple companies, not just the Swiss company requesting treaty relief.

**Maximum withholding tax rates**

<table>
<thead>
<tr>
<th>State</th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ordinary maximum (per cent)</td>
<td>Minimum required ownership in subsidiary (per cent)</td>
<td>Holding period (years)</td>
</tr>
<tr>
<td></td>
<td>Maximum on distributions from a subsidiary (per cent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>10</td>
<td>5</td>
<td>25</td>
</tr>
<tr>
<td>France</td>
<td>15</td>
<td>0</td>
<td>10</td>
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<tr>
<td>Germany</td>
<td>15</td>
<td>0</td>
<td>10</td>
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<tr>
<td>Italy</td>
<td>15</td>
<td>15</td>
<td>N/A</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
<td>5/0</td>
<td>10/50</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>15</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Netherlands</td>
<td>15</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>Russia</td>
<td>15</td>
<td>5</td>
<td>20 (at least 200,000 Swiss francs)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>15</td>
<td>0</td>
<td>10</td>
</tr>
<tr>
<td>United States</td>
<td>15</td>
<td>5</td>
<td>10</td>
</tr>
</tbody>
</table>

iv Taxation on receipt

As a rule, Swiss treaties use the exemption method to eliminate double taxation; however, the credit method is used for foreign source dividends, interest and royalties.

As previously explained, participation relief is available under certain conditions.\(^5\) No credit is granted if the income is exempted under participation relief provisions.

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\(^5\) See Section III.i.
VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
Swiss federal and cantonal tax rules contain thin capitalisation safe harbour provisions (maximum debt rule per asset class based on their book or fair market value); for example, 100 per cent for cash, 85 per cent for accounts receivable and inventory, 70 per cent for investments in subsidiaries, 50 per cent for furniture and equipment, 70 per cent for property and plants (commercially used) and 70 per cent for intangibles.

Furthermore, the FTA publishes annual safe harbour interest rates for loans granted to related parties. Interest paid on debt exceeding the maximum allowable debt and interest rates exceeding the safe harbour rates are reclassified as constructive dividends if paid to a shareholder or related party. Consequently, such interest is not a deductible expense for federal and cantonal income tax purposes and is subject to withholding tax at a rate of 35 per cent (which may be reduced under an applicable tax treaty).

However, the rules set out above are merely safe harbour rules and the taxpayer may prove that a different arm’s length debt-to-equity ratio or interest rate should be used.

ii Deduction of finance costs
As mentioned above, companies may not pay interest on loans from shareholders or related parties in excess of what would be paid to an unrelated third party. Generally, there are no other restrictions on interest deductions. In particular, Switzerland has not adopted BEPS Action 4 limiting interest deductions.

In the case of a leveraged acquisition, the absence of consolidated taxation for company groups means interest on the acquiring company’s debt cannot be deducted by the target company if the latter does not have operational income. Further, the Swiss tax authorities may treat debt push down strategies in a leveraged acquisition as tax avoidance.7

iii Restrictions on payments
Swiss company law states that dividends ‘may be paid only from the disposable profit and from reserves formed for this purpose’ (Article 675 of the Swiss Code of Obligations). Thus, interim dividends are not permitted.

Swiss accounting rules permit a parent company to temporarily record dividends paid by a subsidiary in the business year in which the subsidiary earned the profit distributed as dividends, rather than in the year in which the subsidiary decided on the dividend amount. This practice is accepted by the Swiss tax authorities provided that upon distribution the dividends are recorded in the income statement and certain procedural conditions are met.

iv Return of capital
Repayments of capital contributions are not subject to withholding tax and are tax-exempt for individuals who are Swiss tax residents; this includes both share capital and share premium. Share premium can be distributed without capital reductions. However, share premium must be listed in a clearly marked capital contribution reserve and validated by the FTA.

6 See Section VII.i.
7 See Section VIII.i.
Further, the Tax Reform Act limits listed companies from distributing capital contribution reserves, unless they first distribute an equal or greater dividend, or the capital contribution reserves were created during an inbound relocation (to Switzerland).

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Acquisition vehicle

Acquisitions can be carried out using a local or non-local entity.

When using a foreign parent company to acquire a Swiss company, investors should ensure that the foreign parent company is located in a jurisdiction that has a DTT with Switzerland so as to reduce or eliminate withholding tax on dividend distributions. Otherwise, it is advisable to use an intermediary holding company located in a jurisdiction that has a DTT with Switzerland, provided it complies with the criteria for treaty relief.\(^8\)

Additionally, investors should be aware of the ‘old reserves theory’. Under this theory, if a foreign shareholder transfers shares in a Swiss company to a shareholder located in a jurisdiction with a more favourable DTT, withholding tax may continue to be levied on distributable reserves existing at the time of the transaction at the same rate applicable to a tax resident of the first jurisdiction if at the time of the transfer, the company had commercially distributable reserves and assets not economically required.

Acquisition structure

Acquisitions may be structured as either a share deal or an asset deal.

Asset deals tend to be more favourable for buyers, because a step-up in basis is allowed, while share deals are beneficial for sellers, in particular for individual sellers, because individuals are not subject to tax on gains arising from private assets, but are subject to income tax on dividends.

Asset deals permit the company to record part of the purchase price as goodwill. Payment in excess of the assets’ market value is recorded as goodwill; goodwill can be depreciated.\(^9\)

Transferred assets may be subject to VAT and transfer stamp duty (for transfers of securities).

In the case of a share deal, the purchase price is recorded in the books of account as the share value. This value cannot be decreased (unless the market value decreases). If the buyer or seller is a professional securities dealer then transfer stamp duty will be levied.

Special attention must be paid to rules concerning indirect partial liquidation and transposition during share deals involving sales by individuals resident in Switzerland, because tax-free capital gains can be retroactively reclassified as taxable participation income.

The criteria for indirect partial liquidation are: (1) sale of at least 20 per cent of the share capital in a Swiss or foreign company to a third party; (2) the shares are transferred from the seller’s private assets to a company or to the acquirer’s business assets (in the case of acquisition by an individual); (3) the target company has commercially distributable reserves at the moment of the transfer and assets beyond those required to run the business; and (4) these assets are distributed to the acquirer during the five years following the acquisition.

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\(^8\) See Section VI.iii.

\(^9\) See Section III.i.
Generally, indirect partial liquidation can be avoided by adding a clause to the share purchase agreement that prevents distributions during the five years following the transfer.

Transposition occurs under the following conditions: (1) transfer of share capital of a company from the private assets of an individual to a partnership or company in which said individual holds at least 50 per cent of the capital after the transfer; and (2) the consideration is worth more than the nominal value of the transferred shares.

Income resulting from transposition is taxed as participation income, rather than as a capital gain.

**Financing structure**

Financing can be provided through either equity or debt.

Stamp duty is levied on the creation of equity in excess of the 1 million Swiss francs exemption. Additionally, there is no notional interest deduction.

Ordinarily, interest on debt is a tax-deductible expense.

As previously mentioned, loans granted by shareholders and related parties must be at arm's length. Further, thin capitalisation will result in increased corporate income taxes and capital tax.

As mentioned above, debt pushdown in a leveraged acquisition may be regarded as tax avoidance by the Swiss tax authorities, so an acquisition company cannot acquire a target company, merge with it and then deduct interest on loans taken out by the target company. If the Swiss tax authorities consider the debt push down to be tax avoidance, interest on the loan may not be deducted.

If the acquiring company intends to acquire multiple target companies, one solution is to structure the acquisition as a cascade purchase. In a cascade purchase, a target company first acquires another target company, which in turn acquires another target company, and so on. Because the target companies have operational income and assets that can be leveraged, they can take out loans to fund the acquisition of other target companies and deduct the interest on these loans.

**ii Reorganisation**

In principle, reorganisations (mergers, demergers, conversions and the transfer of assets) are tax-neutral. The following conditions must be respected for a reorganisation to be tax-neutral: (1) the company remains subject to tax in Switzerland; and (2) there is no re-evaluation of commercial assets.

Additionally, in the event of a demerger, a business unit or part of a business unit must be transferred. Likewise, the intra-group transfer of assets is tax-free, but only for operational assets; there is blocking period of five years (participations and assets that were part of the reorganising cannot be sold for five years).

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10 See Section III.ii.
11 See Section VII.i.
12 See Section VII.ii.
iii Exit

In the event of a reorganisation that leads to downsizing or closing Swiss operations, all transactions between associated enterprises resulting from the reorganisation must be at arm’s length, as enumerated in Chapter IX of the OECD Transfer Pricing Guidelines.

Exit tax is levied on hidden reserves upon emigration. Likewise, withholding tax is levied on distributable reserves and hidden reserves. The Tax Reform Act provides a clear legal base for levying exit tax on hidden reserves.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

In Switzerland, general anti-avoidance rules (GAARs) are not contained in a specific act. However, the Swiss Federal Supreme Court has developed a general principle of tax avoidance and abuse of rights, applicable to all Swiss taxes. In accordance with this principle, in certain situations, tax authorities have the right to tax a taxpayer’s structure based on its economic substance, rather than its legal structure.

According to case law, there is tax avoidance if: (1) the taxpayer has chosen an abnormal structure; (2) it was done with the intention to save on taxes; and (3) the taxpayer would save on taxes if permitted to use the structure.

ii Controlled foreign corporations (CFCs)

Switzerland does not have CFC rules. However, the case law of the Swiss Federal Supreme Court stipulates that a company whose statutory seat is located abroad, but has little or no substance abroad and is effectively managed from Switzerland, may be deemed a Swiss taxpayer.

iii Transfer pricing

The Swiss tax code contains very few rules relating to transfer pricing.

The Swiss tax authorities do not require specific transfer pricing documents, but Swiss tax law states that a company’s expenses must be commercially justified and that profits not shown in the company’s profit and loss statement still must be included in the taxable profit. Based on these general rules, Swiss tax authorities can correct intra-group transactions that are not at arm’s length. In determining whether an intra-group transaction is at arm’s length, the Swiss tax authorities follow the OECD Transfer Pricing Guidelines.

It is possible to request an advance pricing agreement from the Swiss tax authorities; the competent authority is the State Secretariat for International Financial Matters.

iv Tax clearances and rulings

Tax rulings are common in Switzerland and help eliminate uncertainty and avoid future disputes.

Generally, it is recommended to request a ruling before entering into a complex transaction or other situation where tax uncertainty could arise.

Rulings concerning tax planning or preferential tax regimes are now automatically exchanged under automatic exchange of information agreements and in accordance with the BEPS rules. This has led to a reduction in the number of rulings, some of which were
not necessary in the first place. Conversely, rulings concerning the treatment of specific transactions, generally, are not part of the automatic exchange of information and continue to be commonplace.

X   YEAR IN REVIEW

Switzerland offers a stable, BEPS-compliant environment for companies looking to make inward investments.

Switzerland is committed to implementing the BEPS minimum standards. On 7 June 2017, Switzerland signed the OECD’s Multilateral Instrument (MLI) and on 29 August 2019, Switzerland deposited its instruments of ratification; the MLI enters into force for Switzerland on 1 December 2019.

Switzerland is a signatory to the Multilateral Competent Authority Agreement and the Common Reporting Standard and the first automatic exchanges of information started in autumn 2018. Switzerland has also signed the Multilateral Competent Authority Agreement for the automatic exchange of country-by-country reports, so starting in 2018, MNEs in Switzerland had to submit country-by-country reports; the first automatic exchanges of country-by-country reports are scheduled to take place in 2020.

Switzerland recently reformed its corporate tax system to bring it in line with OECD and EU requirements. In 2018, the Swiss Parliament adopted the Tax Reform Act, which was accepted by Swiss voters in a referendum held on 19 May 2019; the Tax Reform Act entered into force on 1 January 2020.

The EU considers the changes introduced by Tax Reform Act sufficient to bring Switzerland into compliance with EU standards. Consequently, on 10 October 2019, the EU removed Switzerland from its grey list of countries considered tax havens.

XI   OUTLOOK AND CONCLUSIONS

Swiss tax law underwent a myriad of changes when the Tax Reform Act entered into force on 1 January 2020.

The Tax Reform Act abolished the special cantonal statuses, as well as the principal company reduction and introduced mandatory IP boxes in all cantons; cantons may offer additional R&D deductions. Most cantons lowered their corporate income tax rates to compensate for the loss of the special cantonal statuses; some cantons lowered their capital tax rates.

In response to the Tax Reform Act, many Swiss companies, as well as foreign companies with a Swiss presence, are in the process of reorganising and restructuring to ensure maximum tax efficiency; we expect that this will continue well into 2020.
Chapter 31

TAIWAN

Michael Wong and Dennis Lee

I INTRODUCTION

In 2018, the Taiwan government implemented some amendments on corporate income tax to structure a fair taxation system to cope with domestic demand. Accordingly, the corporate income tax rate has been increased from 17 per cent to 20 per cent as a remedy for reduced personal income tax collections. In addition, the withholding tax rate for foreign investors has been slightly increased from 20 per cent to 21 per cent. To mitigate the implications of the above amendments, the tax rate on undistributed earnings has been decreased from 10 per cent to 5 per cent.

For the purpose of industry innovation, Taiwan offers several tax incentives in the Statute for Industrial Innovation to encourage companies to invest in R&D, Intellectual Property, 5G, etc. in exchange for income tax credit in the coming year.

In addition to the above taxes, Taiwan now has tax treaties with many major economies, including Canada, Japan, the United Kingdom, France, Germany, Switzerland, the Netherlands and Australia. However, it still does not have a tax treaty with the United States, one of its largest trading partners.

As a result of political obstacles, Taiwan’s tax authority is relatively isolated from the tax community in the rest of the world. Taiwan is not a member of the Organisation for Economic Co-operation and Development (OECD). Accordingly, Taiwan has not participated in the information exchange of the Common Reporting Standard. However, Taiwan has agreements with Japan and Australia to exchange financial and tax information.

Although the Taiwan tax authority always maintains that it generally follows OECD guidelines and practices, in reality it tends to cherry-pick OECD guidelines in its favour, and in many instances does not follow the generally accepted international interpretation of tax law. The aggressive demand for the withholding tax for cross-border payments outbound from Taiwan is the most notable example of this.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

To conduct businesses in Taiwan, a foreign company often sets up a subsidiary or a branch office in Taiwan.

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1 Michael Wong is a principal partner and Dennis Lee is a senior consultant at Baker McKenzie.
A subsidiary can be a limited company or a company limited by shares. There is a less onerous administrative and corporate maintenance burden for a limited company. However, if the foreign shareholder needs to carry out merger and acquisition projects in Taiwan, or if the Taiwan subsidiary is a joint venture, then a company limited by shares is more appropriate, because the Taiwan Company Law provides extensive corporate governance guidance for a company limited by shares (the requirements for a limited company are less sophisticated) and only a company limited by shares can participate in merger and acquisition activities under the Company Law and the Business Mergers and Acquisitions Law. Effective from 4 September 2015, a new entity type – a closely held company limited by shares – was added to the Taiwan Company Law. The reason behind adding this new variety of company limited by shares is to relax certain requirements of a traditional company limited by shares that assume that such a company will have many shareholders, and that most of these are general and small investors who need statutory protection. For instance, for a closely held company limited by shares, compared to a traditional company limited by shares, the scope of non-cash contributions is broader, there are more approaches to convene a shareholders’ meeting (i.e., a written resolution or video conference is permissible) and profits can be distributed semi-annually.

The foreign company can also set up a branch office in Taiwan to conduct business. Currently, from a business-conducting perspective, a branch is generally the same as a subsidiary. The administrative and corporate maintenance burden for a branch is even lighter than for a subsidiary. However, the main legal concern is that a branch office is part of the headquarters and is not an independent legal entity.

In practice, a branch is more popular because of tax reasons. For example, the profit of a subsidiary is subject to Taiwan corporate income tax (currently at a rate of 20 per cent), but when remitting dividends outbound from Taiwan, a 21 per cent (if no tax treaty exists between Taiwan and the destination country) withholding tax will also be imposed. On the other hand, although the profit of a branch office is subject to the same corporate income tax, there is no dividends withholding tax equivalent when the branch office remits back the profits.

ii Non-corporate

A partnership under the Civil Code is a possible format for a foreign company to conduct business activities in Taiwan. However, this is not a suitable format for a foreign company. A partnership under the Civil Code is not an independent legal entity. It is a contract between individuals or companies. As a result, partners under the partnership contract are subject to unlimited liability. This is one of the reasons why partnerships are not a popular business format. The profit earned by the partners through a partnership will be included as part of the partner’s income and subject to the partner’s income tax rate.

After the limited partnership came into effect in 2015, the limited partners’ liability has been limited to the amount of his or her capital contribution under a limited partnership agreement while the general partners should be jointly and severally liable when the assets of the limited partnership are not sufficient to meet its liabilities. There is no minimum capital requirement for partnerships. A limited partnership is considered a legal entity. All partners of a partnership and general partners of a limited partnership (after being elected) have the authority to represent the partnership unless otherwise provided by the partnership agreement.
or the resolutions of the partners and bind the partnership with respect to third parties. The equity contribution and profit-sharing percentage among partners may be provided for in the partnership agreement.

For a limited partnership, in principle, its income should be subject to the corporate income tax. However, if a limited partnership meets certain conditions regarding the capital and investing activities, pursuant to Article 23-1 of the Statute for Industrial Innovation, within 10 years from the fiscal year of establishment, it can choose to be taxed on a see-through basis.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

_Determination of taxable profit_

Taxable profits are based on accounting profits and are adjusted for by tax law. Profits are taxed on an accrual basis. In principle, taxpayers are taxed on worldwide-source profit. For any profit-seeking enterprise operating within Taiwan, profit-seeking enterprise income tax shall be levied. For any profit-seeking enterprise with its head office within Taiwan, profit-seeking enterprise income tax shall be levied on its total profit-seeking enterprise income derived from both within and outside of Taiwan. On the other hand, a branch of a foreign company is taxed only on its Taiwan-sourced income.

Depreciation is tax-deductible based on a table of service lives for various categories of assets. Service lives actually adopted cannot be shorter than those in the table, and an estimated residual value is required to calculate the annual depreciation. Depreciation methods allowed include straight line, fixed percentage on a declining base, sum of the years’ digits, units of output and service hours. Any other method adopted requires advance approval from the tax authority. Amortisation of intangibles is provided on the following useful lives: (1) operating rights: 10 years; (2) copyright: 15 years; and (3) trademarks, patents and other franchise rights: the remaining statutory lives.

_Capital and income_

Generally, all profits are taxed on an actual realised basis with only two exceptions:

_a_ Land: gains on sales of land are free from regular income tax but subject to a land increment tax based on a special formula and government-regulated prices. However, starting 1 January 2016, capital gains of foreign nationals derived from the disposition of real estate acquired after 31 December 2015 will be taxed at a rate of 45 per cent for real estate held for less than one year. This rate will be reduced to 35 per cent if the real estate is held for more than one year.

_b_ Securities: gains from the trading of securities are generally free from regular income tax but subject to an alternative minimum tax.

_Losses_

Tax losses are allowed to be carried forward for 10 years. No loss carry-back is allowed under Taiwan law.

_Rates_

The current corporate income tax rate is 20 per cent.
Administration

There is only one level of corporate income tax in Taiwan, known as the profit-seeking enterprises' income tax. An enterprise is required to pay an interim income tax based on 50 per cent of the previous year's income tax payable in the ninth month of the year. Alternatively, under certain circumstances, an enterprise can choose to pay the interim tax based on the actual operating results of the current year's first six months.

An enterprise is then required to file an annual income tax return in the fifth month of the following year. The return should be filed along with the simultaneous payment of any taxes due.

Enterprises are encouraged to have their income tax returns certified by certified public accountants (CPAs) prior to filing. Income tax returns filed with a CPA's certification are in theory less likely to be chosen for a tax audit by the tax authority. This certification involves a limited audit of the balance sheet accounts and a more extensive audit of the profit and loss accounts.

The tax authority does not have a fixed audit cycle and will only choose targets for audit randomly. The statute of limitations is five years if the tax return is filed on time and no tax fraud is involved.

It is possible to obtain advance rulings from the tax authority for clarification of tax treatments.

There are clear administrative remedy procedures to resolve disputes with the tax authority. In Taiwan, tax litigation cases are handled by two levels of administrative courts: the high administrative courts and the supreme administrative courts.

Tax grouping

Taiwan does not have consolidated tax grouping rules except for financial holding companies, and for companies that have been through a merger, acquisition or spin-off executed in accordance with the Business Merger and Acquisitions Law. All group companies with holdings over 90 per cent shall be included if tax grouping is selected. The company’s taxable income and loss are allowed to be offset with each other. Other than that, there is no other meaningful tax benefit under a tax grouping. Basically, this is simply a combination of group companies’ taxable income and loss, and thus is not a true consolidated tax grouping.

Other relevant taxes

Other than corporate income tax, business tax is the other major tax of interest to multinational companies doing business in Taiwan. Sales of goods and services in Taiwan are subject to business tax, which comes in two forms: value added tax (VAT) and gross business revenue tax (GBRT), currently at a rate of 5 per cent of gross revenues. GBRT mainly applies to financial institutions and is borne by sellers. VAT applies to other general industries, and is to be collected from buyers of goods and services by the sellers. Sales of certain products and services are exempt from VAT, whereas exports of goods and services are generally entitled to a zero rate of VAT.

Net profit not appropriated before the end of the following year will be subject to a surplus tax on retained earnings at a rate of 5 per cent. Unlike in the past, any surplus tax paid can no longer be creditable against the dividends withholding tax when the profit is subsequently distributed.
IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

Corporate residence is determined based on where the corporate entity is incorporated regardless of the place of effective management (PEM) under current law. However, Taiwan introduced a new provision regarding the PEM in July 2016 through the addition of Article 43-4 to the Income Tax Act. Prior to the amendment, only companies incorporated under Taiwan laws will be subject to corporate income tax in Taiwan, and foreign companies will not be taxed in Taiwan unless they maintain a fixed place of business or a business agent in Taiwan. With the introduction of the PEM rules, foreign companies will be taxed in Taiwan if they are construed as having their PEM within Taiwan. According to Article 43-4 of the Income Tax Act, foreign companies will be deemed Taiwan tax residents if all of the following conditions are met:

2.1 Decision makers (individual and corporate) for significant operation management, financial management, and human resource management are residents in Taiwan or incorporated in Taiwan; or such decisions are made within the territory of Taiwan;

2.2 Creation and storage or financial statements, accounting records and shareholders'/directors' meeting minutes are within the territory of Taiwan; and

2.3 Main business activities are executed within Taiwan.

Nevertheless, the effective date of this new provision is still pending.

ii Branch or permanent establishment

Foreign companies can do business in Taiwan through a branch, and will only be taxed on the profit of that branch in Taiwan. The tax will be limited to the branch’s Taiwan-sourced income, and head office expenses can be allocated to Taiwan through a special mechanism. The definition of the permanent establishment varies from treaty to treaty.

From the income tax perspective, the Income Tax Act does not provide the definition of the permanent establishment. However, the Income Tax Act has a similar concept, which is the ‘fixed place of business’ and ‘business agent’. The term ‘fixed place of business’ refers to fixed places for operation of business, including administrative offices, branch or sub-branch offices, business offices, factories, workshops, warehouses, mining fields, and construction sites; however, this shall exclude warehouse or storage sites used exclusively for purchase of goods and maintenance shops not used for processing or manufacturing products.

The term ‘business agent’ means an agent fulfilling any of the following requirements:

a where the agent, in addition to representing its principal in the purchase of goods, is authorised to regularly represent the principal in making business arrangements and in signing contracts;

b where the agent regularly keeps in store goods of its principal and delivers the same, for its principal, to others; and

c where the agent regularly accepts, for its principal, orders for goods.
V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

According to the Statute for Industrial Innovation, Taiwan offers some tax incentives to attract foreign investment.

Taiwan companies or limited partnerships can either get an income tax credit at a rate of 15 per cent of their annual R&D expenditure in the current year, or at a rate of 10 per cent of the R&D expenditure to offset the profit-seeking enterprise income tax payable in the ensuing three years. The R&D tax credit is capped at 30 per cent of the annual taxable income.

Starting from 1 January 2019, Taiwan companies or limited partnerships that have invested in brand-new smart machines for their own use or have invested in brand-new hardware, software, technology or technical services introducing 5th-generation mobile networks by spending a total of NT$1 million up to NT$1 billion in the same taxable year, the company or limited partnership may select one of the following incentives for crediting the funds so invested by it against the corporate income tax payable by it in the taxable year. Once the company or limited partnership selects an incentive, it cannot change its selection, and the creditable amount shall not exceed 30 per cent of the corporate income tax payable by it in the then-current year:

\[ a \] up to 5 per cent of the annual spending sum may be credited against the corporate income tax payable by it in the then current year; or
\[ b \] up to 3 per cent of the annual spending sum may be credited against the corporate income tax payable by it in each of the three years from the then-current year.

Starting from 1 January 2019, Taiwan companies or limited partnerships receive revenue from assignment or licensing of its intellectual property rights in its own R&D results, up to 200 per cent of its R&D expenditures in the then-current year may be deducted from the amount of its taxable income up to the amount of the above revenue in that year, and the company or limited partnership may choose between the tax credit against its R&D expenditures and the investment tax credit.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
Payments of dividends are subject to a 21 per cent withholding tax rate and payments of interest and royalties are subject to a withholding tax at a rate of 20 per cent unless there is an applicable tax treaty that offers preferential withholding rates.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
No exemption is available for payments of dividends.

Interest payments to foreign governments and interbank interest payments are free from the Taiwan withholding tax.

Royalties paid for the introduction of patents, trademarks and computer programs to 20 designated industries can qualify for an income tax exemption with advance approval from the competent authority.
### Double tax treaties

Taiwan has entered into 32 tax treaties, and the following table shows the withholding rates applicable under the respective tax treaties as of 20 November 2019. Without a tax treaty, the withholding rate for dividends is 21 per cent, whereas the withholding rate for both interest and royalties is 20 per cent.

<table>
<thead>
<tr>
<th>Jurisdiction</th>
<th>Dividends (per cent)</th>
<th>Interest (per cent)</th>
<th>Royalties (per cent)</th>
<th>Effective</th>
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<tr>
<td>Australia</td>
<td>10, 15</td>
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<td>12.5</td>
<td>1 January 1997</td>
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<td>Belgium</td>
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<td>19 December 2016</td>
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<td>10</td>
<td>31 December 2015</td>
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<td>1 January 2001</td>
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<td>Netherlands</td>
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</tr>
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<td>Singapore</td>
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<td>Nil**</td>
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<td>zero, 10</td>
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</tr>
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<td>Thailand</td>
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<tr>
<td>United Kingdom</td>
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<td>10</td>
<td>1 January 2003</td>
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<tr>
<td>Vietnam</td>
<td>15</td>
<td>10</td>
<td>10</td>
<td>1 January 1998</td>
</tr>
</tbody>
</table>

* The total tax imposed on the dividend together with profit-seeking enterprise income tax should not exceed 40 per cent of pre-tax income.
** There is no provision for a reduced withholding tax rate under the treaty.
iv  Taxation on receipt
Local dividends from one Taiwan company to another Taiwan company are free from the Taiwan income tax. In Taiwan, dividends are only taxable when they reach the hands of Taiwan individual shareholders or foreign shareholders.
Foreign dividends received by Taiwan companies are subject to the regular corporate income tax at a rate of 20 per cent. Dividends withholding tax paid at source can be used to credit against corporate income tax in Taiwan, but only to the extent of the additional income tax incurred by the inclusion of the foreign dividends in the taxable income.

VII  TAXATION OF FUNDING STRUCTURES
i  Thin capitalisation
Taiwan has thin capitalisation rules that set the debt-to-equity ratio at 3:1. Only debts from related parties or guaranteed by related parties count, and interest expenses on excessive borrowing are not tax deductible.

ii  Deduction of finance costs
The law itself is general and vague. It only stipulates that expenses necessary for the operation of the business shall be tax deductible, and interest expenses are generally regarded as necessary for generating taxable income and are, therefore, tax deductible.

iii  Restrictions on payments
Dividends can only be declared from retained earnings. Companies with a cumulative deficit are not allowed to declare dividends.
Ten per cent of annual earnings must be set aside as a legal reserve before the declaration of dividends until the accumulative legal reserve set aside equals the paid-in capital. Certain chartered industries, such as banking and insurance, have higher reserve requirements for setting up various reserves before dividends can be declared.

iv  Return of capital
Return of capital is tax-neutral. The main barrier to capital reduction is that there might be a minimum capital requirement for some chartered businesses.

VIII  ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES
i  Acquisition
A foreign company will normally have its existing subsidiary or a newly incorporated special purpose vehicle in Taiwan acquire a majority holding and follow up with a statutory merger with the target. There are two main reasons behind this acquisition structure. The first is to ensure a 100 per cent acquisition. A direct acquisition cannot guarantee a 100 per cent buyout, whereas a statutory merger can legitimately squeeze out the minority shareholders. On the financial side, the acquisition fund can be a mix of capital and intercompany loans, bearing in mind that the thin cap rule sets the debt-to-equity ratio at 3:1.
ii Reorganisation
Mergers and demergers (or spin-offs) are allowed under the Business Mergers and Acquisitions Act and can be executed on a tax-free basis. Shareholders’ dividend withholding tax may be triggered under certain special circumstances. A merger with a foreign company is possible, and will require statutory approval from both sides.

iii Exit
Taiwan law does not permit the change of domicile of a Taiwan corporate entity into a non-Taiwan corporate entity. Thus, if a foreign business decides to relocate from Taiwan, it can only liquidate its Taiwan business and pay whatever tax is due before relocating to another country. Other than the tax liabilities that may be due following the liquidation, there are no additional tax penalties from this process.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Controversies and even litigation cases have often arisen in the past when the tax authorities assessed tax liabilities by relying on the ‘form over substance’ principle for lack of a more precise legal basis for its position. To fill that void, the legislature enacted Article 12-1 of the Tax Collection Act on 15 May 2009, which mandates that the application of tax law and regulations shall be based on the concept of taxation by law, taking into consideration the legislative purpose of the relevant applicable tax laws, economic meaning and fair tax in substance. Article 12-1 further stipulates that when construing tax events and objects, the tax authority will base its construction on substantive economic substance and the related ownership and sharing of the substantive economic benefit. Finally, Article 12-1 stipulates that the tax authority shall bear the burden of proof for the application of substance over form.

Taiwan does not have any tax regulations that target low-tax jurisdictions. It does not have controlled foreign corporation (CFC) rules, although the government has considered the idea on several occasions.

ii CFCs
Taiwan introduced CFC rules in July 2016 through the addition of Article 43-3 to the Income Tax Act, which requires a Taiwan corporate taxpayer to include in its taxable income its pro rata share of the taxable profits of its CFC. For the purposes of Article 43-3 of the Income Tax Act, CFCs are defined as corporations established in low-tax territories that are more than 50 per cent owned (directly or indirectly) or dominantly influenced by a Taiwan business entity. Exemptions apply when a CFC has actual business activities in the jurisdiction of its incorporation or its profits do not reach the threshold prescribed by the Taiwan tax authorities. The adoption of CFC rules would eliminate the deferral of taxation on those overseas profits and would discourage businesses from leaving earnings in foreign jurisdictions.

Nevertheless, the effective date of this new CFC regime is still pending. According to recent news, it is possible that the CFC regime will come into effect in the next two years.
iii Transfer pricing
Taiwan introduced its transfer pricing rules in 2004, which follow the general principles and concepts adopted by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the United States of America Inland Revenue Code Sections 482-1 to 482-6 and their corresponding regulations.

Since then, Taiwan taxpayers have been required to explicitly state on their income tax returns whether related-party transactions are executed within an arm’s-length range. However, a comprehensive contemporaneous transfer pricing report will only be required within one month of the receipt of a transfer pricing audit notice from the tax office if the safe harbour threshold is exceeded.

Under the current safe harbour rules, taxpayers will not be required to prepare a comprehensive contemporaneous transfer pricing report if:

- a their annual turnover is below NT$300 million;
- b their annual turnover is between NT$300 million and NT$500 million without the utilisation of loss carry-forward or any income tax incentive; or
- c the total of related-party transactions is below NT$200 million.

Advance pricing agreements are available to qualifying taxpayers. An advance pricing agreement is usually valid for three to five years. An extension of up to five years is available.

To keep up with the international trend, Taiwan introduced the three-tiered reporting requirement in 2017, where companies exceeding the safe harbour threshold summarised below are required to file master file and country-by-country reports (CbCRs) at the end of the following year.

A Taiwan entity that meets any one of the following conditions will be exempt from filing the master file:

- a the Taiwan entity’s total annual turnover (including operating and non-operating) does not exceed NT$3 billion; or
- b the Taiwanese entity’s total cross-border controlled transaction amount does not exceed NT$1.5 billion.

An enterprise in Taiwan meeting any of the following conditions will be exempt from CbCR filing:

- a the ultimate parent entity (UPE) of a multinational enterprise (MNE) group is a Taiwan entity and with annual consolidated group revenue in the immediately preceding fiscal year of less than NT$27 billion; or
- b a Taiwan subsidiary or branch with a UPE outside of Taiwan, which meets one of the following conditions:
  • the jurisdiction of tax residence of the UPE has statutory provisions to file the CbCR, and also meets the exemption requirements for filing the CbCR;
  • the jurisdiction of tax residence of the UPE does not have the statutory provisions to file the CbCR, the MNE appoints one of the members to act as a surrogate parent entity (SPE) to file the CbCR, which meets the exemption requirements for filing the CbCR; or
the jurisdiction of tax residence of the UPE does not have the statutory provisions to file a CbCR, nor do they appoint any other members as an SPE, but meet the exemption requirements to file the CbCR in Taiwan (annual consolidated group revenue during the fiscal year immediately preceding the reporting fiscal year that does not exceed NT$27 billion).

iv Tax clearances and rulings
The taxpayer can apply for advance tax rulings to secure certainty. No tax clearance or ruling will be required for the acquisition of a local business.

X YEAR IN REVIEW
Taiwan introduced a number of significant reforms to its income tax law effective in 2018: the imputation system was abolished, corporate income tax was raised from 17 per cent to 20 per cent, the highest tax bracket for personal income tax was dropped from 45 per cent to 40 per cent, and the surplus tax on retained earnings was cut from 10 per cent to 5 per cent, among other items.

Income tax on non-resident companies that sell electronically supplied services to Taiwan was introduced. This is the first regime in the world to levy income tax on the cross-border digital economy.

XI OUTLOOK AND CONCLUSIONS
Following the passage of significant tax reform in 2018, we expect that the Ministry of Finance (MOF) will not make any substantial changes to the law in 2020. The challenge for the MOF in 2020 will be to continuously keep up with the Common Reporting Standard. With its unique political standing in the world, it is extremely difficult for Taiwan to engage with the international tax community to exchange information. Although Japan and Australia have agreed to conduct information exchange with Taiwan, Taiwan still needs to sign a multilateral competent authority agreement with other countries that currently have tax treaties with Taiwan towards the exchange of information.
Chapter 32

TANZANIA

Paul Kibuuka

I INTRODUCTION

Strategically located in East Africa and bordered by eight countries (seven of which are landlocked) and the Indian Ocean, Tanzania offers easy connectivity and access to markets in Africa and around the world. Tanzania has a population of over 55 million and is the largest country in East Africa with a burgeoning consumer market. Tanzania is endowed with diverse climatic and terrain zones and a rich and varied natural resource base. Proven natural gas reserves stand at 57 trillion cubic feet and are anticipated to generate substantial export earnings. The eight main sectors of the economy presenting a host of investment opportunities are: agriculture, mining, tourism, construction, financial services, manufacturing, telecommunications and utilities. All these factors have attracted investor interest in Tanzania for a long time. Consequently, in its 2019 African Economic Outlook, the African Development Bank dubbed Tanzania as one of Africa’s 10 fastest growing economies that are reshaping the continental order. The rank of Tanzania on the World Bank’s ‘Ease of Doing Business’ index 2019 improved, following reforms that have made it easier to, inter alia, start a business and trade across borders. Despite the infrastructure deficit, hard and soft, some of the initiatives, including the ‘Blueprint for Regulatory Reforms to Improve the Business Environment’, will further enhance a friendlier and predictable investor climate and pave the way for more investment and economic growth. Tanzania’s official languages are Kiswahili and English. The Tanzanian shilling is the official currency of Tanzania, the capital city of which is Dodoma.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The main forms of business vehicles commonly used in Tanzania are companies, general partnerships, and sole proprietorships. That said, the vast majority of businesses in the country, including banking and financial services; oil, gas and mineral exploration; and telecommunications, can only be undertaken using companies.

i Corporate

Businesses in Tanzania generally adopt a corporate form. The limited liability company is the most common form of corporate structure in the country. This can either be private or public. A minimum of two shareholders and two directors is required to set up a private

1 Paul Kibuuka is the chief executive of Isidora & Company.
limited liability company or a public limited liability company (plc). A limited liability company offers great benefits over a sole proprietorship or partnership; for example, separate and distinct legal personality from its shareholders, while still enjoying limited liability; in addition, to the business not being automatically terminated at the death of one of the shareholders. Some of the disadvantages of a limited liability company include complex reporting requirements, and the possibility of lifting the ‘veil of incorporation’ and holding shareholders liable for the company’s obligations. However, for many investors, the disadvantages do not outweigh the benefits of organising business using the limited liability company. Although a shareholders’ agreement is not mandatory, it is highly recommended in joint ventures between locals and foreign investors to avert the risk of being edged out of making decisions about how the company is run. There is also the single shareholder company, which limits liability to the company, and not the shareholder. Tanzania’s Minister responsible for trade has not yet issued the envisaged regulations and rules to guide the establishment, management and administration of a single shareholder company; therefore, it is currently not possible to organise business using this corporate form. The basic tax treatment of a company is that the company itself, and not the shareholders, is taxed on its profits. After the company has paid its corporation tax, it remains with the shareholders to pay their tax on the dividends received.

ii Non-corporate

Sole proprietorships and general partnerships are the most commonly used non-corporate entities in Tanzania. This is so because, in contrast to companies, sole proprietorships and general partnerships are easier to form, manage and run; and the set-up costs are lower. It’s always better to enter into a partnership deed to control the business of the partnership business and the decision-making process to avoid any potential disputes and litigation among the partners. Professional services, such as audit, taxation, management consulting, actuarial, corporate finance, private equity fund services and legal services can be provided using sole proprietorships and general partnerships. Sole proprietorships and general partnerships are fiscally transparent for the purpose of Tanzanian income tax. Under the Income Tax Act, 2004 (ITA-2004), partnerships are not liable to tax, instead the profits of the partnership are distributed among the partners and then taxed in the hands of the individual partner. Finally, a limited liability partnership (LLP), a partnership in which some or all partners have limited liabilities, has not yet been introduced into Tanzanian law.

III DIRECT TAXATION OF BUSINESSES

i  Tax on profits

Determination of taxable profit

Subject to any contrary provision in the ITA-2004, taxable income is required to be calculated within the framework of generally accepted accounting principles (GAAP). Tanzanian GAAP is based on International Financial Reporting Standards (IFRS). Under Section 21(3) of the ITA-2004, companies must apply an accrual basis of accounting. In calculating taxable profits, deductions are generally allowed for revenue expenditure expended ‘wholly and exclusively’ in the production of income. Additionally, in computing taxable income, adjustments on account of specific tax depreciation allowances are available to a company in relation to its capital expenditures. For example, a 100 per cent capital deduction applies to equipment.
used for prospecting and exploration of minerals or petroleum. Residents are taxed on their worldwide income, regardless of source, whereas non-residents are taxed on income derived from sources within Tanzania.

**Capital and income**

Tanzania does not have a separate capital gains tax regime. As an alternative, taxable profit derived from a gain on realisation of an ‘investment asset’ is subjected to income tax, depending on the nature of the investment asset and on whether the gain is realised by a company or individual. Subject to certain exceptions, investment assets include: shares, interests in land and buildings, and beneficial interest in a non-resident trust. How is the gain determined? Under Section 36(1) of the ITA-2004, a gain from the realisation of an asset is determined as the difference between costs incurred and sale proceeds. Although the original cost of the asset can be deducted in computing the gain, the ITA-2004 does not provide indexation to adjust inflation or devaluation.

**Losses**

Tax losses are allowed to be carried forward, and there’s no limit on the period for carrying forward such losses. However, Section 19(2) of the ITA-2004 ring-fences losses incurred by certain businesses under specific circumstances. For example, losses on investment can only be offset against investment income; foreign-source losses from an investment can only be offset against foreign-source income; losses from agricultural business can only be offset against income derived from agricultural business; and losses incurred in dealing with speculative transactions can only be offset against income derived from speculative transactions. ‘Speculative transaction’ means a transaction that is ‘a contract for sale or purchase of a commodity including stocks and shares settled otherwise than by delivery or transfer of the commodity; or any agreement for repurchase or resale, forward sale or purchase, futures contract, option or swap contract’ (Section 19(4), ITA-2004). Furthermore, deductibility of the losses carried forward is restricted. Tax losses are permitted to be carried back only in long-term contracts, where the contract is completed and the taxpayer has unrelieved losses for that period or a previous period attributable to the long-term contract (Section 26(3)(a) and (b), ITA-2004). In addition, tax losses cannot survive change in the underlying control of an entity unless there is continuity of the business for a period of two years after the change as provided for under Section 56(4) of the ITA-2004.

**Rates**

The relevant rates of income tax are prescribed under Section 4 of the ITA-2004, read together with the First Schedule thereto. Income tax is charged at a rate of 30 per cent on income of a resident corporation and of a permanent establishment of a non-resident corporation. Resident technical and management service providers to mining, oil and gas entities are charged income tax at a rate of 5 per cent of turnover, deducted by way of withholding tax. Dividends, interest, royalties, rental income and certain other payments are subject to tax at the relevant resident and non-resident withholding tax rates. Gains from the disposal of investment assets situated in Tanzania are subject to income tax at the single instalment rate of 20 per cent (non-residents) and 10 per cent (residents), regardless of whether the disposal is made inside or outside Tanzania. Newly listed companies at the Dar es Salaam Stock Exchange with at least 30 per cent shares issued to the public enjoy a reduced corporate income tax (CIT) rate of 25 per cent for three consecutive years from the date of listing. In a bid to attract
investments, the government of Tanzania has provided reduced, time-limited CIT rates as follows: 10 per cent CIT for new assemblers of vehicles, tractors and fishing boats (for the first five years from commencement of production); 20 per cent CIT for new manufacturers of pharmaceutical or leather products (for five consecutive years from commencement of production); and 25 per cent CIT for new investors dealing in the manufacture of sanitary pads (for two consecutive years from 1 July 2019 to 30 June 2021). To qualify, investors have to enter into performance agreements with the government. An alternative minimum tax (AMT) applies at a rate of 0.5 per cent to the turnover of corporations with perpetual unrelieved tax loss for the current year and the preceding two years of income. Some of the rates may change on 1 July 2020 after Tanzania's National Budget for fiscal year 2020/21 is tabled in, and approved by, Parliament in June 2020.

**Administration**

The Tanzania Revenue Authority (TRA) is the revenue service of Tanzania responsible for the assessment, collection and enforcement of various taxes of the Central Government. The Zanzibar Revenue Board (ZRB) administers domestic consumption taxes in Zanzibar, while local government authorities administer various local government levies, licences, fees and charges. The Constitution of the United Republic of Tanzania recognises two parts of the union, namely Mainland Tanzania (formerly Tanganyika) and Zanzibar (also known as Unguja). Thus, there are 'union taxes' and 'non-union taxes'. The TRA collects union taxes, whereas the ZRB collects non-union taxes. Union taxes comprise of income taxes imposed under the Income Tax Act, 2004, and customs duties imposed under the East African Community Customs Management Act, 2004. Non-union taxes are the domestic consumption taxes, including Value Added Tax (VAT), excise duties, stamp duties, etc. Efforts to develop and modernise services rendered by the TRA by providing an e-filing system have moved forward. E-filing is one of the e-government initiatives in Tanzania, aiming to bring public administration services closer to people and businesses.

The Tanzanian tax year is the calendar year, but an entity may apply to use its own accounting period, instead of the calendar year. A statement of estimated tax payable is due for filing with the TRA within three months from the start of the accounting period. Entities must file their final tax returns within six months from the end of the accounting period. Withholding tax returns must be filed every half year; the due date is 30 days after each six-month calendar period. Instalment tax is payable in four equal instalments, and final tax is payable on the date on which the final return is due for filing. The functional currency for the filings is the Tanzanian shilling; however, permission may be sought from the TRA to use a foreign currency convertible to Tanzanian shillings. Withholding tax is payable seven days after the month of deduction. Failure to file a return or pay tax on due dates attracts a penalty and interest for each month during which failure continues. Further, the TRA is empowered to audit or investigate a corporation's tax affairs for any particular period. However, there is a five-year time limit for the TRA to adjust an income tax return filed by a taxpayer. Private rulings and class rulings are part of the TRA's advice and guidance framework by which the Commissioner General, on an application by a taxpayer or class of taxpayers, sets out how a tax law applies to that taxpayer or class of taxpayers in relation to a specific circumstance. The rulings are binding on the Commissioner General, subject to certain exceptions. There is room to challenge a tax decision taken by the Commissioner General that is felt to be incorrect. This is done by filing an objection to the Commissioner General within 30 days from the date of service of the tax decision.
In Tanzania, there are no specific provisions in the Income Tax Act, 2004 on group taxation. Therefore, for tax purposes, companies in a group do not get any special treatment.

Other relevant taxes

Besides income taxes, businesses in Tanzania are also subject to VAT, customs and excise duties, and stamp duties. These taxes are administered under the Value Added Tax Act, 2014, the East African Community Customs Management Act, 2004 and the Stamp Duty Act, Cap 189. VAT is levied on all taxable goods and services supplied in, or imported into, Mainland Tanzania. The standard rate of VAT is 18 per cent; however, the export of goods and certain services is eligible for zero-rating (i.e., taxable at a rate of 0 per cent). Businesses with an annual taxable turnover of 100 million Tanzanian shillings must register for VAT. Investors whose projects have not started producing taxable supplies but desire to be VAT-registered to reclaim the VAT incurred on start-up costs may apply to the Commissioner General to be registered. A business that produces exempt supplies cannot be VAT-registered and, therefore, it cannot recover the VAT incurred on inputs. VAT returns and any related payments are due on the 20th day of the following month. Mandatory registration for VAT also applies to professional services providers and government institutions carrying out economic activities. Non-resident suppliers without a fixed place in Tanzania and who make taxable supplies in excess of the VAT registration threshold must appoint a VAT representative. VAT on imported goods is payable at the time of importation, together with any customs and excise duties. In respect of imported services, a reverse charge mechanism applies to a recipient in Tanzania who must account for VAT on the services. The Stamp Duty Act prescribes stamp duty rates for certain instruments (e.g., conveyances, leases, share transfers, debentures, etc.) that are executed in Mainland Tanzania, or if executed outside Tanzania, relate to any property, thing or matter that is to be performed or done in Mainland Tanzania. The applicable stamp duty rate for most of these instruments is 1 per cent of the consideration. Instruments that have not been duly stamped cannot be produced as evidence in any court in Tanzania. Other taxes include the railway development levy (RDL), which is 1.5 per cent of the value of imported goods subject to certain exceptions; payroll taxes and social security contributions, including skills and development levy and workers compensation fund tariff; gaming tax; property taxes, which are charged based on the value and location of the property; and city service levy (or municipal levy), which is charged at 0.3 per cent of the turnover generated by corporate bodies in the relevant district.

IV TAX RESIDENCE AND FISCAL DOMICILE

Corporate residence

A company is resident in Tanzania if it is incorporated or formed under the laws of Tanzania, or if the management and control of its affairs is exercised in Tanzania. The phrase ‘formed under the laws of Tanzania’ has been interpreted by the Tax Revenue Appeals Tribunal in Tax Appeal No. 165 of 2015 between African Barrick Gold Plc v. Commissioner GeneralTRA to include a foreign company that has been issued with a certificate of compliance from the Registrar of Companies at the Business Registration and Licensing Agency.
ii Branch or permanent establishment

Under the ITA-2004, a non-resident entity can have a permanent establishment (PE) in Tanzania if it carries on business in Tanzania, including a place where a person: (1) is carrying on business through a dependent agent; (2) has used or installed, or is using or installing, substantial equipment or machinery; and (3) is engaged in a construction, assembly or installation project for six months or more, including a place where a person is conducting supervisory activities in relation to such a project. The income of the PE is taxed at the normal income tax rate of 30 per cent on net income or 5 per cent of turnover for technical and management services providers to mining, oil and gas entities. In addition, the PE is subject to a tax on repatriated income at a rate of 10 per cent. Business activities of a head office may be attributed to the branch in certain situations. Except for the transfer of an asset or liability between a PE and the head office, arrangements between these two are typically not recognised. Amounts derived or payments received, and expenditures incurred or payments made that relate to assets held by, or liabilities owed by the business of the PE, are attributed to it.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

Tanzania offers three investment regimes under which investors may register their businesses to take advantage of the available tax and other non-fiscal incentives. However, in view of the budgetary deficits that the Tanzanian government is experiencing, the International Monetary Fund (IMF) advised the government to cut back on the tax incentives given to investors. Be that as it is, under the Export Processing Zones Act, 2002 (EPZ Act), investors receive the most generous incentives compared to other investment regimes in Tanzania. A key incentive is the corporation tax holiday for 10 years in respect of the profits earned by the business. But to be eligible, the business needs to be capable of exporting a minimum of 80 per cent of the goods produced. The second regime under which investments may be licensed in Tanzania is provided for under the Special Economic Zones Act, 2006 (SEZ Act). Investments that meet, inter alia, the capital threshold requirements qualify for the licence to produce goods or services for the Tanzanian local market. Although this licence does not provide for the corporation tax holiday, it exempts qualifying investors from payment of interest on foreign sourced loans from withholding tax for a period of 10 years. The third investment regime is that which relates to investments that are issued with certificates of incentives under the Tanzania Investment Act 1997 (TIA). The certificate of incentives does not necessarily provide for any additional tax benefits apart from those already provided for under Tanzanian tax laws. In its absence, the business would still qualify for the common tax incentives under the tax laws. The certificate of incentives is, however, important in view of the entitlement to an initial immigration quota of five persons during the set-up phase of the business. Tanzanian tax laws provide for a number of tax incentives applicable to all businesses in Tanzania, regardless of whether they hold the certificate of incentive, the EPZ licence or the SEZ licence. Such incentives include the entitlement of all capital items purchased by the business to capital allowances, which reduce the taxable profits of any business entity.

i Holding company regimes

Tanzania does not have any special holding company regimes for tax purposes.
**Tanzania**

ii **IP regimes**
Tanzania does not have any special IP regimes for tax purposes.

iii **State aid**
No state aid is available.

iv **General**
See Sections I and V.

VI **WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS**

i **Withholding outward-bound payments (domestic law)**
Dividend payments, interest income, and royalty income are taxed by way of withholding tax (WHT) under the Income Tax Act, 2004. WHT on dividend payments is 10 per cent and this is a final tax. If a dividend is paid by a non-resident company to another resident company holding 25 per cent or more of the shares and voting rights in the company paying the dividend, the WHT rate is 5 per cent. Dividends paid by a company listed on the Dar es Salaam Stock Exchange are subject to 5 per cent WHT irrespective of whether they are paid to a resident or non-resident. WHT on interest income, treated as income from investment, is 10 per cent. Royalty income is also treated as income from investment and the WHT rate thereon is 15 per cent, regardless of whether it is paid to a resident or non-resident. All these rates are subject to any relief under the relevant double tax treaty between Tanzania and the country of residence of the payee.

ii **Domestic law exclusions or exemptions from withholding on outward-bound payments**
Payments that are exempt amounts under the Second Schedule to the Income Tax Act, 2004, are exempt from WHT; for example, there is WHT exemption on payments of interest, fees and other payments in respect of loans to the government of Tanzania from non-resident banks and other international financial institutions.

iii **Double tax treaties**
Tanzania has entered into double tax treaties (DTT) with Canada, Denmark, Finland, India, Italy, Norway, South Africa, Sweden and Zambia and it is thought to be negotiating more DTTs. The domestic withholding tax rate applies unless the rate under a DTT is lower, in which case the lower DTT rate applies subject to certain conditions. Also, in case of conflict between a DTT and the Income Tax Act, 2004, the former prevails.

iv **Taxation on receipt**
Foreign-source income from business or investment received by a resident company is calculated as that company’s worldwide income less any income sourced in Tanzania. A foreign tax credit for any foreign tax paid by the company on foreign income may be available to the Tanzanian resident company, but such credit should not exceed the Tanzanian tax
rate applicable to that income. Subject to ‘change in control’ provisions, any unrelieved amount of foreign tax credit may be carried forward. In addition, foreign tax credits may be relinquished, instead claiming a deduction for the amount of foreign income tax.

VII TAXATION OF FUNDING STRUCTURES

In Tanzania, small and medium-sized enterprises (SMEs) are mainly funded by equity because of the difficulty in accessing long-term debt. In contrast, the majority of large businesses, including foreign-owned companies, are debt-financed.

i Thin capitalisation

Tanzania has a thin capitalisation restriction on the amount of deductible interest for ‘exempt-controlled resident entities’, where the debt-to-equity ratio exceeds 7:3. For purposes of thin capitalisation, the terms ‘debt’ and ‘equity’ are specifically defined.

ii Deduction of finance costs

Interest payments made by a Tanzanian company to a non-resident company are eligible for deduction as an expense by the Tanzanian company if the interest is incurred in the production of income. If, however, the Tanzanian company and the non-resident company are associate companies in terms of the Tax Administration (Transfer Pricing) Regulations, 2018, such interest payments shall be subject to the arms-length principle and the thin capitalisation rule.

iii Restrictions on payments

Payment of dividend by a Tanzanian company is provided for under Section 180 of the Companies Act, 2002. Dividends can only be paid out of the company’s profits or realised revenue. A company is restricted from declaring dividends if it is unable to discharge its liabilities as they fall due.

iv Return of capital

Under Section 69 of the Companies Act, 2002, a company may, if so authorised by its articles, and by special resolution reduce its share capital in any way. The special resolution must be filed with the registrar of companies 35 days after it was passed. Also, the resolution must be advertised in the Gazette, within five working days from the date it was passed.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Acquisitions may be structured by acquisition of shares, or by asset acquisition. The preferred mode of acquisition would depend on a number of factors; for example, tax and regulatory considerations. A foreign company acquiring Tanzanian assets would need to set up a Tanzanian entity that acquires the assets. In share acquisition, foreign companies typically use investment vehicles located offshore because Tanzania has double taxation agreements with nine countries. Acquisitions are mainly funded by debt. Both asset and equity acquisitions attract capital gains tax. Although there are no laws prohibiting foreign investment, there are limits on the amount of equity that a foreign investor can invest for various sectors.
ii Reorganisation
Mergers, amalgamations and demergers are tax neutral in Tanzania, provided that certain specified conditions are met.

iii Exit
Tanzania does not have specific tax rules for exits, but any gains from the disposal of investment will be subject to a capital gains tax at a rate of 30 per cent. Stamp duty and VAT may also apply. Moreover, exits by change in the underlying ownership by more than 50 per cent may trigger tax consequences for the local entity. If the exit is by share transfer, no VAT is applicable. On the other hand, if the exit is by way of sale of individual assets, VAT will apply unless the sale is considered as a disposal of a going concern.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
The General Anti-Avoidance Rule (GAAR) is provided for under Section 8 of the Tax Administration Act, 2015. The GAAR may be invoked by the TRA to deny tax benefit of transactions or arrangements that are devoid of commercial substance and whose only purpose is achieving the tax benefit.

ii Controlled foreign corporations
Tanzania has provisions that relate to the treatment of unallocated income of controlled foreign corporations (CFCs). Tanzanian CFC rules operate as an international anti-avoidance measure in response to the risk that Tanzanian resident companies with membership interests in foreign companies can strip the tax base of Tanzania by shifting income into a CFC.

iii Transfer pricing
Tax Administration (Transfer Pricing) Regulations, 2018 provide guidance in the application of, inter alia, the arm's-length principle in related-party transactions. Any taxpayer whose transactions with associates exceed 10 billion Tanzanian shillings (approximately US$4.3 million) is obliged to file corporate income tax returns together with contemporaneous transfer pricing documentation. This documentation is to be submitted within 30 days from the date of request by the TRA. Non-compliance with the arm's-length principle (upon audit) attracts a penalty of 100 per cent of a transfer pricing adjustment, not the resultant tax.

iv Tax clearances and rulings
Under Section 11 of the Tax Administration Act, 2015, it is possible for a taxpayer or class of taxpayers to apply for a private ruling or class ruling from the Commissioner General of the TRA, setting out the Commissioner's interpretation of how a tax law applies to that taxpayer or class of taxpayers in relation to a specific circumstance. The rulings are binding, subject to certain exceptions. In addition, the TRA issues 'practice notes' regarding the tax treatment of contentious issues; however, these are non-binding.
X YEAR IN REVIEW

In the tax and regulatory environment, the government of Tanzania has embarked on a number of reforms aimed at improving the Tanzanian business environment and attracting foreign investment. In addition to abolishing more than 50 levies and fees, the government has removed some duplications of responsibilities between existing ministries, regulatory authorities and institutions. This has tremendously cut back on the overlap of regulatory powers. The Office of the Tax Ombudsman was also established within the Ministry of Finance to address complaints from taxpayers in relation to the administration of taxes, including corruption and unfair closures of businesses by tax officials. Efforts to implement the use of an electronic system in collecting taxes and non-tax revenue and to clear the backlog of cases, especially in tax matters, moved forward.

XI OUTLOOK AND CONCLUSIONS

The next presidential election in Tanzania is scheduled in 2020. An election year always means new opportunities and changes that can lead to improvements related to taxes, investment incentives and more. Still, we don’t expect significant tax changes in 2020. However, we anticipate moves to ease some regulations and to relax some restrictions on foreign investment in a bid to attract further investments, enhance economic growth and spur job creation.
I INTRODUCTION

Thailand is a top destination for foreign direct investment (FDI). With its strategic location in the centre of Asia, which is the fastest-growing economic market in the world and offers great business potential, Thailand serves as a gateway to South East Asia and has become a hub for multinational companies.

Despite internal political unrest, Thailand continues to maintain investor confidence and welcome investment from all over the world. The government has actively encouraged FDI, especially investment that contributes to the development of the economy and employment, as well as technology transfer. The World Bank’s Ease of Doing Business 2020 report ranked Thailand as the 21st easiest country in which to do business out of 190 countries worldwide, which is higher than Japan, China, India and most of the Association of Southeast Asian Nations.

The government supports FDI through various vehicles. For example, foreign businesses promoted under the Board of Investment (BOI) scheme may be granted tax and import duty exemptions for a specified period, permission to bring in foreign expatriates, permission to own land and permission to transfer foreign currency, as well as other support services.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i Corporate

Businesses generally adopt a corporate form. The principal forms of corporate organisation are limited liability companies (either private or public), registered partnerships, branch offices, representative offices and regional offices.

Limited liability companies

The nature and form of a limited liability company in Thailand are essentially the same as in many other jurisdictions. The capital of a limited liability company is divided equally and is represented by shares of a designated (par) value. The liability of each shareholder is limited to the unpaid portion of the shares held. Limited liability companies can be private limited companies, which are subject to the Civil and Commercial Code (CCC), or public limited companies, which are subject to the Public Limited Companies Act, BE 2535 (1992) (PLCA). Companies are subject to corporate income tax (CIT) on their net profits.

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1 Panya Sittisakonsin is a partner and Sirirasi Gobpradit is an associate at Baker McKenzie.
**Private limited companies**

At least three natural persons (not necessarily Thai citizens) must act as promoters to establish a private limited company, with each promoter holding at least one share and thus becoming a shareholder upon incorporation. The par value of a share of a private limited company is at least 5 baht, and each share must be at least 25 per cent paid up. The incorporation of a private limited company can be completed in one day, provided that all conditions under the CCC are met. Generally, there are no restrictions as to the nationality of the directors, except for companies that engage in certain commercial activities.

Shares in a private limited company may not be offered publicly. However, a private limited company may issue certain debt instruments to the public, subject to approval from the Securities and Exchange Commission (SEC) under the authority of the Securities and Exchange Act, BE 2535 (1992) (the SEC Act).

**Public limited companies**

There must be at least 15 promoters to apply to incorporate a public limited company. The promoters must subscribe to at least 5 per cent of the total shares, and must hold such shares for two years from the company’s incorporation date, unless approval has been obtained otherwise by a shareholders’ meeting. In addition, at least 50 per cent of the promoters must be residents of Thailand. The shares in a public limited company must be fully paid up. The board of directors must have no less than five members, at least half of whom must reside in Thailand. The directors must make full disclosure of their shareholdings in the company or its affiliates, and generally have greater responsibility than directors of private limited companies.

The SEC, under the authority of the SEC Act, is responsible for approving the offering of securities to the public or any person, and for supervising the Stock Exchange of Thailand (SET). Only shares of public limited companies may be offered publicly and traded on the SET. Public limited companies may also issue debentures and other forms of securities to the public.

**Registered partnerships**

In a partnership, two or more parties join for a common business purpose and share the profits. Partnerships may be ordinary or limited. In ordinary partnerships, all partners have joint and unlimited liability for the debts and obligations of the partnership. In a limited partnership, some partners have only limited liability for the obligations and debts of the partnership. Limited partnerships must be registered, while ordinary partnerships may be unregistered. Registered partnerships are classified as juristic partnerships and are subject to CIT on their net profits.

**Branch offices**

A foreign enterprise may establish a branch office in Thailand. Such branch office, in terms of its status and liability, is considered to be the same legal entity as its head office overseas. The branch can carry on any or all of the activities within the scope of the head office’s business objectives, subject to certain restrictions under the Foreign Business Act BE 2542 (1999) (FBA). A branch office is subject to CIT on net profits generated from business carried on in Thailand.
Representative offices
A foreign enterprise can establish a representative office in Thailand with the primary function of providing information and assistance to its foreign head office. The representative office must not generate income from its activities, and must have no power to accept purchase orders, make sale offers or carry out business negotiations. A representative office has a limited scope of activity in that it may only provide the following support services to its head office located offshore:

a finding sources from which the head office can purchase goods or services in Thailand;
b checking and controlling the quality and quantity of goods purchased, or contracted to be manufactured, by the head office in Thailand;
c giving advice on various aspects concerning goods that the head office has sold to distributors or consumers;
d disseminating information concerning new goods or services of the head office; and
e reporting on business movements in Thailand to the head office.

Regional offices
A foreign enterprise can establish a regional office in Thailand, provided that it is a juristic person incorporated under foreign law carrying on business in other countries, and it has at least one branch or affiliate in Asia, which may include Thailand.

The regional office in Thailand must not generate income from its activities, and must have no power to accept purchase orders from, make sale offers to, or carry out business negotiations with, persons or juristic persons in Thailand. Furthermore, the regional office’s expenses can only be funded by the head office. A regional office is permitted to carry out duties in communicating, coordinating and directing the operations of branches and affiliates located in the same region on behalf of the head office, and to provide the following services on behalf of the head office:

a consulting and management;
b training and personnel development;
c financial management;
d marketing control and sales promotion planning;
e product development; and
f research and development.

ii Non-corporate
Unregistered ordinary partnerships
Unregistered ordinary partnerships are not regarded as juristic persons under Thai law. Income generated by unregistered ordinary partnerships is subject to personal income tax at progressive rates of 5 to 35 per cent. Certain allowances and deductions are allowed under the conditions prescribed in the Revenue Code. Partners are no longer exempt from income tax on profit-sharing distributions by unregistered ordinary partnerships, with effect from 1 January 2015 onwards.

Non-juristic groups of persons
Non-juristic groups of persons are defined in the Revenue Code as two or more persons agreeing to jointly perform acts but are not regarded as an ordinary partnership. Income generated by non-juristic groups of persons is subject to personal income tax at progressive
rates of 5 to 35 per cent. Certain allowances and deductions are allowed under the conditions prescribed in the Revenue Code. Members of the groups are no longer exempt from income tax on profit-sharing distributions by non-juristic groups of persons, with effect from 1 January 2015 onwards.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

_Determination of taxable profit_

CIT is usually imposed on the net profits of a business for one tax year (the tax year can be any 12-month period selected by each taxpayer). Net profits are ascertained according to conditions imposed under the Revenue Code. An all-inclusive concept of income is used, and all realised economic gains are treated as income (including capital gains), whether they occur regularly or only occasionally.

CIT is generally computed on an accrual basis – that is, income accruing in any accounting period (whether or not it has been received) is included as income for that period, and expenses may be deducted as they accrue (whether or not they have actually been paid out).

As a general matter, expenses incurred exclusively for the purpose of acquiring profits, or from conducting business in Thailand (other than those expenses specifically excluded), are deductible expenses for determining net profit. Therefore, normal business expenses, interest incurred during the normal course of business operations, qualifying bad debts and depreciation at maximum rates ranging from 5 to 20 per cent per annum are allowed as deductions. Any generally accepted accounting method may be used to calculate depreciation, as long as the resulting depreciation rate is not greater than that provided by using the straight-line method at the rate prescribed in the Revenue Code. The following items, inter alia, are not allowed as deductions:

a. the portion of the purchase price of assets that exceeds the normal price, without justifiable reasons;
b. private expenses, including gifts for customers;
c. gifts to charitable institutions exceeding 2 per cent of net profit;
d. capital expenditures;
e. CIT, penalties, surcharges and criminal fines under the Revenue Code;
f. the portion of salary paid to shareholders that exceeds a reasonable amount; and
g. any expenses not exclusively incurred for the purpose of making profits or business.

Entertainment expenses up to a maximum of 0.3 per cent of gross revenues or the paid-up capital of the company (whichever is higher) are deductible if they are generally necessary for that type of business, but only up to 10 million baht. Certain bad debts can generally be written off if reasonable efforts have been made to recover them under criteria set out in relevant regulations. For example, where a lawsuit has been filed against the debtor, the court has issued an order or injunction, and the debtor has no assets to repay the debt.
**Losses**

Net losses may be carried forward for five consecutive years. However, there is no provision for the carry-back of losses. Losses survive a change in ownership, such as a change of shareholders of the company. However, in changes of ownership where the company is dissolved and liquidated (e.g., in an amalgamation), losses of the dissolved company are not transferred to the new company.

**Rates**

In general, all companies and registered partnerships pay CIT at a flat rate of 20 per cent of net profits. However, the following progressive rates have applied to net profits derived by small and medium-sized enterprises (companies or juristic partnerships with paid-up capital of not more than 5 million baht, and with an annual income from the supply of goods and services of not more than 30 million baht), for the accounting period beginning on 1 January 2017 onwards:

<table>
<thead>
<tr>
<th>Amount of net profits (baht)</th>
<th>CIT rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 to 300,000</td>
<td>Exempt</td>
</tr>
<tr>
<td>300,001 to 3 million</td>
<td>15 per cent</td>
</tr>
<tr>
<td>3,000,001 upwards</td>
<td>20 per cent</td>
</tr>
</tbody>
</table>

Standard deductions are allowed depending on the type of business activity that gives rise to the income. Net profits are taxed at the normal rate. Any Thai or foreign-incorporated company or registered partnership conducting business in Thailand that fails to file a return in accordance with the law may be assessed to owe income tax at a rate of 5 per cent of the aggregate of either its gross receipts or total sales, without any deductions. Certain types of business are subject to CIT on their gross receipts or gross sales instead of their net profits. For example, foreign-incorporated companies engaged in the business of international transportation of passengers or goods pay 3 per cent CIT on gross receipts of fares collected in Thailand, or gross freight collected in or outside Thailand with regard to goods carried out of Thailand. Foundations and associations pay CIT at a rate of either 2 or 10 per cent of their gross income, depending on the type of income they have received. Mutual funds are subject to CIT at a rate of 15 per cent on certain income, such as interests and discounts.

**Administration**

CIT is payable twice a year. The first instalment is 50 per cent of the total tax, normally based on estimated net profits for the year. This is due within two months of the close of the first half of the financial year of the company. An annual income tax return must be filed within 150 days of the close of the company’s financial year. In the case of failure to file, a penalty of twice the amount of tax due is imposed when an official conducts an assessment. If tax is to be paid on the basis of net profits, then the return must be accompanied by an audited financial statement. If tax is to be paid on a gross-receipts basis, then a statement of gross receipts must be filed along with the return. Currently, filing can be done either by paper return or an electronic form.
The Revenue Department of the Ministry of Finance is responsible for tax under the Revenue Code (e.g., income tax, value added tax (VAT), specific business tax (SBT) and stamp duty). Other taxes (e.g., customs duty, excise tax, property tax and signboard tax) are the responsibility of other government authorities.

There is a standard appeal procedure for grievances arising from income tax assessments. To qualify for consideration, an appeal must be filed with the Board of Appeals within 30 days of receiving the notice of assessment. A further appeal can be made to the Central Tax Court against the Board's decision within 30 days of the date of receipt of the decision on appeal. Then, parties are entitled to submit an appeal against the decision of the Central Tax Court to the Specialised Court of Appeal within one month from the date of judgment hearing, subject to certain conditions. If the approval from the Supreme Court is obtained, a further appeal can be made to the Supreme Court against the Specialised Court of Appeal's judgment, within one month from the date of judgment hearing.

**Tax grouping**

There is no concept of consolidated tax grouping in Thailand. All corporate entities are treated as separate taxable entities and are subject to tax on their own merits.

ii Other relevant taxes

**VAT**

VAT is essentially a consumption tax on goods and services, operating at each stage of production and distribution. In effect, VAT covers all retailers, manufacturers, wholesalers, producers and importers of goods, as well as service providers, other than those excluded by the Revenue Code.

VAT is currently levied at a reduced rate of 7 per cent; however, this rate will increase to a standard rate of 10 per cent from 1 October 2020 onwards (unless the reduced rate is extended). Municipal tax at a rate of one-ninth of the VAT is already included in the VAT rate. VAT on exported goods and services, under the terms and conditions of the Revenue Code, is rated at zero per cent.

Certain businesses are exempt from VAT, including the following:

- enterprises with annual gross sales of less than 1.8 million baht;
- private and government healthcare services;
- educational services;
- religious and charitable organisations; and
- leasing of immovable property.

**SBT**

Eight categories of businesses are subject to SBT:

- banking and similar businesses;
- finance, securities and credit foncier businesses;
- life insurance brokers;
- pawnbrokers;
- traders of immovable property;
- securities repurchase businesses;
- factoring businesses; and
- selling securities on the SET (currently exempt).
SBT is imposed on gross receipts at rates ranging from 0.01 to 3 per cent, according to the nature of the services provided. Businesses that are subject to SBT must also pay municipal tax at a rate of 10 per cent of the SBT. As such, the effective SBT rates vary from 0.011 to 3.3 per cent.

**Stamp duty**

Stamp duty is levied on the execution or importation of 28 dutiable documents listed in the Stamp Duty Schedule of the Revenue Code, including share transfer instruments and hire-of-work contracts. Rates and payment procedures depend upon the type of instrument. Penalties for failure to stamp documents can be imposed at a rate of up to six times the original duty. Furthermore, documents that have not been properly stamped are not admissible as evidence in civil court proceedings.

**IV  TAX RESIDENCE AND FISCAL DOMICILE**

**i  Corporate residence**

An entity becomes resident for Thai tax purposes if it is incorporated under Thai law, regardless of where management and control are exercised. A Thai tax-resident entity is subject to CIT in Thailand on a worldwide-income basis.

**ii  Branch or permanent establishment**

A non-locally incorporated entity can have a fiscal presence in Thailand through a branch, agency relationship or permanent establishment. A branch of a foreign company carrying on business in Thailand is subject to CIT on net profits generated from business carried on in Thailand. Profits attributable to a permanent establishment in Thailand are subject to CIT.

Income derived in or from Thailand by an offshore principal as a result of an agency relationship with a person in Thailand is usually subject to CIT. The appointment of an agent (or an employee, representative or go-between) in Thailand exposes the overseas business entity to the risk of being deemed to be ‘conducting business in Thailand’, and results in a tax burden. However, where the Thai agent does not act solely for the overseas company, but acts as a general agent for various companies (i.e., he or she is an independent agent), income tax liability may not be incurred. There may also be relief effective under applicable agreements for the avoidance of double taxation.

**V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT**

**i  Holding company regimes**

A Thai company holding shares in another Thai company for at least three months before and after the dividends distribution is eligible:

a to include only half of the received dividends as income for CIT purposes; or

b not to include the entire dividends received as income, provided that:

- the recipient of dividends is a company listed on the SET; or
- the recipient of dividends holds at least 25 per cent of voting shares in the company paying dividends, and there is no cross-shareholding, either directly or indirectly, between the two companies.
Dividends received by a Thai company from a foreign company are exempt from CIT if a Thai company holds not less than 25 per cent of the total shares with voting rights in the foreign company for not less than six months from the share acquisition until the dividends distribution; and the dividends are paid from net profits that are subject to tax in the country of the foreign company at a rate of not less than 15 per cent (regardless of any reduction or exemption granted under the tax law of the country in which the foreign company is incorporated).

**ii General**

**BOI incentives**

Under the Investment Promotion Act, the BOI is able to provide BOI-promoted enterprises with various tax incentives, which include the following:

- **a** import duty exemptions or reductions on imported machinery, imported raw materials and components;
- **b** a CIT exemption for three to eight years from the date on which income is first earned, with permission to carry forward losses and deduct them as expenses for up to five years; and
- **c** exemptions from withholding tax on dividends derived from promoted projects during the CIT exemption period or within six months from the date on which the CIT exemption period expires.

**International business centre (IBC)**

A new tax scheme called IBC was launched under the Royal Decree (No. 674) B.E. 2561 to replace Regional Operation Headquarter (ROH), which consists of ROH1 and ROH2, International Headquarter (IHQ), and International Trade Centre (ITC) schemes. An IBC is defined as a company established under the laws of Thailand carrying on the businesses of providing management services, technical services, support services, or financial management services (under a treasury centre licence granted by the Bank of Thailand) to affiliates, or operating business of an ITC.

Key qualifications for obtaining tax privileges under the IBC scheme are as follows:

- **a** the amount of paid-up capital on the last day of each accounting period shall be at least 10 million baht;
- **b** at least 10 employees, who possess knowledge and skills necessary for IBC business, or at least five employees if the IBC operates financial management services only;
- **c** minimum expenditure of IBC business paid to recipients in Thailand of at least 60 million baht in each accounting period;
- **d** providing management services, technical services, support services, or financial management services to the associated enterprises; and
- **e** other criteria can be prescribed by the Director General of the Revenue Department.

Examples of tax incentives for IBCs include the following:

- **a** reduced CIT rates to 8, 5 or 3 per cent of net profits, depending on amount of expenditure in Thailand (60 million, 300 million or 600 million baht, respectively);
- **b** exemption on CIT for dividend received from an affiliate;
- **c** reduced personal income tax rate to 15 per cent for expatriates working for an IBC;
- **d** exemption on SBT for income from provision of financial management services to an affiliate; and
exemption on withholding tax for offshore affiliates receiving dividend or interest paid from an IBC.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
The Revenue Code requires certain payments made from or in Thailand to an offshore entity not carrying on business in Thailand to be subject to withholding tax. Payments subject to withholding tax include dividends, interest and royalties. The withholding tax rate is 10 per cent for dividends, and 15 per cent for interest and royalties.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
There are no domestic law exclusions or exemptions from withholding on outward-bound payments of dividends, interest and royalties to an offshore entity.

iii Double tax treaties
The withholding tax rate on dividends, interest and royalties, paid to a foreign entity that is a tax resident of a country that has a double taxation agreement (DTA) with Thailand, may be reduced.

**Dividends**
Normally, the 10 per cent withholding tax rate on dividends would still be applicable under the DTAs to which Thailand is a party. However, certain DTAs provide for a reduction of the withholding tax on dividends. For example, the DTA between Thailand and Taiwan reduces the withholding tax rate on dividends to 5 per cent if the beneficial owner directly holds at least 25 per cent of the capital of the company paying the dividends.

**Interest**
Depending on the terms of each DTA, the withholding tax rate on interest can be reduced to 10 per cent if the interest is paid to financial institutions or insurance companies.

**Royalties**
Depending on the terms of each DTA, and the type of royalties, the withholding tax rate on royalties can be reduced to 5, 8 or 10 per cent.

iv Taxation on receipt
Thai companies must include income received, or receivable, from offshore entities in their taxable income for the calculation of CIT. However, foreign-sourced dividends may be exempt from CIT. See Section V.i for more details.

Thai companies are entitled to a CIT exemption equal to the tax paid in a foreign country from carrying on business in such foreign country. The tax exemption must not exceed the CIT imposed on such income.
Regarding tax paid in a country with which Thailand has a DTA, such amount could be used as a tax credit. Such tax credit will be given only on the portion not exceeding the CIT imposed on such income.

VII TAXATION OF FUNDING STRUCTURES

Entities in Thailand are funded either by equity or by a combination of equity and debt.

i Thin capitalisation
There are no specific rules regarding thin capitalisation under the Revenue Code. The debt-to-equity ratio may, however, be limited by the FBA, which governs the business conduct of the company.

ii Deduction of finance costs
Finance costs may be deductible if incurred for the purpose of making profits, or for the business in Thailand. Acquisition finance costs will generally be treated as capital expenditure; thus, depreciation deduction would be allowed.

iii Restrictions on payments
A company can pay dividends only if it has accumulated profits and has obtained approval from the shareholders’ meeting. At each distribution of dividends, a company must retain a legal reserve of at least 5 per cent of its profits until the legal reserve reaches 10 per cent of the capital of the company.

iv Return of capital
Capital can be returned to shareholders in two ways: capital reduction and liquidation. The company is required to comply with the procedures prescribed under the CCC or PLCA to proceed with a capital reduction, and cannot reduce its capital to less than one-quarter of its total capital.

The return of originally invested capital under liquidation is not subject to tax. However, the amount of capital returned via a capital reduction will be included as income of the shareholders if the amount of reduced capital does not exceed the retained profits or reserves at the time of making the distribution. In such event, said distribution may be deemed as being made out of the company’s profits or reserves, which are subject to tax.
VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Generally, the acquisition of a business in Thailand can be conducted through a share deal or asset deal. It is important to take into account several laws and regulations that govern the extent of foreign participation in business activities in Thailand. The main governing law is the FBA. Under the FBA, if a company is deemed to be foreign, the debt-to-equity ratio must not exceed 7:1 to obtain a licence to conduct business in Thailand.

Gains derived from the sale of shares or assets in a business acquisition transaction are subject to Thai taxes. In the case of foreign shareholders disposing of their shares in a Thai company to a Thai-resident buyer, withholding tax at a rate of 15 per cent will be imposed, unless exempted or reduced by a relevant DTA.

ii Reorganisation

In a reorganisation, whether via a merger or demerger, the transferor may be subject to CIT if it has gains arising from the transfer of shares or assets. In addition, transfers of businesses, assets or assignments may trigger VAT, SBT and stamp duty. However, qualified business transfers will be entitled to tax benefits as discussed below.

Entire business transfer (EBT)

A business transfer under the EBT scheme is exempt from CIT, SBT and stamp duty, and is not subject to VAT. To qualify for tax benefits, the following criteria must be met:

a) both the transferor and the transferee must be companies incorporated under Thai laws, and must not owe any outstanding tax or duty to the Revenue Department as of the date of the transfer, unless there is a bank guarantee or other form of security provided;

b) the transferor must transfer its entire business (e.g., all assets, licences, contracts, liabilities and employees) to the transferee;

c) the transferor must submit its dissolution application to the Ministry of Commerce in the same fiscal year as the EBT; and

d) the transferee must report the names of its shareholders, and the number of shares and their par value, of both the transferor and the transferee, to the Revenue Department within 30 days of the EBT.

Partial business transfer

VAT, SBT and stamp duty are exempt for a qualifying partial business transfer. The tax exemption does not cover CIT; therefore, the transferor may be subject to CIT on the gains arising from the transfer.

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2 The FBA limits the rights of foreigners to engage in certain business activities in Thailand, and investors must carefully consider the FBA before attempting to acquire any business in Thailand. A foreigner may wholly own a business in Thailand unless the specific activity of that business is restricted under the FBA or is otherwise prohibited by another law.
Exit
As a company is treated as a Thai tax resident if it is incorporated in Thailand, ceasing such status can be achieved by the dissolution and liquidation of the company. There is no specific tax imposed on the company ceasing to be a tax resident of Thailand; therefore, tax provisions concerning liquidation will apply.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
There are no specific anti-avoidance rules stated in the Revenue Code. However, the principle of substance over form, and the sham transaction concept under the CCC, are generally applied by the Revenue Department and Thai courts.

ii Controlled foreign corporations (CFCs)
There are no specific controlled foreign corporation tax rules in Thailand. Thus, a company’s Thai-resident shareholders are not subject to taxation on the income earned by an offshore company until such time as the company distributes income to such shareholders.

iii Transfer pricing
Under Section 65 bis (4) of the Revenue Code, Thai companies are required to sell goods, provide services or lend money for a consideration of not less than the market rate. Otherwise, the assessment officer is empowered to assess CIT against such companies.

Under Departmental Instruction No. Por 113/2545, the Revenue Department accepts two kinds of transfer pricing methods: traditional transactional methods, namely the comparable uncontrolled price, resale price and cost plus methods, which are the preferred methods; and other methods, such as the profit split, transactional net margin and other internationally accepted methods.

Departmental Instruction No. Por 113/2545 also provides guidelines on the bilateral advance pricing arrangement (APA). A taxpayer who wishes to conclude an APA with the Revenue Department for any transaction may request this in writing, together with the relevant documents. Generally, an APA will be effective for three to five fiscal years.

In addition, on 22 November 2018, the Act amending the Revenue Code (No. 47) B.E. 2561 regarding transfer pricing (the Transfer Pricing Act) came into force. The Transfer Pricing Act added three sections in the Revenue Code that will apply to accounting periods that commence on or after 1 January 2019. Key contents of the Transfer Pricing Act include: (1) definition of the term ‘related party’; (2) authority of the Revenue Department to adjust income and expenses on an arm’s-length basis; (3) the right to claim refunds for excess taxes paid as a result of tax assessment; (4) the time period and threshold for taxpayers required to prepare a report on the relationship between companies and the total amount of related-party transactions (the threshold will be determined later by subordinated regulations, with a minimum gross income threshold of 200 million baht); and (5) a fine for not complying with obligations to prepare a report of not more than 200,000 baht.
iv Tax clearances and rulings

It is possible to obtain an advance tax ruling from the Revenue Department. However, there is no requirement to acquire any tax clearance or tax ruling to acquire a local business in Thailand.

X YEAR IN REVIEW

i Base erosion and profit shifting

There have been developments in the field of international taxation to tackle base erosion and profit shifting (BEPS), which refers to tax avoidance strategies that exploit gaps and mismatches in tax rules in different countries to artificially shift profits to low- or no-tax countries. There are currently 15 action plans that can be undertaken by each country to address weaknesses in the current domestic laws effectively and efficiently.

Although Thailand is not an Organisation for Economic Co-operation and Development (OECD) member, Thailand has joined the Inclusive Framework on BEPS on 2 June 2017. As a member of the Inclusive Framework, Thailand will develop a monitoring process for the four minimum standards of the BEPS action plans, and put in place the review mechanisms for other elements of the BEPS.

The four minimum standards of the BEPS consist of:

a Action 5: Harmful tax practices;
b Action 6: Treaty abuse;
c Action 13: Transfer pricing documentation; and
d Action 14: Dispute resolution.

The Revenue Department is currently studying and researching the implementation of the BEPS action plans. For example, to comply with BEPS Action 5 on harmful tax practices, the royal decrees cancelling tax incentive schemes, namely ROH, IHQ and ITC, and introducing the IBC scheme were issued in 2018. See Section V.ii for more details.

ii Reporting of deposits and transfer transactions

As part of the National e-Payment Master Plan, the Revenue Department aims to develop and implement a new electronic system to enhance its efficiencies of tax assessments and tax filings. On 21 March 2019, the act amending the Revenue Code (No. 48) B.E. 2562 entered into force. Under this act, financial institutions and electronic money service providers are required to annually report the details of the following persons by the end of March:

a a person who has at least 3,000 times of deposits or inward transfer transactions in all accounts in the previous year; or
b a person who has at least 400 times of deposits or inward transfer transactions with a total value of at least 2 million baht in the previous year.

Failure to comply with the reporting obligations will lead to an administrative fine of not exceeding 100,000 baht, and a fine of not exceeding 10,000 baht per day until the failure has been remedied.
iii Payment of stamp duty for e-instruments

On 1 July 2019, the Notification of the Director-General of the Revenue Department re: stamp duty (No. 58) prescribing rules for stamp duty payment for instruments prepared in electronic format (e-instruments) under the laws governing electronic transactions came into force. Under these rules, stamp duty imposed on five types of e-instruments, which are: (1) a hire-of-work contract; (2) a loan agreement or agreement for bank overdraft; (3) a power of attorney; (4) a proxy for voting at a company’s meeting; and (5) a guarantee agreement, is required to be paid in cash. Taxpayers must file stamp duty payment form through the Revenue Department’s website or Application Programming Interface. The stamp duty amount must be electronically transferred into the Revenue Department’s bank account. However, for the e-instruments executed between 1 July 2019 and 31 December 2020, taxpayers may alternatively pay stamp duty in cash at the Revenue Department.

XI OUTLOOK AND CONCLUSIONS

Land and building tax is a new property tax that has been introduced to replace and revoke house and land tax and local development tax. The Land and Building Tax Act B.E. 2562 became effective on 13 March 2019, and the collection of land and building tax commenced on 1 January 2020. The land and building tax rates vary depending on the purposes of the property. The rates will be subsequently announced in the royal decree, but would not exceed the following ceiling rates:

a for property used for agricultural purposes, the ceiling rate is 0.15 per cent of the official appraisal value;
b for property used for residential purposes, the ceiling rate is 0.3 per cent of the official appraisal value;
c for property used for commercial purposes, the ceiling rate is 1.2 per cent of the official appraisal value;
d for vacant property, the ceiling rate is 1.2 per cent of the official appraisal value. The rate would increase by 0.3 per cent every three years if the property remains unused, but the rate shall not exceed 3 per cent of the official appraisal value.

In the first years of the enforcement of the Land and Building Act, the reduced tax rates and certain reliefs will apply to minimise tax burdens.

The land and building tax will be levied annually, and the local authority will send assessment notice to taxpayers by the end of February. The taxpayers must pay the assessed land and building tax by the end of April.
UNITED ARAB EMIRATES

Gregory J Mayew and Silvia A Pretorius

I INTRODUCTION

The United Arab Emirates (UAE) was established in 1971 under a written constitution as a federation of the seven emirates of Abu Dhabi, Ajman, Dubai, Fujairah, Ras Al Khaimah, Sharjah and Umm Al Quwain. The significance of the UAE economy is based on the discovery, in the 1950s in Abu Dhabi and the 1960s in Dubai, of major quantities of crude oil and the subsequent generation of very substantial revenues from its export, especially following the price increases in 1973.

Abu Dhabi is the federal capital of the UAE, and the site of a number of federal ministries, the UAE Central Bank, and other government institutions and agencies.

Under the Constitution of the UAE, each of the seven emirates retains a very substantial measure of control over the conduct of governmental affairs within the emirate. The important subjects over which the federation exercises control are defence, foreign affairs, communications, education and health. In addition, the federation has legislative authority with regard to a number of matters, including commercial and corporate law. The individual emirates retain control over all matters not specifically stated in the Constitution to be under federal authority.

The UAE attracts substantial foreign direct investment (FDI). The World Investment Report 2019 reported that the UAE received $30.4 billion in FDI from 2016 to 2018, which ranked the UAE 27th globally in attracting FDI in 2018, a rise of three places from its 2017 classification. Key advantages for investing and doing business in the UAE include the fact that the UAE has a stable economic and political background, and that it provides a unique geographical location for worldwide business opportunities. Many financial institutions and international industrial companies have taken advantage of the location’s appeal. Other factors include no income tax (with limited exceptions), fast population growth in recent years and the absence of exchange control or of any constraint relating to repatriation of funds.

Despite the recent global economic crisis, the UAE has in excess of 97 billion barrels of proven oil reserves, or about 8 per cent of the world’s proven oil reserves, and Abu Dhabi commands one of the wealthiest sovereign investment funds in the world. Furthermore, the UAE has one of the highest incomes per capita in the world, and the UAE ranked 11th out of 190 countries in the 2019 Doing Business ranking published by the World Bank. The UAE is the highest-ranking economy in the Middle East and North Africa, and joins the World

1 Gregory J Mayew is a partner and Silvia A Pretorius is a senior associate at Afridi & Angell.
Bank’s top 20 ranking out of 190 economies for the first time. All of these factors should see the UAE continue to have a per capita income in the foreseeable future that is among the highest in the world, and continue to remain a preferred jurisdiction for inward investment.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The types of business entity most commonly used in the UAE by inward-investing corporates and non-residents are companies or branch offices of foreign companies created under UAE Federal Law No. 2 of 2015 on Commercial Companies (the Companies Law). Another commonly used option is establishing an entity in one of the many free zones in the UAE.

Prior to discussing these various corporate structures in more detail, it is important to note that there is no federal income tax law in the UAE, and although all but one of the emirates have statutory income tax laws providing for tax on corporate bodies that are still technically effective with certain exceptions (principally oil-producing businesses and banks), a foreign business currently investing inwardly can safely conclude that its activity will not be subject to taxation.

i Corporate

The Companies Law applies to all companies established in the UAE, and to foreign companies with one or more branches in the UAE. It regulates existing branch offices of foreign companies, and contains regulations for the establishment of new branch offices of foreign companies. It does not apply to sole proprietorships or to non-commercial entities.

The following provisions of the Companies Law are of particular importance: all companies organised in the UAE are required to have a minimum of 51 per cent UAE national ownership; all branch offices of foreign companies are required to have a national agent unless the foreign company has established its offices pursuant to an agreement with the federal government or an emirate government; and all general partnership interests must be owned by UAE nationals.

The Companies Law provides for the organisation of five types of businesses: joint liability company, simple partnership company, limited liability company (LLC), public shareholding company and private shareholding company.

The LLC is the preferred choice of corporate vehicle in the UAE. An LLC must have at least one and not more than 50 owners. Foreigners (individuals or corporate entities) are permitted to hold minority shareholdings of up to 49 per cent of the capital of the LLC.

A new law regarding foreign investment in the UAE was announced during 2018, being Federal Decree-Law No. 19 of 2018 On Foreign Direct Investment. A detailed analysis of the new Foreign Direct Investment Law is beyond the scope of this chapter.

The Foreign Direct Investment Law provides that a Foreign Direct Investment Committee (the Foreign Direct Investment Committee) shall be formed by a decision of the

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3 Citizens of other Cooperation Council for the Arab States of the Gulf (GCC) countries are generally treated like UAE citizens for the purposes of meeting the 51 per cent ownership requirement, although there is a small list of exceptions for certain types of businesses. The GCC Member States are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE.
Cabinet and shall be presided over by the UAE Minister of Economy. The Foreign Direct Investment Committee shall have the authority to study and provide recommendations to the UAE Cabinet, after coordinating with the local governments, regarding the following:

a) setting out a list of economic activities that may be carried out by a company wholly owned by foreign investors in the United Arab Emirates (the Positive List);

b) adding certain sectors and activities to the list of the sectors and activities that are not available to foreign investors;

c) approving foreign investment projects to conduct activities that are not set out in the Positive List following recommendations made by the relevant licensing governmental departments; and

d) deciding on the benefits granted to foreign direct investment projects in the UAE.

The Prime Minister of the UAE issued a statement on 2 July 2019 announcing the Cabinet’s approval of a Positive List of 122 economic activities in sectors such as agriculture, manufacturing, renewable energy, electronic commerce, transportation, arts, construction and entertainment. While permitting majority or 100 per cent foreign ownership in certain sectors would be a major development, the Positive List imposes additional requirements such as minimum capital requirements on some activities, obligations to employ advanced technology on other activities, and requirements to contribute to the Emiratisation of the workforce on others. For many business and service activities, existing restrictions and qualifications are expressly retained. The Companies Law gives the shareholders considerable freedom in structuring the articles of association for the LLC, and particularly those provisions regarding the management and governance of the LLC, according to their particular needs. Inter alia, the parties are free to include provisions allowing the minority shareholder to retain considerable management control of the LLC. This makes the LLC a useful vehicle for foreign companies wishing to set up subsidiaries in the UAE. An LLC may be licensed to conduct any lawful activity, except for the business of insurance, banking and investment of money for the account of others.

Despite the restriction of foreign ownership to 49 per cent, foreign investors continue to invest in local companies. To facilitate this, practices have developed to work around the 51 per cent local shareholder requirement. Various contractual arrangements and powers of attorney are often put in place between the UAE shareholder and the foreign owner confirming that the foreign party has the right to receive all distributions, including profits and assets on a liquidation, to exercise all voting rights and to manage the business. In turn, the UAE shareholder agrees not to interfere with the management of the business, not to make any claim for profits, capital, assets, equipment, dividends, ownership or voting rights, not to transfer or pledge his or her shares, and to provide all reasonable assistance required from him or her.

In exchange for this, the foreign party will pay an annual fee to the UAE shareholder, and accept all liabilities of the company and indemnify the UAE shareholder in respect of any claims and losses brought against him or her as shareholder (as long as he or she is not at fault or in breach).

Although such contractual arrangements are widely used in the UAE, they have not been fully tested in the courts and remain an uncertain tool. In practice, such arrangements are not often challenged, and a court could seek to give effect to such agreements as a
private agreement between the parties where third-party interests are not thereby prejudiced. However, a law that came into effect in 2009 may have potential implications for such agreements.4

The second preferred choice, a branch of a foreign company, is required by Article 329 of the Companies Law to have a sponsor (termed a national agent). The national agent must be a UAE national or a company wholly owned by UAE nationals. The national agent has no ownership rights in the branch, and is responsible only for rendering certain basic services, but is not responsible for any financial or other liabilities or obligations of the foreign company. In exchange for this, the foreign party will pay an annual fee to the national agent (usually called a sponsorship fee), and accept all liabilities of the branch and indemnify the national agent in respect of any claims and losses brought against him or her as national agent (as long as he or she is not at fault or in breach). Terminating a relationship with a national agent can often be difficult as a practical matter, and will require the continuing cooperation and consent of the national agent.

The national agent is not the same as a commercial agent, and the provisions of Federal Law No. 18 of 1981 Regulating Commercial Agencies Law (Commercial Agencies Law) (discussed below) should not apply to the national agent.

The term ‘free zone’ refers to one of the many areas designated as such within the UAE. Free zones are often established to cater to particular types of businesses.

Foreign companies are generally permitted to establish branches in free zones, and such branches are exempt from the requirement to appoint a local agent. Legislation in each of the free zones also permits the incorporation of corporate entities that exist and operate outside the purview of the Companies Law, and that do not require the involvement of a UAE national partner (i.e., 100 per cent foreign ownership is permitted). The establishment of a free zone branch or a corporate entity is handled by the relevant free zone authority. Free zones generally guarantee freedom from corporate and income taxes for a specified period.

Conceptually, companies operating in a free zone are treated as offshore or foreign companies for non-export purposes, and are not permitted to conduct business activities within the rest of the UAE without complying with the rules generally applicable to the establishment of a foreign business presence. Normal import duties are payable on sales by free zone companies to customers within the UAE.

In 2005, the Emirate of Dubai launched the Dubai International Financial Centre (DIFC). The DIFC represents a radical development, in that it is designed to operate independently of UAE civil and commercial laws generally, and it has its own legislation and court system modelled generally on English common law. The language of the DIFC is English, and a majority of DIFC judges have common law experience. Similarly, the Abu Dhabi Global Market (ADGM) was established pursuant to Abu Dhabi Law No. 4 of 2013 as a financial free zone in the Emirate of Abu Dhabi, with its own civil and commercial laws. The ADGM commenced operations in 2015.

As an alternative option, many foreign companies will appoint a commercial agent to offer their goods and services to consumers in the UAE through local agents and distributors. The Commercial Agencies Law governs the relationship between foreign principals and local agents and distributors. It offers significant protections to the local party if the agency

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4 UAE Federal Law No. 17 of 2004 concerning Commercial Concealment came into effect in late 2009 and, although its intended purpose and implications are open to interpretation, has raised concerns about the validity and enforceability of such contractual arrangements.
or distributorship is registered with the Ministry of Economy. To register the agency or distributorship, the agent or distributor must be a UAE national or a company wholly owned by UAE nationals. The statutory protections to the local party flowing from registration include, inter alia, exclusivity, restrictions on the foreign party’s right to terminate or withhold renewal of the relationship, and the right to receive compensation on termination or non-renewal of the relationship. Although there are a number of disadvantages to registration of an agency or distributorship from the foreign party’s perspective, certain government departments may insist on dealing only with registered agents or distributors.\(^5\)

ii Non-corporate

All general partnership and limited partnership interests can only be owned by UAE nationals. They are not subject to any taxation and are not fiscally transparent as, unlike other companies, they are not required to have their annual financial statements audited by accountants registered in the UAE and to submit such audited statements to the Ministry of Economy.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

There is no federal income tax law in the UAE, or any federal taxes on income (except as noted further below in this section). Accordingly, the pre-federation income tax decrees of the individual emirates remain applicable.

Corporate income tax statutes have been enacted in each of the emirates, but they are not implemented. Instead, corporate taxes are collected with respect to branches of foreign banks (at the emirate level) and courier companies (at the federal level). Further, emirate-level ‘taxes’ are imposed on the holders of petroleum concessions at rates specifically negotiated in the relevant concession agreements. There is no personal income tax.

Dubai and certain other emirates impose taxes on some goods and services (including sales of alcoholic beverages, hotels, restaurant bills, and residential and commercial leases).

Although there is currently no sales tax or value added tax (VAT) in the UAE, notable headway has been made in the move to introduce VAT and corporate tax in the UAE.

On 27 November 2016, the Member States of the GCC signed the Unified VAT Agreement for the Cooperation Council for the Arab States of the Gulf (the GCC VAT Framework Agreement). The GCC VAT Framework Agreement provides that each GCC state will be allowed to introduce its own VAT regime, providing that common principles are adopted by all GCC states.

The UAE has introduced a number of new laws to be able to prepare for the implementation of VAT. The Federal Tax Authority was established under Federal Law No. 13 of 2016, and will be in charge of managing and collecting federal taxes and related fines, distributing tax-generated revenues and applying the tax-related procedures in force in the UAE.

\(^5\) Many agency relationships in the UAE are not registered, and non-registration generally works to the foreign principal’s advantage.
Following on the Federal Tax Authority, the Tax Procedures Law was then issued as Federal Law No. 7 of 2017. The Tax Procedures Law establishes the framework for federal taxes administration in the UAE.

Thereafter, Federal Decree-Law No. 8 of 2017 (the VAT Law) was issued, and a dedicated tax website launched for the Federal Tax Authority. The VAT Law is based on the common principles agreed in the GCC VAT Framework Agreement, and sets the general rules for the implementation of the new tax and includes some details on the goods and services subjected to VAT, as well as those that will receive special treatment. The VAT Law introduced a 5 per cent VAT starting January 2018, and this is imposed on a taxable supply of goods or services for consideration and deemed supplies by a taxable person conducting business in the UAE and the import of taxable goods. The supplier of the goods or services, the importer of taxable goods and the taxable person registered for VAT who acquires goods will be required to account for VAT. Registration is mandatory for any taxable person if the total value of its taxable supplies made within the UAE exceeds the mandatory registration threshold of 375,000 dirhams over the previous 12-month period or if it is anticipated that the taxable supplies will exceed the threshold in the next 30 days. VAT registration will be optional if the mandatory registration threshold requirement (375,000 dirhams) is not met, but the voluntary registration threshold (187,500 dirhams) has been exceeded. The VAT Law provides for tax grouping, which allows companies with common control or ownership to be combined together into one entity for the purposes of VAT. Zero-rated supplies include certain exports, international transportation, supply of certain education and healthcare services and related supplies, certain investment grade precious metals, supply of crude oil and natural gas, supply of newly constructed residential properties within three years of completion and supply of certain land, sea and air means of transportation. Exempt supplies will include certain financial services, residential supplies, bare land and local passenger transport. Provision is made for reverse charging VAT on certain transactions between entities within the GCC. As of October 2017, the Federal Tax Authority has commenced accepting registrations for VAT through its online portal.

While the VAT Law provides a framework for implementation of VAT in the UAE, the operative provisions are contained within the VAT Law's Executive Regulations, issued as Cabinet Decision No. 52 of 2017. The Executive Regulations provide additional legislative and procedural guidance to the application of VAT within the UAE, specifically where it concerns the tax treatment of free zone entities. Cabinet Decision No. 52 of 2017 also outlines supply of goods and services in all cases, including supply in special cases, supply of more than one component and exemption related to legal supply. The regulation also defines the mandatory and voluntary tax registration thresholds, exceptions from registration, tax grouping, as well as the process to apply for deregistration.

Revenues from the UAE’s value added tax exceeded government expectations in 2018, reaching 27 billion dirhams compared to the government’s original projection of 12 billion dirhams, and accounted for 1.7 per cent of the UAE’s 2018 nominal GDP.6

Separately, the Ministry of Finance (MOF) has announced that it is still studying reforms to the UAE corporate tax regime, that the tax rate is under study and that businesses will be given at least one year to prepare for any changes. As there are still many stages to go through before a corporate tax law is enacted, there is still no firm timeline in place for the implementation of this corporate tax law.

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Each emirate, except for Umm Al Quwain, has an income tax decree. The income tax decrees of the emirates of Fujairah (1966), Sharjah (1968), Ajman (1968), Dubai (1969) and Ras Al Khaimah (1969) are based on and broadly similar to the Emirate of Abu Dhabi Income Tax Decree of 1965 (together, as amended, Income Tax Decrees), which will be the basis for discussion here.7 No other taxes are imposed on corporate income.

Taxable persons are defined as juristic entities or any branches thereof,8 wherever organised, that conduct trade or business9 at any time during the tax year through a permanent establishment10 based in the respective emirate, whether directly or through the agency of another juristic entity, unless exempted.11 The Income Tax Decrees make no distinction between resident and non-resident corporations, but instead define a taxable person as, inter alia, having a permanent establishment within the respective emirate.

**Banks**

The principal difference in the treatment of local and foreign commercial banks is that local banks are not subject to any taxation on their income, whereas foreign banks may be subject to taxation at the emirate level. Additionally, a foreign bank may not establish more than eight branches in the UAE. The tax paid by banks varies from emirate to emirate and also within each emirate where certain banks are allowed to make annual payment of an agreed sum without reference to the level of profits or losses. In Abu Dhabi, banks are required to pay a tax of 20 per cent on net profits.

The government of Dubai issued Regulation No. 2 of 1996 (Regulation No. 2) setting out guidelines to be used by branches of foreign banks in calculating income tax due to the government of Dubai from taxable income arising from the conduct of business in the Emirate of Dubai.

Foreign banks operate in the Emirate of Dubai without local equity participation pursuant to special arrangements with the government. Generally, foreign banks are required to pay 20 per cent of their net profits to the government of Dubai as an income tax. Regulation No. 2 enumerates the permissible deductions that foreign banks may take in determining taxable income. For example, a foreign bank may not deduct more than 2.5 per

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7 The official language in the UAE is Arabic; as such, all legislation is promulgated in Arabic. The discussion in this chapter is based largely on unofficial translations of this legislation, although the official Arabic texts of the Abu Dhabi Income Tax Decree of 1985 (as amended) (Abu Dhabi ITD) and the Dubai Income Tax Decree of 1969 (as amended) (Dubai ITD) have been consulted. Some of the material differences in treatment between the Abu Dhabi ITD and the Income Tax Decrees of the other emirates are indicated in these footnotes.

8 Abu Dhabi ITD, Article 2(3) refers to a ‘body corporate’, a term that does not refer solely to corporations. Dubai ITD, Article 2(3) refers to any ‘body having juristic personality’ as being a taxable person.

9 Conduct of trade or business encompasses the sale of goods or rights therein; the operation of any manufacturing, industrial or commercial enterprise; the leasing of property; and the rendering of services. The simple purchasing of goods or rights therein is excluded (Abu Dhabi ITD, Article 2(4)). Dubai ITD, Article 2(6)(e) specifically includes the production of petroleum or other hydrocarbons. The Fujairah Income Tax Decree of 1966 (Fujairah ITD), Article 1 provides that only entities engaged in oil production or extraction of other natural resources are taxable persons.

10 ‘Permanent establishment’ is defined as a branch, place of management or other place of business. It does not include an agency relationship unless the agent is authorised, and habitually exercises this authority, to conclude contracts on behalf of the principal (Abu Dhabi ITD, Article 2(10)).
cent of its total revenue in any year for head office charges and regional management expenses combined. Furthermore, centralised or shared expenses (including regional management expenses) of foreign branches of banks operating in Dubai may be deducted on a prorated basis. Head office expenses must be reflected in the Dubai branch’s books and certified by the external auditors of the bank’s head office.

The guidelines also set out acceptable methods for calculating ‘doubtful debts’, losses, amortisation of assets and capital expenditures. Losses may be carried forward and set off against taxable profits in the next tax year. Losses, however, may not be deducted from a previous year’s tax obligation.

Branches must file an annual tax declaration together with audited financial statements. The financial year for foreign banks operating in Dubai must be 1 January to 31 December. Taxes are due and payable to the Dubai Department of Finance no later than 31 March of the following year. The penalty for late payment has been fixed at 1 per cent for each 30-day period that such payment is in arrears.

**Oil companies**

The revenue of oil-producing companies is subject to the payment of both a royalty and an income tax. Royalties are calculated as a percentage of total revenue derived from production, while the income tax is calculated on net profit after depreciation.

In the Emirate of Abu Dhabi, the Supreme Petroleum Council (SPC), created pursuant to Abu Dhabi Law No. 1 of 1988, was designated as the supreme authority responsible for petroleum affairs in Abu Dhabi in charge of formulating and implementing policy in the oil sector. However, Law No. 1 of 1988 did not delegate to the SPC any powers of the Ruler to, inter alia, levy taxes on petrochemical activities in Abu Dhabi according to the Abu Dhabi ITD. Accordingly, any royalties levied by the SPC on concessions in the Emirate of Abu Dhabi are not taxes levied in accordance with the Abu Dhabi ITD, but duties levied pursuant to the SPC’s role as a petroleum policy and regulatory body, and distinct from the power of the sovereign or ruler of Abu Dhabi to impose taxes.

A taxpayer’s taxable income is defined as its net income arising in the respective emirate from the conduct of trade or business, after making permitted deductions.¹² Taxable income is to be computed by the method of commercial accounting regularly used by the taxpayer for its own records, provided that such method fairly reflects taxable income. Such method may be on either a cash basis or an accrual basis.¹³

Costs and expenses incurred in the production of income are treated as deductions.¹⁴ Such deductions include:

a the direct costs to the taxable person of producing goods sold or of providing services rendered by it;¹⁵

b other costs and expenses incurred by the taxable person for the purpose of carrying on trade or business;¹⁶

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¹² Abu Dhabi ITD, Articles 2(5) and 6.
¹³ id., Articles 5(1) and 5(2).
¹⁴ id., Article 6(1). In Dubai, banks are expressly permitted to treat as deductions head office overhead expenses charged to branches in Dubai (government of Dubai, Circular to All Banks Subject to Dubai Tax, 24 December 1984).
¹⁵ Abu Dhabi ITD, Article 6(1)(a).
¹⁶ id., Article 6(1)(b).
a specified annual allowance in respect of depreciation, obsolescence, exhaustion or amortisation of physical and intangible assets;\textsuperscript{17} 

uninsured losses sustained by the taxable person in connection with carrying on trade or business;\textsuperscript{18} and 

any net operating loss of the taxable person incurred in carrying on trade or business that is carried forward from a previous tax year.\textsuperscript{19}

Deductions allowed to a taxable person dealing in oil\textsuperscript{20} as costs and expenses incurred for the purpose of carrying on trade or business are specifically defined\textsuperscript{21} to include certain costs and expenses incurred for the exploration for and development of petroleum or other hydrocarbons,\textsuperscript{22} and certain royalties paid on crude petroleum dealt in by such taxable person,\textsuperscript{23} but not to include any sums included in the credit aggregate\textsuperscript{24} or certain sums paid to the ruler of the respective emirate as the ruler’s share in profits from oil under an agreement between the taxpayer and the ruler.\textsuperscript{25}

The following amounts may not be deducted from the taxable income of a taxable person dealing in oil: expenses deemed to be contributions to capital by agreement with the ruler of the relevant emirate,\textsuperscript{26} sums included in the credit aggregate,\textsuperscript{27} and certain sums paid to the ruler of the respective emirate as the ruler’s share in profits from oil under an agreement between the taxpayer and the ruler.\textsuperscript{28} No non-deductible business expenses are specifically enumerated with respect to taxable persons not dealing in oil.\textsuperscript{29}

An annual deduction in respect of the depreciation, obsolescence, exhaustion or amortisation of physical and intangible assets calculated as a reasonable percentage of the

\textsuperscript{17} id., Article 6(1)(c).
\textsuperscript{18} id., Article 6(1)(d).
\textsuperscript{19} id., Article 6(1)(e). Dubai ITD does not provide for loss carry-forward, but does provide for deduction of losses on sales of certain depreciable property (Article 4(1)(d)), and of 10 per cent of certain expenses incurred prior to commencing trade or business in Dubai (Article 4(1)(e)).
\textsuperscript{20} ‘Dealing in oil’ is defined by Abu Dhabi ITD, Article 2(15) as ‘dealing [...] in oil or in rights to oil’.
\textsuperscript{21} But not in Dubai ITD.
\textsuperscript{22} id., Article 6(2)(a)(i).
\textsuperscript{23} id., Article 6(2)(a)(ii). The royalty payable under all concession agreements is 14.5 per cent pursuant to Article 1 of Federal Decree No. 55 of 1974.
\textsuperscript{24} Abu Dhabi ITD Article 6(2)(a)(iii). Article 2(18) provides as follows: 

\textit{. . . credit aggregate’ means in relation to oil of a producing company the aggregate value of all royalties (other than royalties on Crude Petroleum equal to one eighth of the value, or such greater amount as may from time to time be agreed between the Ruler and such producing company, at the applicable posted price in Abu Dhabi, of crude petroleum produced in Abu Dhabi and exported therefrom) and rentals, and of all taxes (other than the tax imposed by this Decree), duties, import duties and other exactions of a like nature and of any payments in lieu of any tax which accrue from or are paid by whomsoever to the Ruler or to any State, governmental or other public authority in Abu Dhabi (whether central or local) in respect of the relevant income tax year in connection with the production, transportation, sale, shipment or export of such oil.}
\textsuperscript{25} Abu Dhabi ITD, Article 6(2)(a)(iv).
\textsuperscript{26} id., Article 6(2)(a)(i).
\textsuperscript{27} id., Article 6(2)(a)(iii). See footnote 24 for a definition of credit aggregate.
\textsuperscript{28} Abu Dhabi ITD, Article 6(2)(a)(iv).
\textsuperscript{29} The corresponding non-deductible business expenses apply to all taxpayers under Dubai ITD, Article 4(1)(b).
original cost of such assets, and any additions thereto, are allowed. For certain specified assets, a straight-line depreciation in percentages stipulated in the Abu Dhabi ITD is presumed reasonable, subject to proof to the contrary.\footnote{Abu Dhabi ITD, Article 6(1)(c)(i).}

The total of deductions for depreciation and losses in any tax year in respect of any asset may not, when added to the total of deductions previously allowed in respect of that asset, exceed the actual cost to the taxable person of such asset.\footnote{id., Article 6(c)(iii).}

The Income Tax Decrees do not specifically address accounting issues relating to stock and inventory as a discrete category of asset. Therefore, valuation of stock and inventory may be accomplished by the method of commercial accounting regularly used by the taxpayer in maintaining its own records, provided that it fairly reflects the taxpayer’s taxable income.\footnote{id., Articles 5(1) and 9.}

The Income Tax Decrees do not specifically refer to the depreciation of stock and inventory.\footnote{Abu Dhabi ITD, Articles 5(1) and 9.}

Since the Income Tax Decrees do not specifically address the treatment of reserves, such treatment is to be governed by the method of commercial accounting regularly followed by the taxpayer in keeping its own records, provided that such method fairly reflects the taxpayer’s taxable income.\footnote{id., Article 6(1)(c).}

The Income Tax Decrees do not provide that dividends paid affect the taxpayer’s taxable income; nor do they require a dividend-paying taxpayer to withhold a portion of the dividend as a withholding of the recipient’s income tax.

Dividends received and income from capital gains are treated no differently from other types of income.

**Losses**

Net operating losses not allowed to be deducted from a taxpayer’s income in a tax year may be carried forward indefinitely.\footnote{id., Article 6(2)(e). In Dubai, banks are not permitted to make general provisions for bad debts, but are permitted to make specific provisions in respect of doubtful customer accounts (government of Dubai, Circular to All Banks Subject to Dubai Tax, 24 December 1984). A bank may carry forward losses no more than two years (id.).}

**Rates**\footnote{Abu Dhabi ITD, Article 4(1); Ajman Income Tax Decree of 1968 (Ajman ITD), Article 4(1); Dubai ITD, Article 2(19)(a); Sharjah Income Tax Decree of 1968 (as amended) (Sharjah ITD), Article 4(1). Fujairah ITD omits this progressive tax on non-petroleum producing entities. Under the Dubai ITD, a taxpayer whose income reaches a particular tax bracket has the rate of that bracket imposed on his or her entire income. In contrast, the other income tax decrees impose the progressive tax rates only on that portion of the taxpayer's income that falls into the relevant brackets.}

<table>
<thead>
<tr>
<th>Taxable amount (dirhams)</th>
<th>Zero to 1 million</th>
<th>1,000,001 to 2 million</th>
<th>2,000,001 to 2 million</th>
<th>3,000,001 to 4 million</th>
<th>4,000,001 to 5 million</th>
<th>5,000,001 and over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate</td>
<td>–</td>
<td>10 per cent</td>
<td>20 per cent</td>
<td>30 per cent</td>
<td>40 per cent</td>
<td>50 per cent</td>
</tr>
</tbody>
</table>

The rates of tax payable on income of oil-producing taxpayers in the emirates are as follows:
Ajman and Fujairah: 50 per cent;\(^a\)
Abu Dhabi and Dubai: 55 per cent;\(^b\) and
Sharjah: 65 per cent.\(^c\)

Ras Al Khaimah has no separate provision governing petroleum-producing taxpayers.\(^d\)

**Administration**

All foreign companies, public and private shareholding companies, LLCs and share partnership companies are required to have their annual financial statements audited by accountants registered in the UAE, and to submit such audited statements to the Ministry of Economy. Branch offices of foreign companies are required to prepare their annual accounts on an independent basis for operations in the UAE, and to maintain the necessary books and documents of account within the UAE. Pursuant to the recently enacted new Companies Law, every LLC or joint-stock company is now required to keep its accounting books in its head office for a period of at least five years from the end of the financial year of the company.\(^e\)

Within three months of the end of each tax year (1 January to 31 December), taxable persons are required to file a provisional income tax return. Taxable persons with taxable income below the threshold of 1 million dirhams are exempted unless specifically directed to file. The returns are filed with the respective director of tax appointed pursuant to the Income Tax Decrees.\(^f\)

Income tax is to be paid in quarterly instalments based upon the provisional declaration. Within nine months of the end of the tax year, taxable persons are required to file a final income tax declaration. Discrepancies between the provisional and final declarations are to be reconciled by adjustment of the final quarterly tax instalment and, if necessary, a partial tax refund.\(^g\)

Failure to file the declaration or to pay income tax without reasonable cause incurs liability for a fine of 1 per cent of the amount payable for each 30-day period or portion thereof during which the failure continues. Extensions of time for filing may be granted upon proof of a justifiable reason.\(^h\)

The director of tax has power to inspect relevant books and records.\(^i\) Penalties for falsification of records or making false statements include imprisonment or a fine, or both. A taxable person affected by such falsification, if legally responsible, is also liable to a fine.\(^j\)

Disputes as to the application of the tax laws are subject to the jurisdiction of the UAE courts or, by agreement, to arbitration.\(^k\)

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\(^a\) Ajman ITD, Article 4(2); Fujairah ITD, Article 1; Ras Al Khaimah Income Tax Decree of 1969 (as amended), Article 4(2).
\(^b\) Abu Dhabi ITD, Article 4(2); Dubai ITD, Article 2(19)(b).
\(^c\) Article 4(2), Sharjah ITD.
\(^d\) Ras Al Khaimah Income Tax Decree of 1969 (as amended), Article 4.
\(^e\) Companies Law, Article 26.
\(^f\) Abu Dhabi ITD, Article 8(1).
\(^g\) id., Article 8(2).
\(^h\) id., Article 8(3).
\(^i\) id., Article 11.
\(^j\) id., Article 12.
\(^k\) id., Article 13.
ii  Other relevant taxes

Establishment of a branch office or an LLC in the UAE will entail payment of various fees in the course of the licensing and registration process. Although these fees are not taxes as such, the amounts involved can be significant and should be taken into consideration as a potential cost of doing business in the UAE.

Establishment of a branch office in the UAE will also mean payment of sponsorship fees to the national agent of such branch.

Customs duties are generally low. Under the GCC agreement to impose uniform rates for customs duties, the UAE imposes a uniform 5 per cent customs duty on the import of goods from outside the GCC.\(^{48}\) Limited exemptions apply to military and security purchases and some foodstuffs.

Federal Decree Law No. 7 of 2017 introduced an excise tax in the UAE on certain products and became effective as of 1 October 2017. A reasonably high rate of tax on a limited number of goods is imposed by way of an excise tax. This includes a 50 per cent excise on carbonated drinks and a 100 per cent excise on energy drinks and tobacco products.

The Federal Tax Authority announced that the excise tax will be imposed upon electronic smoking devices and tools and sweetened beverages with effect from 1 January 2020, in accordance with the Cabinet and Ministry of Finance decisions issued in this respect.\(^{49}\)

IV  TAX RESIDENCE AND FISCAL DOMICILE

i  Corporate residence

Tax residency is not clearly defined under UAE law in the absence of any enforced income tax legislation. The Income Tax Decrees make no distinction between resident and non-resident corporations, but instead define a taxable person as, inter alia, having a permanent establishment within the respective emirate. In addition, double taxation treaties provide a basis for determining tax residency under the applicable treaty. Eligible foreign companies can obtain tax residency certificates from the MOF.

ii  Branch or permanent establishment

Entities incorporated outside of the UAE can have a fiscal presence through licensed branches in the UAE. Indeed, a branch of a foreign company is treated the same as a company incorporated in the UAE under the Income Tax Decrees, as both constitute permanent establishments in the UAE. However, with limited exceptions (discussed above), there are no UAE tax consequences as a result of such fiscal presence.

Tax residence may be relevant to tax considerations in the foreign company’s home jurisdiction under the relevant double taxation treaty.

\(^{48}\) In 2003, the GCC became a customs union (i.e., a free trade area with a common 5 per cent external customs tariff).

V  TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i  Holding company regimes
While the recent enactment of the new Companies Law has introduced the concept of a holding company, whereby a holding company can be incorporated as either a joint-stock company or an LLC, and can establish subsidiaries inside the UAE or abroad, or has control of existing companies by holding shares or stocks enabling such holding company to control the management of the subsidiary and to have influence on the resolutions of the subsidiary, the applicable laws and regulations in the UAE do not provide for any special holding company regimes.

ii  IP regimes
Similarly, there are no special IP regimes in the UAE.

iii  State aid
Tax law should be considered in the context of any major project, notwithstanding that the UAE is generally a tax-free jurisdiction. The tax treatment that will be extended to the project should be negotiated in detail and in advance. For major projects, tax holidays or the extension of national treatment may be available for a specified period of time. Some entities that would otherwise be taxable persons have been expressly exempted by the respective rulers, by federal legislation or by their location in a free zone. For other taxable persons, the Income Tax Decrees have in practice only been enforced against oil companies and certain foreign banks. This selective application, however, is neither codified nor assured for the future.
As discussed above, free zones in the UAE generally provide inward investors guaranteed freedom from corporate and income taxes for a specified period.

iv  General
As noted above, the UAE is essentially a tax-free jurisdiction, and the absence of corporate or personal income tax is one of the UAE’s most attractive features for foreign investors.

VI  WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i  Withholding on outward-bound payments (domestic law)
There are currently no withholding taxes on dividends, interest and royalties paid out by a company or other business entity.

50  Companies Law, Article 266.
51  The reason for seeking a tax holiday is to guard against the possibility of income tax being implemented before completion of the project.
52  See, for example, the order exempting the Middle East Bank from income tax, Dubai Official Gazette No. 129 of 1979. Such exemptions are expressly contemplated by the Income Tax Decrees (Abu Dhabi ITD, Article 2(3) and Dubai ITD, Article 2(3)).
53  As noted previously, courier companies are also taxed by the federal government.
ii  Domestic law exclusions or exemptions from withholding on outward-bound payments
There are currently no withholding taxes, and accordingly the issue of exemptions does not apply.

iii  Double tax treaties
The UAE has an extensive and growing list of double taxation treaties with more than 90 countries. Under these treaties, profits derived from shares, dividends, interest, royalties and fees are taxable only in the contracting state where the income is earned. Although corporate income tax is not levied in the UAE, the provisions of the treaties do not state that such income must be taxed to qualify for benefits. Thus, dividend income paid by a UAE company to a company that has a double taxation treaty with the UAE may not be taxable in the hands of the foreign parent corporation; however, it is wise to study the text of the treaties themselves before assuming anything about the tax treatment of untaxed income flows originating in the UAE.

It is possible to make an application and pay a fee to obtain a tax residency certificate issued by the MOF to confirm a company’s residence in the UAE, and to qualify for the benefits that may accrue to it in another tax jurisdiction with which a double tax treaty has been signed.

iv  Taxation on receipt
As noted previously, the UAE is essentially a tax-free jurisdiction, and most businesses are not taxed at all. Companies falling into the small list of exceptions (foreign banks, foreign petroleum companies and courier companies) are not subject to taxation on receipt.

VII  TAXATION OF FUNDING STRUCTURES
i  Thin capitalisation
There are no thin capitalisation rules (restrictions on loans from foreign affiliates) applicable in the UAE.

54 This network includes treaties with Albania, Algeria, Antigua and Barbuda, Argentina, Armenia, Austria, Azerbaijan, Barbados, Belarus, Belgium, Belize, Benin, Bermuda, Bosnia and Herzegovina, Brunei, Bulgaria, Burundi, Canada, Cameroon, Chile, China, Colombia, Comoros, Croatia, Cyprus, the Czech Republic, Egypt, Equatorial Guinea, Ethiopia, Fiji, Finland, France, Gambia, Georgia, Germany, Greece, Honduras, Hong Kong, Hungary, India, Indonesia, Iraq, Italy, Japan, Jersey, Jordan, Kazakhstan, Kenya, Korea, Kosovo, Kuwait, Kyrgyzstan, Latvia, Lebanon, Libya, Liechtenstein, Luxembourg, Macedonia, Maldives, Malaysia, Malta, Mauritius, Moldova, Mongolia, Montenegro, Morocco, Mozambique, the Netherlands, New Zealand, Nigeria, Pakistan, Palestine, Panama, the Philippines, Poland, Romania, Russia, Rwanda, Saint Kitts and Nevis, Senegal, Serbia, the Seychelles, Singapore, Slovakia, Slovenia, Spain, Sri Lanka, Sudan, Switzerland, Syria, Tajikistan, Thailand, Tunisia, Turkey, Turkmenistan, Ukraine, the United Mexican States (Mexico), the United Kingdom of Great Britain and Northern Ireland, Uruguay, Uzbekistan, Vietnam, Venezuela and Yemen.
ii Deduction of finance costs

For most types of business, the absence of corporate taxation in the UAE renders the issue of deductions meaningless. However, for foreign banks and oil companies there may be relevant considerations relating to deduction of finance costs. These will vary depending on the emirate and the type of business. For example, for foreign oil companies in Abu Dhabi, finance costs may be deductible if they reflect costs incurred in the production of income and are computed by the method of accounting regularly used by the company, provided such method fairly reflects taxable income.

iii Restrictions on payments

Any rules that may prevent the payment of dividends are not tax-driven, and would depend on the provisions in a company's constitutional document (such as its articles of association) or whether the shareholders have specifically agreed conditions that may prohibit paying dividends (e.g., unless the directors are satisfied the paying company can pay debts as they fall due).

iv Return of capital

There are no applicable tax rules or regulations relating to equity capital, and accordingly no UAE tax consequences.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Foreign companies acquiring interests in a local business generally use foreign entities for the acquisition. The reason is not tax-driven, but rather a result of local ownership requirements. As noted above, UAE law requires 51 per cent UAE ownership of companies incorporated in the UAE.

UAE tax considerations are not relevant to the structuring of the financing of the transaction. Note that share capital must be paid in cash at the time the shares are issued. Some investors contribute capital through a combination of equity and shareholder loans. The reasons for using shareholder loans rather than equity are generally to lower statutory reserve requirements and facilitate return of investments to shareholders without having to go through the process of applying to reduce the share capital of the company.

ii Reorganisation

There is no taxation levied when a business in the UAE merges with (or demerges from) an existing local business.

iii Exit

Should a business decide to exit from the UAE, this will not give rise to any taxes or penalties as such. It will, however, attract fees in the course of the deregistration process, and the amounts involved can be significant.

Where an inward investor has done business in the UAE through a local agent or distributor (and which has been registered pursuant to the Commercial Agencies Law), the statutory protections to the local party flowing from such registration include, inter alia,
exclusivity, restrictions on the foreign party’s right to terminate or withhold renewal of the relationship, and the right to receive compensation on termination or non-renewal of the relationship.

**IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION**

i **General anti-avoidance**
There are no applicable general avoidance rules owing to the fact that the majority of businesses are exempt from taxation.

ii **Controlled foreign corporations**
There are no controlled foreign corporation rules in the UAE.

iii **Transfer pricing**
No transfer pricing rules apply in the UAE.

iv **Tax clearances and rulings**
It is possible to obtain advance tax rulings to secure a measure of certainty. Although the UAE is generally a tax-free jurisdiction, taxes are imposed on foreign oil companies. The tax treatment that will be extended to, for example, a specific petroleum project must be negotiated in detail and in advance, and a legislative relief required to implement the desired tax relief must be validly obtained under local law. For major projects, tax holidays or the extension of national treatment may only be available for a specified period of time.

**X YEAR IN REVIEW**

In recent years, the International Monetary Fund and World Bank have recommended the introduction of taxes in various oil-rich Gulf nations to reduce subsidies and consider adopting alternative sources of revenue, and potential changes in taxation policy. The UAE has acted on this advice. Examples include the establishment of the Federal Tax Authority and the implementation of VAT and the excise tax. Rumours about corporate income tax have thus far been premature.

The European Union maintains a blacklist of non-cooperative jurisdictions for tax purposes. The UAE was added to the blacklist in March of 2019. In response, the UAE Cabinet issued Cabinet Resolution 31 of 2019 Concerning Economic Substance Regulations (the Economic Substance Regulations), which came into effect on 30 April 2019. On 11 September 2019, the MOF issued Guidance on the Economic Substance Regulations. In October 2019, the UAE was removed from this blacklist.

The United Arab Emirates issued federal decree No. 24 of 2019 for the ratification of the country-by-country reporting Agreement. Thereafter, on 30 April 2019, Cabinet Resolution No. 32 of 2019 was issued introducing the requirements on Country-by-Country Reporting (CbCR) in the UAE. CbCR is part of Action 13 of the Base Erosion and Profit Shifting (BEPS) initiative led by the Organization for Economic Co-operation and Development (OECD) and the Group of Twenty (G20) industrialised nations. BEPS

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55 As discussed above, foreign banks and courier companies are also subject to taxation.
Action 13 requires large multinational groups of entities (MNEs) to file a CbC Report that should provide a breakdown of the MNE group’s global revenue, profit before tax, income tax accrued and some other indicators of economic activities for each jurisdiction in which the MNE operates. The purpose of CbCR is to eliminate any gap in information between the taxpayers and tax administrations with regard to information on where the economic value is generated within the MNE group and whether it matches where profits are allocated and taxes are paid on a global level.

Groups of companies that meet the following criteria should comply with CbCR legislation in the UAE:

a. MNE Groups, that is, groups that consist of two or more enterprises that are residents for tax purposes in different jurisdictions (an enterprise that is resident for tax purposes in one jurisdiction and has a taxable permanent establishment in another jurisdiction should be considered as a separate enterprise in the context of this definition); and

b. have a total consolidated revenue that is equal to or more than 3.15 billion dirhams for the financial year preceding the reporting year concerned.

According to Cabinet Resolution No. 32 of 2019, CbCR requirements are applicable to financial reporting years starting on or after 1 January 2019.

XI OUTLOOK AND CONCLUSIONS

The UAE has long been a tax-free haven, but this is starting to change. Following the implementation of VAT and an excise tax in recent years, the introduction of the Economic Substance Regulations in 2019 is another indication of the UAE’s willingness to change its tax rules. Furthermore, lower oil prices and a desire to diversify the economy have changed the landscape. The introduction of VAT has resulted in a change to the way business is conducted and administratively maintained in the UAE. Although the rate of VAT imposition is set at a low 5 per cent initially, there have been rumours (if not expectations) that the rate will be increased. However, the UAE’s Minister of State for Financial Affairs has ruled out increasing VAT and excise tax over the next five years, and an official from the MOF recently reiterated this position. Moreover, it is possible that corporate tax may be introduced in the future, although the MOF says the UAE has no plans to do so.

56 ‘No VAT, excise tax increase over next five years in UAE’, Khaleej Times, 11 February 2018.
57 ‘UAE has ‘no income tax plans’ says senior government official’, The National, 7 November 2019.
58 ibid.
Introduction

Over a number of years, the UK has developed a very competitive tax system for business, with low tax rates and wide-ranging reliefs and exemptions. However, for much of 2019, the future of the UK as an attractive business location was under pressure from the debate over whether the UK would leave the European Union (EU) at all, and if so on what basis. This uncertainty was compounded by the ever-present prospect of a general election and possible change of government and with it a radical change in UK fiscal policies. The Labour Party pledged that, if elected, it would reverse some of the measures referred to above, notably: increasing corporation taxes in stages to 26 per cent (21 per cent for small businesses) and increasing income taxes to 50 per cent above £123,000 and to 45 per cent above £80,000. In addition, the Labour Party proposed tightening the regime for public issuance of debt, advance tax rulings and general tax avoidance rules.

The election of a Conservative government with a large majority on 12 December 2019 has removed much of this uncertainty. It now looks certain that the UK will leave the EU in 2020 and that most of the provisions of the Finance Bill 2020 put forward by the Conservatives prior to the election (published on 11 July 2019 and due to become law in March 2020), referred to in more detail below, will pass into law in 2020. However, while the position at the end of 2019 was considerably more certain than it was for most of the year, a residual level of uncertainty remains. While it looks highly likely that the Conservative government’s legislation for the UK to leave the EU during 2020 (the target date is 31 January) with most EU based cross-border arrangements and laws continuing until 1 January 2021 during a transitional period, will be passed, what will happen after 1 January 2021 remains an open question. Agreeing the detailed terms of a trade deal with the EU is no easy matter and during the election the Prime Minister promised not to extend the transitional period beyond January 2021, so raising the prospect of a ‘no-deal’ Brexit if terms cannot be agreed in the next year or potentially a further extension to the transition period if a deal takes longer to agree.

Although recent surveys suggest that businesses already in the UK continue to regard the UK as a good business location, it remains to be seen what effect these factors will have on business confidence and whether businesses looking to relocate will be deterred, or at least defer making a decision until the immediate future looks more certain.

1 Tim Sanders is a retired partner at Skadden, Arps, Slate, Meagher & Flom LLP and currently works as a tax adviser for an NYSE-listed company.
II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

There are many different entities and business organisations through which business can be conducted in the United Kingdom. Numerous factors influence the final choice, notably market practice in the business sector, regulatory requirements and tax treatment. The most common types are described below.

i Companies

The most commonly adopted vehicle for doing business in the United Kingdom is a limited liability company. Such companies can be incorporated quickly and cheaply, subject to agreeing the preliminary details such as the names of its officers, its registered address and its name; it is common to buy pre-formed or ‘off-the-shelf’ companies.

Although such companies can be limited by guarantee or unlimited, businesses generally use a ‘limited liability’ company, which is liable for all its debts and obligations without limit but where the investing shareholders’ liability is limited to the share capital they invest. This reflects the fact that generally, under UK law, a company and its shareholders are separate legal persons. In very limited circumstances, notably where a person seeks to deliberately avoid an existing liability or restriction by interposing a company they control, a court may look through the corporate veil to the controlling person.

There are two forms of limited company: the private limited company (designated with the suffix ‘Limited’ or ‘Ltd’) and the public limited company (designated with the suffix ‘plc’).

Limited companies can issue share capital of different classes, if required, with each share class conferring different rights (to dividends, on voting, etc.). Share capital in a UK company can be denominated in a currency other than sterling. There are no minimum capital requirements for private companies, but a public limited company must have a minimum share capital to comply with UK company law, which is derived from the Second Company Law Directive (77/91/EEC). A UK public company has a minimum capital requirement of either £50,000 or €57,100, and this must initially be satisfied entirely in either sterling or euros (although only one-quarter, or £12,500, of this needs to be paid up, and the company may have shares denominated in currencies other than euros or sterling).

Only public companies can offer shares to the public, so it follows that all listed companies will be plcs. Not all plcs, however, are listed on recognised investment exchanges, or for that matter offer their shares to the public.

In return for providing the shareholders with limited liability, the law requires a degree of disclosure, and limited companies must file annual information that is kept on a public register, notably annual audited accounts (with some exceptions for small companies), details of its directors and shareholders, and details of share transfers.

Unless prohibited by the company’s constitution, the directors and the company secretary can conduct the company’s affairs and bind it. The directors are subject to statutory obligations that ensure that when they act they pay proper regard to the interests of shareholders, creditors and employees; thus, for example, if a director allows a company to continue to trade while insolvent, such director may be held personally liable for the company’s debts.

Directors of UK limited companies do not have to hold shares in the companies or reside in the United Kingdom, and no professional qualifications are required.
United Kingdom

**Taxation**

A detailed description of how companies are taxed is set out below. Broadly, however, a UK-resident company is taxed on its worldwide profits calculated on the basis of the profits shown in its audited accounts as adjusted in accordance with tax principles.

**ii Partnerships**

Partnerships are used by many businesses in the United Kingdom, notably by professions such as accountants, lawyers and doctors, and as investment vehicles for private equity. They can take several forms: contractual or general partnerships, limited partnerships and limited liability partnerships (LLPs).

A straightforward contractual partnership has no separate legal personality (although a Scottish partnership is an exception), and the partners are liable for the acts of the partnership. For tax purposes, a contractual partnership is transparent.

A limited partnership must have a 'general' partner, which has unlimited liability for the partnership, and which generally manages the partnership's business affairs. The limited partners' liabilities are limited to their capital contributions, rather like a shareholder in a limited company, and they are not permitted to participate in the general management of the partnership.

The Limited Liability Partnerships Act 2000 introduced LLPs. An LLP has similar disclosure and filing requirements to UK limited companies, including the filing of an annual return and accounts. An LLP has separate legal personality from its members, but for tax purposes is transparent provided it carries on a trade (profession) or a business for the purpose of making a profit. Her Majesty’s Revenue & Customs (HMRC) has confirmed that the word ‘business’ may be widely interpreted, so, for example, it would only be in exceptional circumstances that holding and managing a portfolio of investments, or letting a building on a commercial basis, would not be considered a business.

Despite the general rule that a partner in an LLP’s exposure is limited to capital invested, if the Finance Bill 2020 is enacted materially in the form introduced in July 2019, members and shadow members of an LLP involved in tax avoidance, evasion or phoenixsm (the practice of carrying on the same business or trade successively through a series of companies where each becomes insolvent) may become jointly and severally liable for tax due to HMRC. This may happen if the LLP becomes subject to an insolvency procedure or such involvement is likely. A shadow member of an LLP is a person in accordance with whose directions or instructions the members of the LLP are accustomed to act, other those providing advice in a professional capacity.

**Taxation**

UK general partnerships, limited partnerships and limited liability partnerships are all generally transparent for UK tax purposes. The activities of the partnership are treated as being carried on by the individual partners and not by the partnership as a body. Partners are individually responsible for reporting and paying the tax due on their share of the partnership’s profit and gain.

Although generally one partner is nominated to complete and file a tax return for the partnership showing the aggregate taxable profits and the partners’ allocated shares, the only purpose of such return is to enable the partners to extract their share of the profit from it to include in their tax returns. The partnership tax return is not used to pay tax for the partnership, as happens when a corporate entity submits its tax return. In 2019 a first-tier
tribunal case (Inverclyde Property Renovation LLP and another v. HMRC [2019] UK FTT 408(TC)) held that an LLP should not be treated as corporates so not transparent for tax administrative purposes. However, despite this decision, HMRC’s guidance continues to state that an LLP is treated as a partnership for administrative purposes.

One complication of this system is that the partnership must calculate its profits and losses on the same technical basis as applies to its partners. Thus, a partnership comprising UK resident companies and individuals and non-UK-resident companies and individuals would have to prepare a tax computation under the rules applicable to each type of partner, so four different tax computations. To simplify the system provisions were introduced in the Finance (No. 2) Act 2017 that broadly calculate the partnership profits as if each partner is the same then allocates profits to each partner based on their profit share.

A partner is normally self-employed for tax purposes, so there are more liberal rules about offsetting expenses, and since partners are not employees (although salaried partners may be), no employers’ national insurance contributions (NIC) will be payable and partners will be subject to a different rate of NIC.

There are rules that counter some perceived abuse in the use of partnerships in certain areas that cause loss of tax to the UK Treasury. In particular, these rules apply where firms disguise what in reality are employment relationships as self-employed arrangements by making employees partners in limited liability partnerships (to benefit from the above NIC advantages). Also, where there are partnerships with non-individual members, in certain circumstances profits allocated to such non-individual members may be reallocated to an individual member; for example, if an individual member forms a company, makes it a partner in the LLP and then artificially diverts his or her profit share to such company.

As regards disguised employments: in broad terms, if three conditions are met by a member of an LLP incorporated under the Limited Liability Partnerships Act 2000, that person will be treated as an employee, but if any of the conditions are not met then the member can be treated as a self-employed partner.

Broadly, the three conditions are:

a. it is reasonable to expect that at least 80 per cent of the total remuneration received by the member during the relevant period is disguised salary (i.e., not linked to the LLP’s profits);
b. the member does not have significant influence over how the affairs of the LLP are run. The logic is that one would expect the owner of a business to have such influence whereas an employee would not; and
c. the member’s capital contribution to the LLP is less than 25 per cent of the total amount of the disguised salary.

Although, for tax purposes, the activities of a general partnership are treated as carried out by the individual partners, registration for value added tax (VAT) purposes can be made in the name of the partnership. HMRC treat an LLP as a body corporate for VAT purposes making the partnership rather than the members, liable to register for VAT.

iii UK permanent establishment (place of business or branch)

An overseas company can set up a UK permanent establishment (PE). For example, a French company could rent an office and employ staff and start to trade in the UK through that office. Such a UK PE is the same legal entity as its non-UK parent, which is therefore liable for the obligations incurred by its UK business.
UK law (the Overseas Companies Regulations 2009) governs foreign companies operating in the UK. It provides that foreign companies (but not partnerships or unincorporated bodies) must, within one month of opening a UK establishment, register prescribed particulars of the foreign company and the UK establishment with the Registrar of Companies (the authority charged with the administration of English companies), including:

a. the non-UK company’s corporate name, legal form, register in which it is registered and its registration number;

b. a certified copy of the foreign company’s constitutional documents, together with a certified translation if they are not in English;

c. details of the directors and secretary of the foreign company; and

d. particulars of the UK establishment including its name (if different from the name of the overseas company), address, the date it was opened, the business carried on by it and the name and address of every person resident in the UK who is authorised to accept service of documents on behalf of the foreign company with respect to the establishment.

From 1 October 2011, overseas companies no longer need to register charges they create over their UK assets with Companies House. In general, foreign companies must file with the Registrar of Companies any accounting documents that they are required to prepare and disclose under the law of the country in which they are incorporated. The specific filing requirements vary depending on whether a foreign company is incorporated within or outside the EEA, it is a credit or financial institution, or it is a company whose constitution does not limit the liability of its members.

Every foreign company that has registered a UK establishment must, with some exceptions, display at its places of business its name and the country in which it is incorporated. Its name and other prescribed information must also appear on all business letters, websites and other specified correspondence used in its UK activities. There are also restrictions on the name the overseas company can register in the United Kingdom.

**Taxation**

A non-UK-resident company that carries on a trade in the United Kingdom through a UK PE is subject to UK corporation tax on its profits, broadly calculated and charged as if the PE were a UK company. Like a UK incorporated company, a UK PE is taxed on profits, but only to the extent that they are properly attributable to such PE as if such PE is a stand-alone entity dealing on an arm’s length basis with the non-resident company. HMRC broadly follows the Organisation for Economic Co-operation and Development (OECD) guidelines on profit attribution. Agreeing how profits should be allocated can sometimes be an area of dispute. Unlike a UK company, which needs to pay a dividend to extract profits, the net profit of a UK permanent establishment can simply be paid to the non-UK owner.

A PE is sometimes used where the non-UK company anticipates that in the early period of UK trading, losses will be made that can be used to offset profits of the non-UK owner if the business is run through a PE.

If a non-UK resident company has a trade of dealing in UK real estate or developing land with a view to disposing of it, such company can be taxed irrespective of whether it is carried on through a UK PE.
III DIRECT TAXATION OF BUSINESSES

i Corporation tax
UK companies are subject to corporation tax on all worldwide profits, whether such profits are income or capital in nature. Profits for corporation tax purposes must be calculated in accordance with generally accepted accounting principles (GAAP), subject only to any adjustments required or authorised by law. The key adjustments are for losses, allowances and expenditure that, while reflected in the accounting profits, are not allowed for tax purposes so are added back when calculating profits for tax purposes.

Calculation of taxable profits
UK resident companies (see Section IV) are subject to UK corporation tax on their profits, wherever they arise. A non-UK company that trades in the United Kingdom through a PE (branch or agency) is subject to corporation tax on the profits of the branch or agency, which are broadly calculated as if the PE were a stand-alone company in its own right.

Corporation tax is charged on the profits of each financial year, which runs from 1 April (so, for example, the 2018 financial year is the year from 1 April 2018 to 31 March 2019). The tax charged for such financial year is based on the accounts of the company prepared for the accounting period that falls in that financial year (an accounting period is generally 12 months, but while it cannot exceed 12 months, it can be less). Where the company’s accounting period and accounts for such period do not coincide with the financial year, the profit shown in the relevant set of accounts is, when required, apportioned, on a time basis, between the financial years that overlap the accounting period.

Calculation of income profit
The most common adjustments to accounting (income) profits before they are taxed are as follows.

Expenses
Although all expenses incurred by the company will depress accounting profit, not all such expenses will be allowed for tax purposes. To be deductible, an expense must be ‘wholly and exclusively’ incurred for the purposes of the company’s trade. Whether an expense is so incurred is a question of the company’s intent in incurring a cost and is thus a question of fact. It is often clear and obvious that an item of expenditure was incurred to promote the interests of the trade, such as paying staff salaries or suppliers of raw material used to make products produced by the trade. The position is not always clear, however, and there is a great deal of case law that considers when an item of expenditure, deducted in the accounts, is also deductible for tax purposes; for example, expenditure may be incurred on fees connected with changes to share capital, which would generally be regarded as non-deductible, as such an expense is incurred in connection with the company’s capital structure, not its trading activity. In addition, expenditure incurred with a dual purpose, such as the cost of an airfare of an employee who goes on holiday but visits a customer while on the holiday, would generally be disallowed.

In addition to the general rule that expenditure must be wholly and exclusively incurred for the purpose of a trade to be deductible, there are a few important cases provided for in legislation that make specific items of expenditure deductible or non-deductible for corporation tax purposes, irrespective of whether such cost was incurred in the course of trade.
The most important example of this is probably expenditure on client business entertainment. Irrespective of the purpose of incurring expenditure on business entertainment or gifts, the general rule is that it is not deductible. Conversely, incidental costs of obtaining loan finance, such as bank fees and commissions, which under the general rule may be regarded as linked to capital rather than trading, are specifically allowed as a deduction.

Depreciation (capital allowances)
Accounting depreciation is generally not the basis upon which tax depreciation is based, and tax depreciation is based on a system of capital allowances. There a number of exceptions, where tax broadly follows accounting amortisation, most notably in the case of intangible fixed assets and loan relationships.

‘Intangible fixed assets’ defined by GAAP include patents, trademark and copyright. Such assets, provided acquired or created after 1 April 2002 (internally created goodwill for accounting periods starting after 22 April 2009), will be amortised in accordance with the amortisation in the accounts prepared in accordance with GAAP. However, the Finance Act 2015 introduced measures that denied relief for ‘relevant assets’, notably goodwill, customer information and unregistered trademarks. This made the UK less generous than many other countries, as well as creating tax differences in the treatment of intangibles that was not consistent with their accounting treatment. In response to these concerns the Finance Act 2019 introduced relief for the cost of goodwill, customer information and unregistered trademarks from 1 April 2019, with exceptions for such assets acquired as part of the acquisition of a business.

Although not all capital expenditure qualifies for capital allowances, allowances are normally given for expenditure on things such as plant and machinery, and R&D.

Expenditure on plant and machinery is pooled for capital allowance purposes and generally depreciated for tax purposes at 18 per cent per annum on a reducing balance basis. In the case of long-life assets (assets with an anticipated working life of 25 years or more), the rate is 6 per cent per annum from 6 April 2019. However, first year allowances at 100 per cent are available for expenditure on certain qualifying technology with energy-saving or other environmental benefits (often referred to as enhanced capital allowances).

If assets are sold at a price above their tax-depreciated value, there may be a clawback of allowances, or if assets have been under-depreciated there may be a balancing allowance.

Many companies claim an annual investment allowance (AIA) that is designed to encourage businesses to invest in equipment by giving tax relief (broadly a 100 per cent offset for cost in the year in which it is incurred) for qualifying business capital expenditure up to a maximum annual sum (currently £200,000 per annum but temporarily increasing to £1,000,000 per annum for expenditure incurred between 1 January 2019 and 31 December 2020).

Trading and income losses
If there is a trading loss in any year, the loss can be offset against total profits (income or capital) for the current accounting period of the company. The trading loss can be set against all profits (including chargeable gains) and not just the profits arising from the same trade as that in which the loss was incurred.

Excess trading losses can also be surrendered to another UK company in the same group or consortium (see below for a description of the taxation of groups) or carried back to set off against the company’s total profits (income or capital) of the preceding year.
Income and trading losses realised prior to April 2017 can also be carried forward indefinitely and offset but only against income profits arising from the same trade. However, the Finance (No. 2) Act 2017 allows companies to set certain carried-forward losses (notably trading losses) made after April 2017 against total profits, rather than be restricted to set-off against profits of the same trade. However, the Finance (No. 2) Act 2017 imposes a new restriction on the amount of trading profits that can be reduced by carried forward trading losses. Losses made prior to April 2017 can be carried-forward and fully offset against a future accounting period’s profits, but under the new regime only 50 per cent of profits can be reduced by post-April 2017 losses. Companies are entitled to a £5 million allowance against which carried forward losses can be fully offset before the restriction applies. If the Finance Bill 2020 becomes law, then the rules introduced by Finance (No. 2) Act 2017 in respect of trading losses will be extended to capital losses.

R&D tax credit

Relief is available for expenditure on revenue on R&D. The nature and rate of relief depends on whether the company is a large company or a small or medium-sized enterprise (SME).

The relief for SMEs provides a greater than 100 per cent deduction for all qualifying R&D expenditure in computing profits for corporation tax purposes. Relief is given at 230 per cent for SMEs in relation to expenditure incurred on or after 1 April 2015. The enhanced tax benefits used to apply only to small companies but now extend to medium-sized companies (companies with fewer than 500 employees, with an annual turnover not exceeding €100 million or a balance sheet not exceeding €86 million, or both and meets certain independence and going concern tests). If an SME is loss-making after deducting the R&D relief, it can elect to surrender the loss relating to the R&D expenditure and SME R&D relief and take credit in cash from the HMRC, worth up to 14.5 per cent of the surrendered loss. There are proposals that if they become law will cap the repayment at three times the pay-as-you-earn (PAYE) and NIC liability of the company with effect from April 2020.

A separate relief, similar to that available to an SME with some modification, existed for large companies but was phased out and replaced by an R&D expenditure credit (RDEC, also known as the ‘above the line’ tax credit) for R&D expenditure incurred on or after 1 April 2016. Large companies may make an irrevocable election to use the R&D expenditure credit for expenditure incurred on or after 1 April 2013.

Under the RDEC regime, large companies work out the eligible costs directly attributable to R&D, reduce relevant subcontractor or external staff payments to 65 per cent of the original costs, and then multiply the figure by 12 per cent (from 1 January 2018) to obtain the expenditure credit. This credit can then be used to settle the company’s corporation tax liability for the accounting period with any excess being reduced by applying a notional tax charge to it based on the main rate of corporation tax for the accounting period. The remaining amount can be used for various purposes including paying outstanding corporation tax for other accounting periods or surrendered to any group member.

The newly elected Conservative government have pledged to increase the rate of RDEC for larger companies from 12 per cent to 13 per cent and review the regime to see if it can be extended to R&D expenditure on cloud computing and data.

An added attraction of this new regime is the way in which it appears in the company’s accounts. The credit is recognised as part of the company’s profit before tax (hence the reason it is called an ‘above the line credit’) and so will have a favourable impact on a company’s accounting profits.
Expenditure that qualifies for R&D credit is defined by reference to expenditure that qualifies under GAAP, subject to certain exclusions. Most notably, to qualify the R&D must seek to achieve a general advance in knowledge or capability in a field of science or technology, not just a company’s own knowledge or capability; furthermore, the research does not have to be successful for the revenue expenditure to qualify for R&D credit.

It seems likely that proposal to tackle perceived tax avoidance involving claims for R&D tax credits by SMEs notably imposing an annual cap on the amount claimed by an SME loss-making company at three times its total PAYE and NI ability will be introduced from April 2020.

**Calculation of capital (chargeable gains)**

A company is potentially liable for corporation tax on any chargeable gains arising from the disposal of a capital asset. The gain is taxed at the same rate as an income trading profit and is the difference between the original acquisition cost and the disposal value minus designated allowable expenses (e.g. the costs of improvements).

If a capital asset qualifies for capital allowances, these are deducted from the acquisition cost, but only to eliminate or reduce a loss so that if, for example, the asset is sold at a gain, capital allowances are ignored.

Unlike trading losses, capital losses can only be set off against chargeable gains in the same or future accounting periods. Capital losses can be carried forward indefinitely, but not back. Under proposals announced in the 2018 Autumn Statement, from 1 April 2020, the proportion of annual capital gains over a £5 million allowance that can be relieved by brought-forward capital losses will be limited to 50 per cent.

Anti-avoidance rules exist that restrict the ability to buy loss-making companies to use their capital losses, and the use of capital losses made on transactions with related parties.

Rollover relief is available to companies that reinvest the proceeds from disposals of certain types of capital assets into new capital assets. This allows any gains on such assets to be deferred until the new asset is sold, unless the proceeds of that sale are also reinvested.

Subject to the selling company and company being sold meeting certain trading company criteria, broadly a company that holds at least 10 per cent of the share capital of another, and has held such interest for 12 months at any time within a six-year period prior to disposal, may qualify for SSE on a disposal of those shares so that any gain arising on disposal is completely exempt from tax on the capital gain. The Finance (No. 2) Act 2017 introduced certain changes that relax the trading requirements, notably for institutional investors.

**Rates of corporation tax**

The rates of corporation tax are set for each financial year, and if the rate changes during a company’s accounting period, the profits are generally split between the two financial years on a time-apportioned basis and the different rates applied to the relevant part. The corporation tax rate for the financial year commencing on 1 April 2017 is 19 per cent. It was due to be reduced to 17 per cent on 1 April 2020 but this reduction now seems highly unlikely as on 18 November 2019 the prime minister told the annual conference of the Confederation of British Industry (CBI) business lobby group that corporation tax would not fall to 17 per cent next year as the government had originally planned to fund spending on the National Health Service, so it is reasonable to suppose that the rate will remain at 19 per cent.
Groups
Unlike the position in some other jurisdictions, a group is not taxed as a single entity in the United Kingdom, and members of a group are taxed on an entity-by-entity basis but with rules to allow sharing of tax reliefs and movements of assets between group members on a tax-neutral basis. The definition of a group for UK tax purposes differs according to the context, but as a broad rule a company will be grouped with another if 75 per cent of a company’s ordinary share capital (which gives proportionate economic rights, broadly 75 per cent of the right to any dividend paid and assets distributed on a winding-up) is owned by that other company.

Subject to certain exclusions, UK companies within a capital gains tax group may transfer assets between the UK members without triggering a capital gain or UK stamp duty. Current year trading losses (not carried-forward losses or capital losses) and certain other deductions such as debits on loans can be surrendered between group members.

Administration and payment
UK companies self-assess by submitting a tax return generally within 12 months of the end of their accounting period. Returns must be filed with HMRC online in a specified format and the accompanying accounts must also be in a specified format.

If the return is filed late there is a small fixed penalty, which increases to 10 per cent of the unpaid tax if the return is submitted more than 18 months after the end of the accounting period, and then to 20 per cent if the return is more than two years late. Companies (other than small companies) pay their corporation tax by quarterly instalments: two in the current year and two after it has finished. The first payment is due six months and fourteen days after the start of the accounting period; the second three months after the first payment; the third three months after the second payment; and the final payment three months after the third payment. However, for larger companies (those having annual taxable profits of £20 million or more, a figure that is reduced proportionately to reflect profits of associated companies); in respect of accounting periods starting on or after 1 April 2019 this changed to quarterly payments in the third, sixth, ninth and 12th months of the accounting period.

Compliance and reporting
As part of increased compliance and reporting requirements, companies are required to take action outside of the normal requirements to submit accurate tax returns on a timely basis. Large companies (those with turnover greater than £200 million or balance sheet assets over £2 billion) must supply HMRC with the name of their senior accounting officer, who must certify annually that the accounting systems are adequate for the purposes of accurate tax reporting. Penalties are chargeable for careless or deliberate failure to meet these obligations.

Certain tax planning and structuring transactions and arrangements must be disclosed to HMRC before or on implementation of the transaction under the Disclosure of Tax Avoidance Schemes (DOTAS) regime or the Disclosure of Avoidance Schemes for VAT and Other Indirect Taxes (DASVOIT) regime.

Other noteworthy reporting requirements include the obligation to publish tax strategy and country-by-country reporting, discussed in more detail below.

Under the UK Finance Act 2016, all large businesses operating in the UK are required (in respect of all financial years commencing on or after 15 September 2016) to publish, before the end of the first relevant accounting period, their UK tax strategy online. This applies not only to UK companies, UK permanent establishments and UK partnerships with
turnover exceeding £200 million and having a balance sheet total of over £2 billion, but also to multinational groups with a global turnover exceeding €750 million that have any UK presence, no matter how small.

The strategy is restricted to UK strategy and need not divulge how much UK tax is paid or commercially sensitive information but must set out the following relation to UK tax:

a. the company’s approach to risk management and governance arrangements;
b. the company’s attitude to tax planning;
c. the level of risk the company is willing to accept;
d. the company’s approach towards dealings with HMRC; and
e. a statement that the company regards the publication as complying with its duty under the Finance Act 2016.

The strategy must be accessible free of charge on the internet and be republished every subsequent year.

The Criminal Finances Act 2017 introduces new strict liability offences with potentially hefty fines for failing to prevent facilitation of UK and non-UK tax evasion. Businesses in the financial services, legal and accounting sectors are likely to be most affected, but it applies to all companies and partnerships. There is a statutory defence where there are reasonable preventative procedures in place to prevent its associated persons from committing tax evasion facilitation offences. In practice, this will mean that businesses will probably start to introduce policing procedures and start including provisions in commercial contracts, employment contracts, etc., to protect against financial and reputational risk.

The UK country-by-country reporting obligations apply to accounting periods beginning on or after 1 January 2016. UK-parented multinationals with revenues above €750 million or entities with a non-UK parent in a country that has no country-by-country reporting or effective exchange of information mechanism with the UK will need to submit a report (following the OECD template) in respect of the global group or UK subgroup, as appropriate, to HMRC within 12 months of the year end. Following OECD recommendations, a multinational group can file in the UK on a group-wide ‘surrogate’ basis.

ii Other relevant taxes

Stamp duties

The United Kingdom has no capital duties but does levy stamp duties. Stamp duty land tax (SDLT) is charged on the execution of some documents that transfer land in England and Northern Ireland generally at rates of up to 5 per cent on commercial property and 12 per cent on residential property, unless the purchaser is a non-natural person (see below). If the residential property is leasehold and the total rent over the life of the lease is more than £250,000 you also pay 1 per cent on the portion over 1 per cent. SDLT does not apply in Scotland, where Land and Buildings Transaction Tax applies or in Wales, where a Land Transaction Tax applies as of April 2018. Stamp duty is charged on instruments that transfer UK company shares or securities (usually at 0.5 per cent). Securities generally exclude ordinary commercial loan capital, provided such loan capital has no equity-type characteristics, such as a yield linked to profit. Higher rates of SDLT apply to the purchase of additional residential properties (such as second homes and buy-to-let properties) for chargeable consideration exceeding £40,000. The higher rates are 3 per cent above the current SDLT rates for residential property. The new Conservative government has pledged to add a further 3 per cent SDLT surcharge on non-UK residents purchasing UK residential property.
To discourage the practice of buying residential property in an offshore company then transferring shares in such company without paying SDLT, SDLT is charged at 15 per cent on interests in residential dwellings costing more than £500,000 purchased by certain non-natural persons such as companies, collective investment schemes, and partnerships with one or more members who are either a body corporate or a collective investment scheme. In addition, any such non-natural person that owns a residential dwelling will be subject to an annual tax on enveloped dwellings (ATED). The amount of ATED is worked out using a banding system based on the value of the residential property. Properties on which ATED is paid and which were owned on 1 April 2017 need to be revalued to that date for the purposes of the ATED charge. Currently, there are six valuation bands and six corresponding levels of charge from £3,600 per annum (proposed to be increased to £3,650) for properties worth between £500,000 and £1 million up to an annual charge of £226,950 (proposed to be increased to £232,350) for a residential property worth more than £20 million. Capital gains tax applies on a sale of properties in this regime, even for non-UK resident entities. In respect of both the SDLT charge and ATED, there are exclusions notably for companies acting in their capacity as trustees for a settlement and property developers or property rental businesses that meet certain conditions.

Agreements to transfer UK company shares or securities, or shares of a non-UK company that maintains a UK register of such shares or securities, may attract stamp duty reserve tax (SDRT) (usually at 0.5 per cent). If stamp duty is paid on the instrument of transfer within prescribed time limits, the SDRT charge on the contract predating the formal transfer document need not be paid. Generally, there is an exemption for transfers within a (75 per cent) group. In the past duty was charged on what was paid irrespective of market value but the Finance Act 2019 imposed a market value rule if listed shares or securities are transferred to a connected company where group relief does not apply. If the proposals in the Finance Bill 2020 are enacted, similar provision will be introduced for unlisted shares and securities.

Value added tax

VAT is a tax on non-business consumers, and for most business is an administrative burden rather than a tax cost. VAT is charged on goods and services supplied in the course of business. If the customer is itself a business, is registered for VAT and uses the supplies it receives for business purposes, the business will receive credit for the VAT it pays (input tax), which it can offset against the VAT it charges (output tax). If a business is charged more VAT than it charges its own customers it can reclaim the difference, but if it charges more than it is charged it pays the difference to HMRC. Thus, generally the burden is passed down the supply chain until it reaches the ultimate non-business consumer who bears the cost.

Certain supplies are exempt from VAT, notably supplies of shares and securities (including loans) and certain supplies of land and buildings. Other supplies are zero-rated, such as books, food, transport, children’s clothing and supplies of goods and services outside the United Kingdom. In cash terms, a zero-rated supply (where VAT is charged at zero per cent) is the same as an exempt supply (where no VAT is chargeable), but the difference is that a business can generally recover VAT incurred on costs incurred in connection with a zero-rated supply but may not recover VAT on costs incurred in respect of exempt supplies.

Currently, UK businesses with a taxable turnover greater than £85,000 in the preceding 12 months (it is proposed that this £85,000 limit will apply to April 2020), or where there
are reasonable grounds for expecting that turnover in the next 30 days will exceed this limit, must register for VAT. Businesses may also choose to register if they anticipate being able to reclaim material amounts on VAT charged by their suppliers.

VAT has been generally charged at 20 per cent, with some exceptions such as a rate of 5 per cent on home energy. Taxpayers are required to maintain detailed records of output and input tax. Large taxpayers pay tax monthly, as do those who regularly reclaim; others may pay quarterly.

From 1 April 2019, businesses registered for VAT (other than certain exempt and complex businesses) must keep their VAT records in digital format and must use software to submit their VAT returns electronically.

**Income tax and social security contributions**

Unlike corporate tax rates, the United Kingdom's income tax rates are relatively high and higher still in Scotland; this is a factor that a business thinking of moving into the United Kingdom and relocating staff will need to take into account. In the current tax year (to 6 April 2020), individuals in England, Northern Ireland and Wales pay tax on total chargeable income at 20 per cent (the basic rate) on the first £37,500 of their income, then at 40 per cent (the higher rate) on income above that figure up to £150,000, then at 45 per cent (the additional rate) on income above £150,000. In Scotland there is a five-band structure with the top two bands charging tax at 41 per cent above £30,931 and 46 per cent above £150,000.

There are personal (tax-free) allowances on the first slice of income (generally £12,500 in the current tax year with different allowances in Scotland). Dividend income above £2,000 is taxed at slightly lower rates and interest is tax free up to £1,000 then taxed above this, although those with incomes in excess of £150,000 pay tax on all of their savings income.

Employers are required to deduct income tax from their employees at source and account to HMRC under a system known as pay-as-you-earn (PAYE).

In addition to income taxes, UK employees (other than the very low paid) and their UK employer are subject to NIC. In the current tax year (to 5 April 2020), a UK employer must pay NIC at 13.8 per cent of their employees' gross earnings. The self-employed also pay NIC, but at lower rates.

Employees must also pay NIC on their earnings and the employer is responsible for collecting it from their earnings. It is charged at a fixed rate (currently 12 per cent) between a threshold and an upper earnings limit (currently £962 per week), and thereafter at 2 per cent.

**IV TAX RESIDENCE AND FISCAL DOMICILE**

UK residence is central to the taxation of businesses. A UK-resident company is subject to UK corporation tax on all its worldwide profits, wherever they arise. A non-UK resident company that carries on a trade in the United Kingdom through a UK PE is also subject to UK corporation tax on its profits, wherever they arise, but only to the extent such profits are properly attributable to such PE.

Chapter 3A in Part 2 of the Corporation Tax Act 2009 exempts all profits (including chargeable gains) attributable to non-UK PEs of UK-resident companies from UK corporation tax. To apply, the UK company must make an irrevocable election. Elections are made on an individual company basis, covering all PEs of the electing company. The relevant profits
of the non-UK PEs are determined in accordance with the relevant double taxation treaty (DTT) with the jurisdiction where the PE is based. The regime contains anti-avoidance rules to prevent the artificial diversion of profit from the UK to an exempt PE.

If a company is not UK-resident, nor has a UK trade carried on through a UK PE, its exposure to UK tax is limited, primarily to taxes on UK-sourced income and gains realised on the sale of UK real property.

i Corporate residence

A company can be UK-resident either by being incorporated in the United Kingdom under the UK Companies Acts or, if incorporated outside the UK, by virtue of having its central ‘management and control’ exercised in the United Kingdom.

This test derives from case law, notably the leading case of *De Beers Consolidated Mines v. House,*\(^2\) in which the House of Lords adopted a fact-based test of UK residence, which became known as the central management and control test.

The *De Beers* case laid down two important principles: that a company is UK-resident if managed and controlled in the United Kingdom, and that where such management and control is exercised is a question of fact. These principles were expanded and clarified in later cases.

In the case of *American Thread Co v. Joyce,*\(^3\) the House of Lords made it clear that management and control is not day-to-day management but strategic and policy decisions, and that such decisions are generally as a matter of fact taken by directors. HMRC is threatening to change this test so it is more akin to the OECD test for a ‘place of effective management’, which takes into account wider management functions.

However, while the presumption is that management and control are exercised by a company’s board, the facts are still paramount, so if, factually, control is exercised outside the board, one looks to where that control is actually exercised. When considering where the ‘central management and control’ exists, it is essential to distinguish cases where management and control are exercised through a company’s constitutional organs from cases where the decisions of those constitutional organs are usurped, and to further distinguish between cases where an ‘outsider’ proposed, advised and influenced decisions taken by the constitutional organs, and cases where such an outsider dictated the decisions and ‘usurped’ such constitutional organs.

The cases illustrate the importance of ensuring that the board exercises real discretion and does not merely rubber-stamp decisions taken elsewhere and that contemporaneous records supporting this are kept.

Residence questions are rarely clear-cut, and the determination will be dependent on what occurs in practice and on the supporting evidence.

Sometimes different tests of residence are applied in different jurisdictions, with the result that a company may be regarded as resident in more than one jurisdiction. In such cases the company is dual-resident, and one has to look to DTTs to avoid exposure to double taxation and specifically to provisions often referred to as tie-breaker provisions. Treaties that follow the OECD model usually contain a clause that refers to a company being resident in the jurisdiction where it has its ‘place of effective management’. The OECD commentary states that the place of effective management is the place where key management and

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\(^2\) [1906] AC 455; 5 TC 198, 211, HL.

\(^3\) (1913) 6 TC 163.
commercial decisions necessary for the conduct of the company’s business are made, which is
normally where the board of directors makes its decisions, but stresses that one must consider
all facts and circumstances. HMRC takes the view that this means that, when looking at the
‘place of effective management’, one has to have regard for the day-to-day management of the
company, and not just the highest level of decision-making required by the UK management
and control test.

ii Residence through a UK branch or PE

As stated above, a non-resident company is only subject to UK corporation tax if it carries on
a trade in the United Kingdom and such trade is conducted through a UK PE. There are two
notable exceptions to this rule: (1) Diverted Profits Tax (broadly where there is manipulation
to avoid a UK PE); and (2) where a non-UK resident company has UK real property income.
From 6 April 2020, non-UK companies that carry on a UK real property business or have
other UK property income will be charged to UK corporation tax on such profit (also certain
capital gains derived from UK real property will also be taxed).

What constitutes a trade is a question of fact determined by looking at certain criteria
known as ‘the badges of trade’ laid down by UK case law, as there is no satisfactory statutory
definition of what constitutes trading.

The UK definition of a PE is based on the OECD Model Treaty definition and means a
fixed place of business through which its business is wholly or partly carried on. A fixed place
of business includes:

a a place of management;
b a branch;
c an office;
d a factory;
e a workshop;
f an installation or structure for the exploration of natural resources;
g a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
or

b a building site or construction or installation project.

UK law also follows the OECD model in excluding from the definition of what constitutes a
UK PE activity carried on at a place of business that are preparatory or auxiliary in character.
For activities to be regarded as preparatory or auxiliary in character they must be sufficiently
remote from the actual realisation of profits by the enterprise that it would be difficult to
allocate part of that profit to the potential UK PE. Such activities include:

a storing, displaying or delivering the company’s goods or merchandise;
b maintaining the company’s goods or merchandise for the purpose of storage, display or
delivery, or processing by another person;
c purchasing goods or merchandise for the company; and
d collecting information for the company.

In addition, if a non-UK company has a UK agent that habitually exercises authority to
conduct the company’s business in the United Kingdom, such agent will also be a PE of the
company unless such agent has independent status and acts for the non-UK company in the
ordinary course of its (the agent’s) business.
It is not enough for a company to have a PE in the United Kingdom: it must also be trading in the United Kingdom, not just with it. To determine this, one must look at where the operations take place and where the profits arise, and a key factor is where the contracts are entered into (see *Firestone v. Llewelin*).4

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

As stated elsewhere in this chapter, the United Kingdom can be attractive as it has:

- a low corporate tax rates;
- b no withholding from dividend payments and a wide exemption from tax on receipt of dividends;
- c a wide treaty network that offers treaty relief from withholding from interest and royalties;
- d generous rules for allowing deductions for borrowing costs even if such borrowing was for a capital purpose such as acquiring a subsidiary; and
- e substantial shareholder exemption that can exempt gains on the sale of 10 per cent (or more) shareholdings in trading companies.

The United Kingdom introduced a patent box regime from 1 April 2013 that applies to all patents (but not copyright, know-how, etc.) first commercialised after 29 November 2010. The regime applies a 10 per cent tax rate to all relevant profits (royalties, fees, sale proceeds, sales of products with embedded patent rights and compensation) derived from the active exploitation of qualifying patent rights.

A qualifying patent is restricted to those registered with the European Patent Office or United Kingdom Intellectual Property Office. The party claiming relief need only to have a beneficial interest.

The regime was modified by the Finance Act 2016 to bring it in line with recommendations from the OECD Forum on Harmful Tax Practices. The key change was the introduction of a ‘nexus’ (or R&D) fraction, which takes into account the location, and nature of a company’s underlying R&D activity, in determining the available patent box benefit. This restricts the relief where R&D is subcontracted out even within the UK group.

To date and despite a UK government desire to encourage innovation, the regime has not proved terribly successful. Many reasons have been advanced for its relatively low take-up, most plausible of which is the regime’s sheer complexity leading to compliance expense that discourages all but the largest companies. Also, much modern innovation falls outside the patent regime.

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4 (1957) 37 TC 111.
VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Dividends

There is no UK withholding tax from dividends paid by a UK company irrespective of the status or location of the holder. Since 1 July 2009, the United Kingdom has operated an exemption regime (prior to 2009 it operated a credit scheme) for dividends received by a UK company, the effect of which is broadly that, provided the company is not involved in a tax-avoidance scheme of which the dividend forms part, dividends are exempt upon receipt. To be exempt, a dividend must meet a number of conditions apart from the tax-avoidance condition. The exemption will not prevent dividends received by share traders and others receiving dividends on trading account being taxed in the normal way.

A small company (one that has fewer than 50 employees, and whose annual turnover or annual balance sheet total (or both) does not exceed €10 million) can receive all dividends free of tax provided the dividend is not capital in nature, is not deductible for the payer and the payer is not based outside the United Kingdom in a non-‘qualifying territory’. A qualifying territory is one with which the United Kingdom has a DTT containing a non-discrimination provision.

All other companies can receive dividends on an exempt basis if, as well as meeting the anti-avoidance test and the dividend being non-deductible for the payer, the dividend falls into an exempt class.

The main exempt classes of dividend are:

a. the ‘control exemption’: dividends paid by a company to a company that controls it;
b. the ‘ordinary shares exemption’: dividends paid in respect of (non-redeemable) ordinary shares;
c. the ‘portfolio exemption’: dividends paid on portfolio shareholdings where the shareholder holds less than 10 per cent of the issued share capital of the paying company; and
d. the ‘relevant profits exemption’: dividends paid out of ‘relevant profits’ being effectively ordinary profits derived from transactions that do not have the effect and main purpose of having a more than negligible reduction in UK tax.

Non-exempt dividends are taxed at the normal rates of corporation tax subject to potential credits for withholding and underlying taxes. UK individuals are taxed on dividends received, and the corporate exemption has no equivalent.

As UK domestic law only imposes withholding tax on dividends paid by UK companies in limited circumstances, Brexit is unlikely to have much impact. However, a UK parent receiving dividends from a subsidiary based in the UK after Brexit, if it happens may, depending on the terms upon which the UK leaves the EU, have to rely on its tax treaties to mitigate EU state (non-UK withholding) from dividends paid to the UK.

ii Interest

The United Kingdom imposes withholding tax (currently at 20 per cent) on payments of annual interest by a UK resident (interest on loans with a term of less than a year can be paid gross). There are a number of important exceptions to the obligation on the payer to withhold and account for tax, notably on:

a. interest paid on bonds listed on a recognised stock exchange;
United Kingdom

Interest

- interest paid to UK corporates;
- interest paid to a UK PE of a non-UK corporate where the UK PE brings such interest into the charge to UK tax; and
- interest paid to a UK ‘bank’ and interest where it is paid without withholding because of the application of a relevant DTT.

Many (but not all) UK treaties eliminate UK withholding tax from interest; however, in order for the relief under a DTT to be applied, the UK payer and non-UK payee must submit an application that can take a number of months to process, and that often causes problems with the first interest payment when interest is payable quarterly or more frequently.

As a member of the EU, the UK was party to both the EU Council Directive 2011/96/EU (Parent-Subsidiary Directive) and Council Directive 2003/49/EC (Interest and Royalties Directive). If Brexit happens and the UK leaves the EU, it should have relatively little impact on withholding from UK source interest and royalties (see below) as the UK has incorporated the Interest and Royalties Directive into UK domestic tax law, so the UK withholding exemptions should continue, at least for a period. However, a UK parent receiving interest and royalties from a subsidiary based in the EU after Brexit may have to rely on its tax treaties.

Interest is generally deductible for a UK business payer, subject to thin capitalisation and corporate interest restriction rules (described below), provided that the loan does not have equity characteristics that result in the interest being recharacterised as a distribution (e.g., interest that varies in line with the payer’s profits).

iii Royalties

Payments of copyright royalties to non-UK residents and payments of patent royalties are subject to withholding tax (currently at 20 per cent), but many UK DTTs eliminate such withholding. As stated above, certain payments between 25 per cent-associated companies within the EU can be made free of withholding from royalties (and interest).

The Finance Act 2016 made some significant changes to withholding from royalties paid to non-UK residents, notably where:

- the payment is part of arrangements that exploit the UK’s double tax treaties to ensure that little, or no, tax is paid on such royalties in the UK or elsewhere, in which case a withholding may have to be made even if this would normally be reduced or eliminated by a double tax treaty. There is an exception where the royalty is covered by the EU Royalties Directive (unless broadly the arrangements are designed to avoid tax and have been made to fall within the Directive); and
- a UK permanent establishment obtains intellectual property rights as a result of its non-UK parent paying a royalty to another non-UK entity. In such a case, the UK permanent establishment is potentially required to withhold from that non-UK royalty payment (previously such a royalty would not be treated as having a UK source so would not be subject to UK withholding).

iv Tax treaties

The United Kingdom has an extensive network of treaties with all developed non-tax haven countries and the majority of countries in the developing world. Most treaties are based on the OECD model, and some have provisions against treaty shopping.
United Kingdom

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

The UK no longer has a specific thin capitalisation rule, although, de facto, there is such a regime included within the transfer pricing regime. Where there are financing transactions between connected parties, transfer pricing rules require tax to be calculated on the basis of what the arm’s-length financing provision would have been should the actual financing confer a tax advantage in comparison with an arm’s-length result. These rules apply to transactions between UK taxpayers, as well as cross-border transactions.

For the transfer pricing rules to apply, there has to be a ‘special relationship’ between the companies concerned. A special relationship is defined as a relationship where one company controls the other, or both are controlled by the same person or persons. This is a narrower definition of special relationship than one typically finds in the United Kingdom’s DTTs. If there is a special relationship, one has to consider if the financing is at arm’s length. One is required to ask a number of questions, most notably:

a whether the loan would have been made at all in the absence of the special relationship;

b the amount of the loan that would have been made in the absence of the special relationship; and

c the rate of interest and other terms that would have been agreed in the absence of that relationship.

Thus, if, for example, X lends its subsidiary Y £300 million at an arm’s-length interest rate on normal commercial terms, but the loan would not have exceeded £200 million had there been no special relationship between X and Y, then the interest paid on the £100 million of debt that exceeds the arm’s-length facility may be disallowed. If the principal was at an arm’s-length amount but the interest rate is, say, 5 per cent, whereas the arm’s-length rate would be 4.75 per cent, then the 0.25 per cent excess rate paid by virtue of the special relationship is likely to be disallowed.

In addition to the thin capitalisation rules in the transfer pricing regime described above, interest costs may be disallowed as a tax deduction under specific rules: under the debt cap prior to 31 March 2017 and post 1 April 2017 under rules introduced by the Finance (No. 2) Act 2017 (the corporate interest restriction regime) in response to the OECD base erosion and profit shifting (BEPS) that replaces the debt cap.

The corporate interest restriction (CIR) regime applies to companies and their subsidiaries with net tax-interest expense amounts of £2 million or more that are listed on a recognised stock exchange and not more than 10 per cent owned by a single participator. The rules are intended to stop groups placing disproportionately high levels of debt in high-tax countries or using intragroup loans to generate interest deductions that exceed third-party borrowing costs or debt to generate tax-exempt income. The default position is that a UK group’s deductible net tax-interest expense for a period is limited to broadly 30 per cent of its taxable earnings before interest, tax, depreciation and amortisation (EBITDA) that cannot exceed the group’s net finance-related expense plus certain carry-forward amounts from previous periods. A company may elect that, instead of the 30 per cent limit, a percentage is used based, broadly, on the ratio of the group’s net interest expense to its accounting EBITDA (ignoring amounts payable to shareholders and on equity-like instruments); again that cannot exceed the group’s net finance-related expense plus certain carry forwards.
Interest and loan expenses in excess of the limited amounts are not lost but can be carried forward. Where a deduction is denied, the allocation of allowed and denied interest costs can be allocated as the group choses.

ii Deduction of finance costs

Subject to thin capitalisation and interest limitation rules, the costs of acquisition finance are generally deductible (this includes not only interest but ancillary costs such as arrangement fees). The United Kingdom does not disallow funding costs because they are incurred for a capital purpose rather than for the trade itself.

An exception to the rule that interest costs are deductible is where the debt has equity characteristics that render the interest liable to being recharacterised as a (non-deductible) distribution, such as a coupon that is to any extent linked to the results of the issuer’s business or interest on convertible securities. Apart from the notable exception of interest at an excessive rate, if an interest coupon is liable to be treated as a distribution it generally will not be where the recipient is a UK corporate or a UK PE that brings the coupon received into the charge to UK corporation tax.

Increasingly, HMRC are seeking to deny a deduction for acquisition finance costs where the finance is put in place in a manner such that there is no corresponding UK receipt. HMRC are known to be taking a number of cases on the basis that the costs are incurred for an unallowable purpose so fall foul of certain UK anti-avoidance rules. It remains to be seen how these cases are decided and how far this attack extends.

iii Restrictions on payments

Apart from potential restrictions on paying dividends in a company’s constitution, its directors are under a duty to safeguard a company’s assets and settle debts as they fall due, so must consider how paying a dividend may affect these areas. Those factors apart, and subject to additional considerations for public companies, the general rule is that a UK company can only pay a dividend to the extent it has ‘distributable reserves’, which are such company’s accumulated, realised profits (as far as not previously used by distribution or capitalisation) less its accumulated, realised losses (as far as not previously written off in a reduction or reorganisation of capital). Whether a profit is a ‘realised profit’ is determined in accordance with GAAP. Thus, unlike many jurisdictions, even if a UK company has material current-year profits, it cannot pay a dividend if it has accumulated deficits that exceed the profit. If the accumulated deficit is, say, £100, and the current year profit is, say, £150, only the excess £50 is distributable, leaving cash of £100 in the company – a situation often referred to as a dividend trap. There are a number of possible solutions, one of which is described below.

Public companies must also beware of an issue called financial assistance, which is designed to stop a target assisting in its own sale (e.g., by waiving debt it is owed by its selling parent). Financial assistance no longer applies to private companies.

iv Return of capital

UK companies can return cash to shareholders by reducing their equity capital. This may be done for a variety of reasons, such as where there are a large number of UK-resident individual shareholders for whom a return of capital is more tax-efficient, but it is often used by companies who have insufficient distributable reserves to return the cash they want to return to their shareholders by way of dividend.
The reserve created by reducing capital is generally treated as a realised profit that can thus be offset against accumulated realised losses, or can increase distributable reserves, or both. Some UK-listed companies have reduced capital to counter the deficits created by their pension funds following changes to the rules on how such funds should be accounted for.

Public companies have to reduce capital through a court scheme, but since 2008, private companies can also use a non-court scheme, provided the directors are satisfied that returning capital will not affect the company’s solvency over the next 12 months. This latter route is known as the solvency statement route.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Often, a UK holding company is used to acquire a UK target. This enables the acquirer to push acquisition debt into the holding company (but see comments made above and below about HMRC attacks on the basis that such debt has an unallowable purpose), the ongoing cost of which can be surrendered into the target group and offset against future trading profit. In cases where a deduction is also potentially available elsewhere in the acquirer’s group, the taxpayer also needs to consider UK anti-avoidance rules that can prevent a double deduction of interest costs.

The amount of debt that can be successfully injected needs careful thought in the light of thin capitalisation and debt cap considerations and, from 2017, the new debt ratio rules. Furthermore, HMRC is aggressively denying deductions for the cost of acquisition debt in situations where it regards debt as pushed into a UK entity without adequate commercial rationale, citing the Corporation Taxes Act 2009, Sections 441–442 that attack debt that has an unallowable purpose.

Subject to certain conditions, UK selling shareholders can roll over gains on the sale of shares to the extent they receive shares in the acquirer or the acquirer’s loan notes. Even if there is a large cash element, a proportionate part of the gain can still be rolled over. The shares or loan notes must be issued by the acquirer (i.e., if X Inc acquires the target but X Inc’s parent Y issues the consideration shares, roll over will not be available; there may be an exception to this rule if the acquisition is structured through a cancellation scheme through the court rather than the more usual tender or exchange offer).

ii Reorganisation

As previously stated, the United Kingdom allows UK companies under a common parent to be grouped even if such common parent is not a UK company. This means that it is generally possible to consolidate any newly acquired UK group into the purchaser’s existing UK group on a tax-free basis. There are also rules that now facilitate merging or consolidation across borders within the EU. It is unclear at the time of writing what impact Brexit will have on such rules.

iii Exit

If the purchaser wants to move parts of a newly acquired group out of the United Kingdom into another part of the group in a non-UK jurisdiction, then the general rule and starting point is that any such transfer will be treated as taking place at market value, and the difference
in value between the historical tax basis and current market value will be recognised as a taxable gain. The United Kingdom’s SSE relief may assist, as may the rules facilitating mergers and transfers within the EU.

A point to note in this context is that under UK tax law, if a target company is acquired at market value, the tax basis that the target company has in underlying subsidiaries’ shares and assets remains at the historical tax basis, and assets cannot be rebased to reflect the open market price paid for the shares in the target. The United Kingdom has no equivalent to the US Section 338 election.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

On 17 July 2013, the United Kingdom introduced its first general anti-avoidance rules (GAAR) to ensure that there was a comprehensive rule for combating abusive tax avoidance encompassing present and future tax provisions. A study group commissioned in 2010 to study the benefits of such a regime did not recommend a ‘broad spectrum’ GAAR, which it was felt would undermine sensible and responsible tax planning, and would require an onerous, comprehensive clearance system that would give an excess of power to HMRC. The report recommended a more measured, targeted approach aimed at highly abusive, contrived and artificial schemes that are widely regarded as intolerable, but which would not affect responsible tax planning. This was generally accepted in the Finance Act 2013 and has been confirmed by guidance provided by HMRC, which accepts that there may be tax avoidance arrangements that are not within the scope of GAAR because they are not abusive. Under the United Kingdom’s Tax Code, in many circumstances, there are different courses of action from which a taxpayer may choose; HMRC has emphasised that any reasonable choice of a course of action is outside the scope of GAAR. In contrast, arrangements will fall within its scope if they are demonstrably contrary to the spirit or policy of the law, seek to exploit shortcomings in legislation or are contrived or abnormal arrangements that produce tax results inconsistent with the economic effect of the underlying transactions.

The Scottish government has its own GAAR for taxes devolved to Scotland.

The United Kingdom currently has a wide range of specific anti-avoidance rules contained in both statute and common law that are detailed and complex and beyond the scope of this chapter. Particular points to note are that there is a regime effective from 1 January 2017 introduced in response to Action 2 of BEPS that widens previous tax arbitrage rules and targets ‘hybrid mismatches. The UK also has the DOTAS regime requiring disclosure where certain classic hallmarks of avoidance are present, such as premium fee arrangements and confidentiality agreements surrounding the arrangements.

The UK introduced a diverted profit tax (DPT) from 1 April 2015. The tax (at the rate of 25 per cent, so 6 per cent higher than the normal corporate tax rate), applies in two cases:

a where a UK company (or permanent establishment) enters into arrangements with a related person where that person or the transaction lack economic substance resulting in a reduction of the UK taxable profits; and

5 HMRC GAAR Guidance – Paragraph B3.1.
6 HMRC GAAR Guidance – Paragraph B4.2.
7 HMRC GAAR Guidance – Paragraphs D2.6, D2.7 and D2.8.
where a person carries on an activity in a manner that avoids creating a UK permanent establishment.

DPT does not apply to small- or medium-sized enterprises or to a PE with annual sales of less than £10 million or where profit is diverted to a jurisdiction whose tax rate is 80 per cent or more of the UK corporation tax rate.

ii Controlled foreign corporations (CFCs)

The UK CFC regime has been considerably revised and made more taxpayer-friendly (by providing a number of gateways and exemptions) and came into force for accounting periods starting after 1 January 2013. Although quite complicated, the basis of the regime is that most bona fide non-UK companies, not being used to artificially divert profit from the UK should fall outside the regime. In response to the final OECD Report on strengthening transfer pricing rules, published in October 2015, the UK government has stated that it is not proposing any change to the UK regime that it regards as already covering the points made by the OECD.

Subject to exceptions, a non-UK company with a UK parent (or one that is controlled by UK persons) is potentially subject to the UK CFC regime. If not excluded by one of the gateways that has to be passed through to be potentially caught by the regime, or if not excluded by one of the many exemptions, a CFC’s profits are deemed apportioned to the UK parent and taxed in the United Kingdom, subject to credit for non-UK tax paid.

There are a series of exemptions, notably:

- the low tax exemption: a company is only subject to CFC treatment if it is subject to a headline tax rate of less than 75 per cent of the equivalent UK tax rate;
- the low profits exemption: a CFC is ignored if it has accounting profits of less than £500,000 and non-trading profits of less than £50,000;
- the exempt activities test: there is a safe harbour if the CFC has business premises in a low-tax jurisdiction, less than 20 per cent of its income, management and exports derive from the United Kingdom, and it has no IP transferred from a related party in the past six years;
- an exemption for certain non-trading finance profits and partial exemption for group financing companies; and
- the excluded territories exemption: the CFC is based in a jurisdiction on a published list provided its total income within certain categories (generally income that is exempt or subject to a reduced rate of tax) does not exceed 10 per cent of the company’s pre-tax profits for the accounting period (or £50,000 if greater).

There is also a high-level gateway and a number of specific gateways that can exclude the application of the regime, but as these are more subjective, an adviser generally prefers to see if one of the exemptions applies in the first instance.

The general gateway is subject to a number of safe harbours that if all the conditions are met mean the gateway is not passed through and the CFC regime does not apply, making it unnecessary to consider other gateways and exemptions. The safe harbour conditions include:

- the main purposes safe harbour: broadly, a series of questions aimed at establishing whether arrangements exist that are intended to reduce or eliminate United Kingdom taxation;
b the UK-managed assets or risks safe harbour: broadly, aimed at establishing whether the CFC’s assets and risks are independently managed. The test is failed if assets or risks are significantly managed in the United Kingdom by connected parties unless they could be replaced by non-connected companies; and

c the commercially effective safe harbour: even if assets and risks are UK-managed, the test may still be satisfied if the CFC could effectively commercially manage the assets or risks were the UK-connected company to cease such management.

There are a series of specific gateways that can apply based on specific activities the CFC carries out.

On 26 October 2017, the European Commission opened an investigation into aspects of the UK’s CFC finance company exemption provisions. On 2 April 2019, the European Commission concluded that the UK finance company exemption constituted illegal state aid but only to the extent it applies to financing income derived from UK activities prior to 1 January 2019, after which changes made by Finance Act 2019 took effect. In June 2019, HM Treasury stated publicly that the UK government disagreed with the Commission’s conclusion and has since sought an annulment of the Commission’s decision.

iii Transfer pricing

Since 2004, to comply with EU laws on discrimination, the UK transfer pricing rules have applied to all transactions even if all the parties are subject to UK tax. The UK transfer pricing rules are expressly based on OECD guidelines and provide that the UK law in this area must be construed in the light of such OECD guidelines. Thus, as one would expect, the UK legislation requires that transactions between related parties be undertaken in accordance with the arm’s-length principle in Article 9 of the OECD Model Law.

Basic UK law

The UK transfer pricing regime applies to ‘provisions’ (broadly equivalent to OECD conditions) of transactions (transactions being defined widely to include arrangements, understandings and mutual practices as well as matters such as contracts), or series of transactions, between certain specified parties. In common with many transfer pricing regimes, the UK regime requires comparison of the actual provision (price, terms and conditions of supply, etc.) with the arm’s-length provision that would have applied in the same transaction between independent parties. The basic rule will apply where the actual provision has created a potential UK advantage because income or profits are less or losses greater than they would have been had the transaction been at arm’s length.

The rules apply where one of the parties to a transaction directly or indirectly participates in the management, control or capital of the other, or where the same person (or persons) directly or indirectly participates in the management, control or capital of the parties. A person is treated as directly participating if that person is a corporate or a partnership and ‘controls’ the other person. In evaluating whether a person (e.g., X Ltd) has control, one takes into account not just current voting power exercisable by X Ltd, but also factors including rights and power that X Ltd is entitled to acquire, or will become entitled to acquire, at a future date, and rights and powers held by a person connected with X Ltd.
The transfer pricing rules also apply if X Ltd exercises indirect control over another person through rights held by connected persons, rights exercised on X Ltd’s behalf or through deeming entitlements to future rights to have been exercised, or because X Ltd is a ‘major participant’.

X Ltd is a major participant if it and another person (taken together) have control and each has at least 40 per cent control of the relevant entity – this is particularly relevant to joint ventures.

Where there are two UK companies, it is likely that in many cases there will be no loss to the UK Treasury, as a deduction in one company will be matched by a corresponding receipt in another. In recognition of this, the regime allows the company that is disadvantaged by the pricing adjustment to make a claim to have its tax calculated on the same deemed arm’s-length terms as the company that obtained an advantage as a result of the adjustment, and tax-free compensatory payments to be made.

The United Kingdom adopts OECD methodology to determine an arm’s-length price, notably the transactional methods (the comparable uncontrolled price method, resale price method and cost plus method) and the profit-based methods (the profit split method and transactional net margin method). In the 2016 Finance Act, the UK government adopted the OECD guidelines on transfer pricing currently in force or as updated. In addition, the UK introduced legislation (Taxes (Base Erosion and Profit Shifting) (Country-by-Country) Reporting Regulations 2016), which requires a UK-resident parent company to report prescribed information, so implementing another OECD BEPS recommendation.

The UK does permit advance pricing agreements (APAs) under which the taxpayer agrees with HMRC an acceptable pricing method in advance of the relevant transactions taking place. These are typically used in more complex transactions, and HMRC has detailed guidelines on the mechanics of negotiating and agreeing an APA.

Over recent years, the European Commission has attacked tax rulings given to taxpayers by tax authorities in Member States on the basis that such rulings amount to an illegal tax benefit and so are contrary to EU State Aid rules. There have been a number of well-publicised examples, notably the August 2016 European Commission decision that tax rulings granted to Apple by Ireland amounted to state aid and the decision published on 4 October 2017 that rulings given by Luxembourg to Amazon in 2003 and 2011, amounted to selective tax treatment and state aid. In the light of these attacks, the position of UK APAs, notably those given to large multinational enterprises, needs to be monitored.

iv Tax clearances and rulings

Of particular relevance in the context of this book is that HMRC will provide advance rulings where there is significant inward investment into the United Kingdom amounting to more than £30 million or that, while less than that figure, may be regarded as significant to a particular region or in the wider public interest (SP2/2012). Under such rulings, HMRC will provide written confirmation of how HMRC will apply UK tax law to specific transactions or events. As stated above, the current attacks by the European Commission on tax rulings means the position needs to be monitored.

Statutory clearances can be sought under a number of statutory provisions, notably on share exchanges and certain types of restructuring and merger. Typically, these clearances do not confirm to the taxpayer that the conditions for relief are met, but simply that the relief’s availability will not be challenged on the basis that it is for tax-avoidance rather than for bona fide commercial purposes. Clearances are only effective if the taxpayer makes a full
and frank disclosure. There is generally a clear timetable that requires HMRC to respond within 30 days, although if HMRC feels that more information is needed, it can ask for such information, and when the taxpayer responds, the 30-day clock starts again from zero.

As well as formal statutory clearance, there is a procedure known as a Code of Practice 10 Ruling, which allows a taxpayer to seek clarification on how recent legislation (that being legislation introduced in the past four years) applies to it where there is material uncertainty. It is possible to request such a ruling going back beyond four years, but in such cases the taxpayer must show that the uncertainty is commercially significant to its business. HMRC will not give a ruling where it believes that the transaction that creates uncertainty is not a primarily commercial one but is rather a tax-driven transaction or a tax-planning exercise.

A taxpayer may also approach HMRC informally but is only likely to receive a satisfactory response if the informal ruling is a question in respect of a transaction that has already happened, and the taxpayer is looking for guidance on how it should deal with an aspect of such transaction in its tax returns.

**X YEAR IN REVIEW**

As outlined in Section I, the major theme in the UK in 2019 was uncertainty. Uncertainty over what type of Brexit would be delivered and its impact on UK taxation and uncertainty over the tax policies that would be introduced by any new government. While the general election of 12 December 2019 has introduced more clarity on both these issues, and it is reasonable to assume that in most material respects the domestic UK tax regime will remain as described in this Chapter for the foreseeable future, until the UK’s future trading relationship with the EU is settled, a degree of uncertainty will remain, particularly on the potential impact on tariffs and duties on cross-border trading after 1 January 2021.

One significant development has been that the United Kingdom has advanced its plans to tax the digital economy. Reform of the taxation of the digital economy was identified as a key action point in the 2015 BEPS project but implementing reform has proved slow and contentious. The UK (and some other countries) has responded by seeking to go it alone and has outlined a Digital services tax (DST) to be introduced from 1 April 2020, if the Finance Bill 2020 becomes law. The planned UK law is intended as a stop gap measure pending a coordinated international response that allows jurisdictions to tax value generated in their territory by digital business. Once such a coordinated response materialises, the proposal is to repeal the UK law and replace it with what is agreed internationally.

Existing UK corporation tax rules are based on the presumption that a business generates profit through physical presence in the UK so do not allow UK corporation taxes to be charged on digitalised businesses who generate material revenues in the UK without having a material UK presence. The Finance Bill 2020 seeks to address this by introducing a tax on turnover, not on profits: broadly a 2 per cent tax on revenues derived from UK users of social media platforms, search engines and online marketplaces (other than certain online financial marketplaces). The tax is likely to impact a small group of large non-UK based multinationals (mainly in the US).
XI OUTLOOK AND CONCLUSIONS

Although the election on 12 December 2019 is likely to mean that the tax regime described above, much of which reflects the current government’s fiscal approach, will remain broadly intact, until the outcome of Brexit becomes clearer, it is hard to predict what lies ahead for the UK in the next few years. Recent surveys suggest that the UK is still seen as a business-friendly location, but there is a danger that upheaval ahead will erode the benefit of the tax changes of recent years that helped to create this business-friendly environment.

However, whatever happens, the process of implementing the BEPS project is likely to continue irrespective of Brexit and any political changes and with it an increasingly heavy and complex compliance and disclosure burden.
I INTRODUCTION

Foreign persons investing in the United States have great flexibility in determining the form and taxation of their investments. However, foreign investors should note that an investment in the United States may be subject to administrative, filing and tax requirements at the state and federal levels. At the federal level, US tax can be imposed on a ‘net’ basis on US business income (using available deductions, etc.) and on a ‘gross’ withholding basis on investment income.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Foreign persons have several options with respect to the organisational form through which they conduct business in the United States (e.g., corporation formed under state law, general or limited partnership, or limited liability company). A foreign person can conduct business in the United States through either a US entity or foreign entity. However, from a tax perspective, regardless of the form chosen, the vehicle used generally will be considered either a corporation taxed at the entity level, with additional potential tax to the entity’s owner when funds are distributed; or a flow-through entity (e.g., partnerships) not subject to an entity-level tax, but with tax imposed directly at the owner (partner) level. Flow-through entities can also include entities treated as ‘branches’ for US tax purposes. The United States has far-reaching entity classification rules, the ‘check-the-box’ rules, which provide the ability in many cases to elect entity status as a corporation, partnership, etc.2

i Corporate

As a matter of corporate law, non-US investors may choose to invest in the United States either through a ‘regular’ corporation (a body corporate for state law purposes), or through a limited liability company or other entity, such as a partnership. For US federal income tax purposes, a regular corporation is subject to US tax at the corporate level. A special class of corporation that provides for ‘flow-through’ treatment (no entity-level tax) to investors, the
‘S’ corporation, is not available to non-US investors. With respect to other forms, such as limited liability companies (LLCs), US tax rules generally permit the entity to elect to be taxed as a corporation or a flow-through entity. Other special types of investment entities, such as real estate investment trusts, generally have the status of a regular corporation and are subject to tax at the corporate level to the extent their earnings are not distributed.

Inbound businesses are often operated through a regular domestic corporation, or an entity formed in the United States that has elected to be taxed as a corporation. Operating through a domestic corporation offers a relatively simplified filing regime, in which the corporation files its tax return on IRS Form 1120, just like a domestic-owned corporation. If a single non-US investor owns 25 per cent of the voting power or value of the domestic corporation, certain additional filing requirements apply. In general, however, many investors prefer the relative anonymity and simplicity that this filing regime provides, as opposed to the filing requirements that apply if a US trade or business is conducted directly through a branch or flow-through entity. Operations through a domestic corporation also insulate a foreign corporate investor from the complex ‘branch profits’ tax (discussed below) applicable to non-corporate forms of business. In addition, only domestic corporations are eligible for certain deductions, such as a deduction for a portion of the corporation's foreign-derived intangible income (FDII). There can, however, be US withholding on dividend distributions by the corporation. Further, whether operating through a domestic corporation or a branch or flow-through entity, certain inbound businesses are subject to a minimum tax on deductible payments to, and depreciation and amortisation of property purchased from, foreign related parties under the Base Erosion and Anti-Abuse Tax (BEAT) discussed in more detail below.

ii Non-corporate

A non-US person wishing to invest in or operate a business in the United States may choose to do so through a pass-through entity (i.e., an entity not taxed at the entity level) that flows through the results of its operations to its owners. Generally, an entity with a single owner can be treated as ‘disregarded’ from its owner (that is, treated as a branch or division of its owner) or as a corporation, and an entity with multiple owners can be treated as a partnership or as a corporation. Treasury Regulations set forth general default classifications of single owner and multiple owner entities, with additional rules that generally permit the entity to adopt or change its classification, subject to certain limitations.3

Non-US partners that engage in a US trade or business through an entity treated as a partnership are treated as if they engage in a US trade or business directly, and generally are subject to US tax on their share of partnership income (regardless of whether distributed) at the same rates applicable to US partners. Generally, the partnership is obliged to withhold and pay over tax on the non-US partner’s distributive share of net business income at the maximum tax rate applicable to such person, and the non-US partner must file a tax return in the United States reporting such income and claiming credit for such withheld tax.4 Gain on the sale of an interest in a partnership that conducts a US trade or business is also subject to US tax and the proceeds from such sale can be subject to US withholding.5 This is one of the few areas where a US withholding tax is imposed on US business income (as opposed to US investment income, as discussed below).

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3 ibid.
4 Section 1446.
5 Sections 864(c)(8) and 1446(f).
Certain industries, such as the banking industry, typically operate directly in the United States through a branch. The United States taxes the branch on all income that is effectively connected with its US trade or business, and, in certain cases, applies special rules in computing the tax base. transfers of ‘dividend equivalent amounts’ from the US branch back to the non-US home office trigger a 30 per cent branch profits tax, which may be reduced by treaty. The policy of the branch profits tax is to establish ‘branch–subsidiary parity’. The notion is that the United States should tax outbound remittances equally, whether they emanate from a US branch (including a partnership’s US operations) or a US corporation. Private equity investments will often be made through a pass-through entity such as a partnership, with non-US investors owning their partnership investment through a foreign or US corporate ‘blocker’ to avoid these complex rules.

In choosing between different forms of investment, non-US investors should also take into account whether the entity is likely to retain a significant portion of its earnings and whether the business might qualify for the new deduction for qualified pass-through business income under Section 199A. Because of the disparity between corporate and individual income tax rates, these considerations in addition to those listed above may make one form of investment more advantageous than the other.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

The United States imposes tax on ‘taxable income’, which is defined as ‘gross income’ less allowable deductions. Gross income is defined as gross revenues (receipts) less cost of goods sold. Allowable deductions include those for expenses that are ordinary and necessary to the conduct of the trade or business, such as salary and rental expenses of the business. Other expenses that may be deducted, subject to certain limitations, include interest expenses, depreciation and amortisation, state and local income taxes and real estate taxes, and certain losses and bad debts. A non-US person engaged in business in the United States is generally entitled to the same wide range of deductions as a US person, with a notable exception for the deduction for FDII.

Among the expenses that are non-deductible are certain excessive employee remuneration, ‘golden parachute payments’ made to executives in connection with a corporate change in control and expenses related to the production of tax-exempt income. In addition, the interest expense deduction to which certain businesses would otherwise be entitled is subject to limitations (discussed further below).

Taxable income is not based on accounting profits, but instead on the method required by the Code and applicable Treasury Regulations. US corporations with assets above a certain threshold are required to reconcile their book and tax income on a separate schedule attached to their tax return.

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6 Section 882.
7 Section 884.
8 Sections 11 and 63.
9 Section 162.
10 Sections 163 to 198.
11 Sections 162(m), 280G, 265.
Generally, taxpayers must compute their taxable income using the method of accounting that the taxpayer uses to compute book income. These methods could include the cash receipts method, the accrual method or any other permitted method. If the US Internal Revenue Service (IRS) successfully determines that the taxpayer’s method does not ‘clearly reflect’ its actual income, it may require the taxpayer to use another method. Once a taxpayer adopts a method of accounting, it generally must obtain the consent of the IRS to change its method.

US citizens and residents are taxed on worldwide income, while US corporations are taxed on a modified territorial basis. Previous law allowed deferral for US shareholders for certain active income earned abroad by a non-US corporation until distributed as a dividend to such shareholder. The Tax Cuts and Jobs Act (TCJA), signed into law on 22 December 2017, moved away from this system of taxation by establishing a participation exemption for US corporate shareholders on certain foreign income, a one-time ‘transition tax’ on certain past accumulated foreign earnings, and a current inclusion in income for such shareholders with regard to certain global intangible low-taxed income (GILTI) of such non-US corporations. GILTI is generally defined as all income of a non-US corporation that is in excess of a fixed return on such corporation’s tangible assets. Although the United States generally grants a ‘credit’ for certain non-US income taxes incurred by US taxpayers (foreign tax credit), no such credit is allowed for any taxes paid with respect to income that qualifies for the participation exemption.

Non-US taxpayers are generally taxed only on income that is effectively connected with a US trade or business (which generally includes US-source income and very limited types of foreign-source income) (ECI), and on US-source income that is passive income, such as interest, dividends, rents and royalties. Non-US persons also may generally claim a foreign tax credit for non-US income taxes paid on income that is considered effectively connected with a US trade or business (other than taxes paid to their country of residence).

**Capital and income**

In general, for US corporate taxpayers there is no difference in the rate of tax applied to ordinary business income as opposed to capital gains. As discussed below, non-US persons generally are not subject to US tax on capital gains (the main exceptions being gains related to certain US real property, including gains realised on an interest in certain domestic corporations that hold US real property, and gains realised in connection with a US trade or business, including gains realised on an interest in a partnership conducting a US trade or business).

**Losses**

A US net operating loss (NOL) generally cannot be carried back but can generally be carried forward indefinitely (with special rules for insurance companies and for farming losses), subject to a limitation that the NOL used in a particular subsequent year cannot exceed 80 per cent of taxable income for such year. The deduction of losses is limited following

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12 Section 446.
13 Sections 27, 901, and 245A(d).
14 Section 906.
15 Section 172.
certain types of ownership changes. An ownership change is generally deemed to occur if there is a change in the stock ownership of a corporation aggregating to more than 50 percentage points over a three-year period. In such a case, the amount of 'pre-change' NOLs that may be deducted in each future year is generally limited to an amount of income each year equal to the value of the target corporation immediately before the ownership change multiplied by the long-term tax-exempt rate of interest published by the IRS for the month of the ownership change.

A capital loss can only offset capital gains. Excess capital losses may be carried back three years and forward five years. Because of the shorter carry-forward period for capital losses, taxpayers may seek to accelerate a capital gain to ensure that the capital loss does not expire unused.

Non-US corporations conducting a trade or business in the United States through a branch or other fiscally transparent entity must file an appropriate and timely tax return in the United States reporting any credits, deductions or losses to preserve their ability to use any credits, deductions or losses in future years.

**Rates**

Under previous law, corporations were subject to graduated rates and an alternative minimum tax (AMT) to the extent that tax exceeded the regular corporate tax. The TCJA reduced the federal corporate rate and repealed the AMT such that for tax years beginning after 2017, the corporate tax rate is a flat 21 per cent rate.

The TCJA also introduced the BEAT, a minimum tax imposed in addition to any other income tax. The BEAT imposes a tax equal to the excess of 10 per cent of the taxpayer’s 'modified taxable income', less the taxpayer’s regular tax liability and certain specified tax credits (but without reduction for any foreign tax credit). Modified taxable income is taxable income computed without regard to base erosion tax benefits (i.e., deductions for payments to related foreign parties or depreciation or amortisation deductions on property purchased from related foreign parties). The BEAT only applies to (1) corporations, other than regulated investment companies (RICs), real estate investment trusts (REITs), or S corporations; (2) with annual gross receipts of at least $500 million for the three-tax year period ending with the preceding tax year; and (3) a base erosion percentage of 2–3 per cent. With certain limited exceptions, tax credits, including foreign tax credits, cannot be used to reduce the minimum tax due pursuant to the BEAT regime.

The rate of US withholding tax for outbound payments of US-source passive ‘investment’ income such as dividends, interest, rents and royalties is generally 30 per cent. This rate is subject to reduction or elimination pursuant to an income tax treaty between the United States and the recipient’s country of residence. If withholding does not properly occur, the foreign recipient of the payment must file a US tax return and pay the appropriate tax. Similarly, as discussed above, branch profits tax, if applicable, is also imposed at a rate of 30 per cent, and is subject to reduction or elimination by treaty.

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16 Section 382.
17 Section 1211.
18 Section 1212.
19 Section 882(c). A similar rule also applies to non-corporate persons, Section 874(a).
20 Section 55(e) repealed by the TCJA.
21 Section 11 as amended by the TCJA.
Administration

A US corporation must generally file its income tax return on or before the 15th day of the fourth month following the end of its taxable year, although an automatic six-month extension is available and typically taken. As a result, a calendar year corporation usually files its returns by the following 15 October. A foreign corporation required to file a US income tax return with respect to its conduct of, for example, a US trade or business is required to file its income tax return on or before the 15th day of the sixth month following the end of its taxable year, although an automatic six-month extension is available. The tax owed for the year must be paid on or before the due date of the tax return (without extensions). Further, corporations must make estimated tax payments on a quarterly basis during the year, generally in an amount each equal to 25 per cent of the required annual payment. Special provisions apply to corporations with assets of $1 billion or more. The total quarterly payments must equal at least the lesser of (1) 100 per cent of the tax shown on the final return for the current year or (2) 100 per cent of the tax shown on the final return for the immediately preceding taxable year. Penalties apply if the estimated tax payments are less than these safe harbour amounts. For corporations with taxable income of at least $1 million during any of the three preceding taxable years, the required annual payment must equal 100 per cent of the current year’s tax liability; that is, the preceding year’s safe harbour in point (2) above cannot be used.

The most significant taxing authority for non-US taxpayers is the IRS, a division of the US Treasury Department. States and local jurisdictions, such as counties and cities, may impose additional taxes.

In general, there is no regular audit cycle. Special audit regimes may apply. For example, certain eligible taxpayers may be part of the compliance assurance process (CAP), which allows compliant taxpayers to resolve certain issues on an expedited basis, with the taxpayer and the IRS agreeing to the treatment of items by the time the tax return is filed, or shortly thereafter. The IRS expanded the CAP programme in 2011 to include pre-CAP (readying taxpayers to enter the CAP programme) and post-CAP (a maintenance stage for taxpayers with a low-compliance risk and low controversy rate) stages of the process. Certain large corporations may also be under continuous audit. Although no specific length of time is used for audit cycles, US corporations, for example, are typically audited for two to four taxable years at any one time.

Before a transaction is undertaken, taxpayers may seek private letter rulings from the IRS when there is uncertainty regarding the treatment of a transaction or an item of income. Each year, the IRS publishes a revenue procedure that details the steps to be taken in requesting a private letter ruling; the revenue procedure also describes those areas in which the IRS normally will not issue a private letter ruling. This general guidance is set forth in the first revenue procedure for the year. In addition, the seventh revenue procedure of each year discusses certain international issues regarding which the IRS will not, or ordinarily will not, issue a private letter ruling. Other forms of administrative filings for rulings are

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22 Sections 6072(a) and 6081.
23 Section 6072(c) and 6081.
24 Section 6655.
25 Section 7803.
26 For example, Revenue Procedure 2019-1.
27 For example, Revenue Procedure 2019-7.
available. Among the most noteworthy are the ‘pre-filing agreement’ with the IRS and an ‘advance pricing agreement’ (APA) for transfer pricing issues with the ‘advance pricing and mutual agreement’ programme, which was formed from the recent combination of the APA Office and certain functions of the US competent authority.

If a taxpayer wishes to challenge a published IRS position on the treatment of an item, the taxpayer can minimise penalties (in the event that it ultimately fails in its challenge) by disclosing on its tax return that it is taking a position contrary to IRS guidance. If the IRS specifically challenges a taxpayer’s position on a tax return, the taxpayer generally has the opportunity to make an administrative appeal of the IRS determination. If the taxpayer does not succeed in its appeal, it may either file a petition in Tax Court (which does not require the taxpayer to pay the asserted deficiency in advance), or it may pay the asserted deficiency and file a suit for refund in either a US federal district court or with the US Court of Federal Claims.

In addition, in certain cases where the IRS has proposed adjustments that result in a taxpayer being subject to double taxation or that should appropriately give rise to a correlative adjustment for a related person in a foreign country, the taxpayer may invoke the mutual agreement procedure of an applicable US tax treaty to attempt to resolve the issue.

**Tax grouping**

An affiliated group of US corporations may elect to file a consolidated income tax return. Non-US corporations generally are not ‘includible members’ in an affiliated group (with exceptions for certain Canadian and Mexican corporations), and therefore are not included in the consolidated group. The stock ownership requirements for an affiliated group are that the common parent must directly own at least 80 per cent of the stock (by vote and value) of at least one subsidiary in the group, and each other subsidiary in the group must be at least 80 per cent directly owned (by vote and value) by one or more of the other members of the group. An election made by the common parent to file a consolidated return applies to all corporations for which the ownership requirements are met. The common parent files the US tax return for the consolidated group.

Under the theory that a consolidated group is a unified entity, assets, losses, dividends and interest can generally move within a group without current tax cost. The consolidated group rules focus, however, on an item of income’s location, and therefore intercompany transactions will ultimately trigger tax when the item is no longer capable of being reflected in the consolidated group. Income and losses of a group member generally give rise to adjustments to tax basis in the stock of that member held by other members.

In general, a consolidated group determines its income tax liability by computing the separate taxable income of each member as if it were filing a separate return, but excluding income and deductions that are determined on a group basis, and computing income and

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28 Treasury Regulation, Sections 1.6662-3 and -4; IRS Forms 8275 and 8275-R.
29 Section 1501.
30 Sections 1504(b) and 1504(d).
31 Treasury Regulation, Section 1.1502-77.
32 Treasury Regulation, Section 1.1502-13.
33 Treasury Regulation, Section 1.1502-32.
deductions on a group basis, such as the NOL deduction. Credits, determined on a group basis, may be available to offset the consolidated income tax liability. Each member of the group is jointly and severally liable for the total tax liability of the entire group.

Losses incurred by a corporation while it is a member of the group are available to offset another member’s income. Losses incurred before a corporation joins a consolidated group are subject to ‘separate return limitation year’ rules, generally permitting use of such losses only to the extent of the corporation’s contribution to the consolidated group’s positive net income. Special limitations also apply to ‘dual consolidated losses’, generally defined as an NOL of a domestic corporation (or component thereof) that is also subject to tax in a foreign country. Thus, for example, a US corporation tax resident in the United Kingdom generally cannot offset its NOL against another member’s income unless it elects to use the loss only in the United States. If such an election is made, the loss could be used in the United Kingdom after five years, provided that UK law permits the loss to be claimed.

ii Other relevant taxes
The United States does not impose value added tax (VAT) or sales tax at the federal level, although many states, counties and cities do impose a sales tax on the sale of goods. The United States also does not impose stamp duty, capital duties, registration taxes or net wealth taxes. US employers have payroll tax obligations, including paying obligations for US social security and Medicare taxes and withholding from employee wages. The United States has considered a federal VAT (or similar tax) from time to time, either as an additional tax or as a replacement for income tax. So far, however, no such tax has been enacted.

IV TAX RESIDENCE AND FISCAL DOMICILE
i Corporate residence
The United States does not generally employ the concept of corporate ‘residency’ based on the seat of management. Instead, how a corporation is taxed is generally based on its place of incorporation, and not where it is managed or controlled. In some circumstances, a non-US corporation can elect to be treated as a US corporation, or in some cases generally designed to prevent a perceived abuse, a foreign corporation may be deemed to be a US corporation.

In recent years, certain members of Congress have periodically proposed legislation that would define a corporation’s residency for US tax purposes based on where it is managed and controlled. This legislation, if ever enacted, would represent a significant change in the US tax treatment of both US and non-US corporations. In addition, the prior Obama administration enacted and the current Trump administration finalised changes to the corporate residence rules that significantly expanded the scope of existing anti-abuse provisions, which potentially cause non-US-incorporated entities to be treated as US corporations for tax purposes, in particular when such non-US-incorporated entities have engaged in cross-border business combination transactions with US corporations.

34 Treasury Regulation, Section 1.1502-11.
35 Treasury Regulation, Section 1.1502-6.
36 Section 1503(d).
37 Sections 3102, 3111 and 3301.
38 See, e.g., Sections 953(d), 897(i), 1504(d).
39 See, e.g., Sections 269B and 7874.
ii Branch or permanent establishment

If a non-US person conducts sufficient activities in the United States, it will be ‘engaged in a US trade or business’, and income that is ‘effectively connected’ to such business generally is subject to net basis tax. The threshold of activities needed to constitute a US trade or business is not precisely defined, but factors derived from case law include whether there are ‘regular and continuous’ activities within the United States, including through employees or agents. To secure greater tax parity between a US subsidiary and a US branch, a 30 per cent ‘branch profits’ tax may apply when the US branch makes distributions (or is deemed to make distributions) to its home office. This is the same rate of US withholding tax that applies to dividend distributions by US corporations. Just as US tax treaties may reduce withholding tax on corporate distributions, so do they provide for a common, reduced rate of tax that applies to branch remittances. Some US treaties even provide for the complete elimination of branch profits tax. The United States no longer imposes a ‘secondary’ withholding tax on dividends paid by a non-US corporation.

If the non-US entity is a resident of a jurisdiction with which the United States has an income tax treaty, the entity will generally become subject to tax on its ‘business profits’ that are attributable to a US permanent establishment (PE) maintained by the non-US entity. The PE standard generally requires a non-US entity to have a greater nexus with the United States than is required to be considered ‘engaged in a US trade or business’. The relevant treaty and domestic law provide rules regarding the definition of a PE and, if a PE exists, the amount of income and expenses that are attributable to that PE and subject to US tax. The rules for attributing income and capital to a PE are generally based on Organisation for Economic Co-operation and Development (OECD) standards, and may result in differing amounts of income and deduction than under the US rules that apply in determining the non-US entity’s effectively connected income. US tax treaties generally require a non-US entity to consistently apply either the PE rules or the US effectively connected rules in determining its income subject to US tax.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

Prior to the passage of the TCJA, potential double taxation was generally addressed with respect to non-US income paid to a US person or branch of a non-US corporation through the US foreign tax credit regime and the relief from double taxation articles of US tax treaties. Recently, however, to encourage US corporations to repatriate earnings, the United States enacted a provision under the TCJA that exempts certain foreign earnings from taxation. This new ‘participation exemption’ system allows certain US corporations a 100 per cent dividends received deduction (DRD) for the ‘foreign-source portion’ of dividends received from a ‘specified 10 per cent owned foreign corporation’. Because, as of the time of writing, the IRS has yet to issue Treasury Regulations or publish guidance under the directive of Section

40 See, e.g., Section 882.
41 Section 884.
42 See, e.g., Section 881.
43 Section 245A(a) and (c).
245A(g), it is uncertain how, or whether, the DRD would apply to a domestic corporation that indirectly owns shares in a foreign corporation through its interest in a partnership. The GILTI regime, discussed further below, significantly reduces the otherwise expansive scope of the DRD by making a significant portion of a non-US subsidiary’s earnings subject to current US taxation at a reduced rate.

Importantly, unlike some other countries, the United States does not generally impose any tax on the sale of capital assets (such as stock) by non-US persons. One key exception to the general rule relates to the sale of certain ‘US real property interests’ (USRPI), which may require the purchaser to withhold 15 per cent of the consideration paid for the property. USRPIs may include stock of a US corporation that is a ‘US real property holding corporation’, which generally occurs if the fair market value of USRPIs held by such corporation exceeds 50 per cent of the fair market value of its total assets. No withholding is required if the non-US person transfers stock in a non-US corporation that holds the USRPI. Other important exceptions relate to deferred payments for property or services, and the sale of assets that are used (or within the prior 10 years were used) in a US trade or business (e.g., depreciable assets). Generally, the US taxation of such income or gain from such payments or sales is determined based on the facts existing when the property or service was provided, without regard to whether the non-US entity is engaged in a US trade or business in the taxable year the income or gain is received. The United States does not impose a withholding tax on ‘portfolio interest’, discussed further below.

ii IP regimes
Research and development (R&D) expenses paid or incurred in tax years before 2022 may be deducted in the year incurred or amortised over five years. Beginning in 2022, R&D expenses must be capitalised and amortised over five (or 15) years. The United States also provides a 20 per cent R&D credit for expenses that exceed a base amount determined by reference to a percentage of the taxpayer’s average annual gross receipts for the preceding four taxable years.

iii FDII
The TCJA adopted a new regime that generally allows a domestic corporation to deduct 37.5 per cent of its FDII for tax years beginning after 2017, decreased to 21.875 per cent of FDII for tax years beginning after 2025. Very generally, a domestic corporation’s FDII is equal to the excess of income earned selling certain goods and services or licensing or leasing property to non-US persons for use outside the United States over the corporation’s deemed return on investments in tangible assets.

44 Section 897.
45 Section 1445.
46 Section 897(c)(2).
47 Section 864(c)(6) and (c)(7).
48 Section 174 repealed by the TCJA.
49 Section 174(a) as amended by the TCJA.
50 Sections 38 and 41 as amended by the TCJA.
51 Section 250.
iv General

Certain tax credits (particularly for renewable energy) and accelerated depreciation deductions can reduce the tax cost of running a US business.\(^{52}\) The TCJA made extensive changes to the depreciation (and expensing) rules, including changes to Section 168(k) that provide a 100 per cent first-year depreciation deduction for certain ‘qualified property’. Additionally, states and local jurisdictions may have investment incentives.

The relatively extensive advance pricing and mutual agreement programme (discussed further below), which can include ‘bilateral’ agreements with other taxing jurisdictions, may help minimise tax controversy for an inbound investor. Investors also benefit from the fact that the United States does not generally impose any tax on the sale of capital assets by non-US persons, unless the asset is a ‘US real property interest’.\(^{53}\)

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

A US person must generally withhold 30 per cent of the gross amount of certain US ‘investment’ income paid to non-US persons, such as dividends, interest and royalties, and certain dividend equivalent amounts.\(^{54}\) This statutory rate, however, can be reduced by an applicable bilateral treaty. Many US bilateral treaties reduce the withholding tax rates on interest or royalties to zero, but as discussed in detail above, for certain taxpayers, the BEAT functionally disallows deductions with regard to deductible payments to related foreign persons below a minimum percentage.\(^{55}\) A recent treaty trend has been to reduce the withholding tax on certain dividend distributions to zero if certain ownership and holding period requirements are met. In certain cases, the US tax rules treat certain payments or distributions by foreign persons (e.g., a foreign partnership) as US-source income subject to withholding.\(^{56}\)

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

A portfolio interest exception applies to eliminate US withholding tax on certain interest payments to non-US corporations and individuals.\(^{57}\) This exception is fairly broad and operates as a matter of domestic US tax law, regardless of the application of any bilateral treaty. The interest recipient must establish its ability to claim the exception by providing documentation to the payor. The exception does not apply to:

\(a\) interest paid to a 10 per cent shareholder of the payor and certain other related persons;
\(b\) interest paid to a controlled foreign corporation (CFC) that is a related person;
\(c\) payments to certain foreign banks;

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\(^{52}\) Sections 48 and 168 as amended by the TCJA.

\(^{53}\) Section 897.

\(^{54}\) Sections 871(m), 1441 and 1442. Further, amounts paid by US corporations or non-corporate US residents for guarantees issued after 27 September 2010 are treated as US-source payments subject to withholding. Section 861(a)(9).

\(^{55}\) Section 59A.

\(^{56}\) Sections 861(a)(1)(B).

\(^{57}\) Sections 871(h) and 881(c).
Outside of the treaty context, or unless the recipient is a non-US sovereign, the United States does not have exemptions from withholding on outbound dividend or royalty payments. Certain income of non-US sovereigns is exempt from US federal income tax, including income received from investments in the United States of stocks and bonds or other US securities, and income from financial investments held in the execution of governmental, financial or monetary policy. The exemption does not apply to income derived from a commercial activity, any income received by or from a controlled commercial entity, or income from the disposition of an interest in such entity.

### iii Double tax treaties

The United States has approximately 60 income tax treaties covering 68 countries. The treaty network is most extensive in Europe, is expanding in Asia, and is limited in South America and Africa. Generally, these income tax treaties reduce the US withholding tax on dividends, interest and royalty payments to residents of a treaty country, provided that the beneficial owner is a resident of the treaty country and meets the anti-treaty shopping provision (i.e., the limitation on benefits (LOB) provision) of the applicable treaty. The current negotiating position of the United States is reflected in its 2016 model income tax convention, which contains certain significant changes from the prior 2006 model income tax convention. The changes generally deny treaty benefits on payments by expatriated entities (generally, US companies that have engaged in an ‘inversion’ transaction), where income is subject to a special tax regime in the country of receipt and where a country reduces its tax rates below a certain threshold. The United States typically uses its own US model treaty rather than, for example, the OECD model, as the starting point for negotiations.

With respect to dividends, the US position is generally to provide for a maximum of 5 per cent withholding if the shareholder holds 10 per cent or more of the US resident corporation, and 15 per cent in all other cases. In an increasing number of US treaties, the United States has agreed to forgo withholding on dividends if the shareholder holds 80 per cent or more of the US tax-resident corporation. This elimination of US dividend withholding tax typically requires updated LOB and exchange of information provisions.

With respect to interest and royalty payments, the general US position is to eliminate withholding.

The table in the Appendix to this chapter summarises the withholding rates applicable to dividend, interest and royalty payments under the double taxation treaties concluded by the United States.

### iv Taxation on receipt

The United States permits US corporations to credit foreign income taxes (or taxes imposed in lieu of a foreign income tax) against the US tax liability on non-US dividends and other income flows. In general, many non-US withholding taxes are creditable in the United States.
provided that certain requirements (such as a minimum holding period) are met. Under prior law, if a US corporation owned at least 10 per cent of the total voting power of a foreign corporation's stock, the US corporation could claim a ‘deemed paid’ credit for foreign taxes that the foreign corporation actually paid on its income, once the US corporation received a dividend (or was deemed to receive a distribution under the US anti-deferral regime) from the foreign corporation.61 If a US corporation claimed a deemed paid credit, it also had to increase its income in the year the dividend was received by the amount of the foreign taxes deemed paid, whether or not the US corporation, after application of various limitation provisions, was able to use the credit to reduce its US tax liability.62

The TCJA repealed the deemed-paid credit with respect to dividends received by a US corporation that owns 10 per cent of the total voting power of a foreign corporation's stock. Instead, earnings of foreign corporations can generally be repatriated free of tax under the participation exemption system of taxation discussed above and subject to the GILTI regime discussed below. The deemed-paid credit regime generally remains in place, albeit with significant new limitations, for the portion of a foreign corporation’s foreign income taxes that are properly attributable to the Subpart F income or GILTI of that corporation.63

v Foreign Account Tax Compliance Act (FATCA)

FATCA is a complex reporting regime intended to encourage US persons to report ownership of offshore accounts; however, the provisions affect, inter alia, non-US entities and financial institutions receiving payments from US sources, directly or indirectly. Under FATCA, withholding at a rate of 30 per cent would apply to certain payments to (or through) certain financial institutions (including investment funds), unless such institution:

a enters into, and complies with, an agreement with the IRS to report, on an annual basis, information with respect to interests in, and accounts maintained by, the institution that are owned by certain US persons or by certain non-US entities that are wholly or partially owned by US persons and to withhold on certain payments;

b if required under an intergovernmental agreement between the United States and an applicable foreign country, reports such information to its local tax authority, which will exchange such information with the US authorities; or

c otherwise qualifies for an exemption.

Similarly, certain amounts payable to a non-financial non-US entity generally will be subject to withholding at a rate of 30 per cent, unless such entity certifies that it does not have any ‘substantial United States owners’, provides certain information regarding the entity’s ‘substantial United States owners’ or otherwise qualifies for an exemption. The Treasury Department has entered into agreements for the implementation of FATCA with the competent authorities of other countries, including Canada, France, Germany, Italy, Japan, Spain, Switzerland and the United Kingdom, among others, which agreements modify certain of these provisions.

61 Sections 902 repealed by the TCJA and 960 before amendment by the TCJA.
62 Section 78.
63 Section 960 as amended by the TCJA.
VII  TAXATION OF FUNDING STRUCTURES

Entities may be funded with capital contributions or with debt funding, but there must be some member with an equity interest in the entity. The US tax rules generally permit a deduction for interest payments made on indebtedness, but do not permit a deduction (or deem a deduction) on capital infused in an entity in exchange for equity. Regardless of the entity's form, contributions of cash or property when forming an entity are generally tax-free for the contributor and the receiving entity.

i  Characterisation of funding as debt or equity

The characterisation of an instrument as debt or equity for US federal income tax purposes generally depends on all the surrounding facts and circumstances. Because the Code does not contain a single defined set of standards for purposes of distinguishing between debt and equity, taxpayers generally rely on case law and certain published pronouncements of the IRS to guide them in making general debt–equity determinations. Courts and the IRS have articulated certain factors that are relevant in determining whether an investment, analysed in terms of its economic characteristics, constitutes risk capital largely subject to the performance of the issuer's business (thus making the investment more like equity) or, alternatively, exhibits the characteristics of a bona fide loan that is expected, or may be compelled, to be repaid in full (thus making the instrument more like debt).

In an effort to discourage ‘earnings stripping’ out of the United States, on 13 October 2016 the US Treasury Department and the IRS issued final and temporary Treasury Regulations under Section 385, and on 31 October 2019 amended such Treasury Regulations. The Treasury Regulations materially impact the treatment of certain related-party debt issued by issuers that are domestic corporations (including disregarded entities and certain partnerships owned by domestic corporations). These new Treasury Regulations generally operate to convert certain instruments that are otherwise classified as indebtedness for US federal income tax purposes into equity (and thus convert interest and principal payments on such debt as distributions on equity). The new Treasury Regulations generally apply to convert into equity debt instruments issued by domestic corporations (including disregarded entities and certain partnerships owned by domestic corporations) to certain related parties (such as a non-US parent corporation or a non-US finance entity that is directly or indirectly owned by the same parent corporation that owns the domestic issuer) if:

a such instruments are issued in certain prohibited transactions, such as a distribution of the instrument to a related party; or

b if the issuer of such instrument engages in certain prohibited transactions, such as a distribution of property to a related person that is funded by or occurs within three years before or after the issuance of such instrument.

ii  Thin capitalisation

Under the new ‘business interest deduction limitation’ passed as part of the TCJA, the interest deduction to which certain taxpayers would otherwise be entitled (after application of other statutory limitations) is generally limited to the sum of: (1) 30 per cent of the taxpayer’s ‘adjusted taxable income’ (roughly equivalent to earnings before interest, taxes,
depreciation and amortisation for tax years beginning before 1 January 2022); and (2) any interest includible in the taxpayer's income for the taxable year.66 If a taxpayer has interest disallowed for a tax year as a result of this new provision, such interest may be carried over to the following tax years indefinitely, subject to restrictions applicable to certain partnerships;67 any excess limitation, however, is not able to be carried forward. In 2018 and 2019, the IRS issued several packages of proposed and final Treasury Regulations under the TCJA, including proposed Treasury Regulations addressing the new business interest deduction limitation and final and proposed Treasury Regulations regarding the new BEAT regime.

### iii Deduction of finance costs

Interest deductions may be limited if the interest is:

- **a** paid with respect to certain acquisition indebtedness that is subordinated and convertible into equity, and the issuer's debt-to-equity ratio exceeds two-to-one, or projected earnings do not exceed three times the interest on the acquisition debt;68
- **b** paid on certain high-yield obligations;69
- **c** payable either in cash or equity of the issuer (or a related party);70
- **d** paid or accrued by or to a hybrid entity or pursuant to a hybrid instrument;71 or
- **e** related to tax-exempt income (e.g., debt incurred to acquire tax-exempt securities).72

Finance costs may generally be deducted by a US debtor, although certain rules may require that these costs be capitalised if related to inventory property or deducted over the term of the financing.

### iv Restrictions on payments

The ability to pay dividends is governed by state, not US federal, law. Many states, such as Delaware, do not impose burdensome restrictions on the ability to pay dividends. In general, a corporation needs either 'surplus' or net profits from the fiscal year in which the dividend is paid (in the latter case, provided that capital represented by outstanding stock of classes having a preference upon the distribution of assets is not impaired).73 However, the definitions of ‘dividend’ for state law and US federal income tax law are not coterminous. For example, a distribution could constitute a dividend under state law because it is paid out of ‘surplus’, while it may not constitute a taxable dividend for US federal income tax purposes because the corporation has no ‘earnings and profits’ (a tax concept that roughly corresponds with taxable income, plus adjustments).74

66 Section 163(j) as amended by the TCJA.
67 Section 163(j)(2) and (j)(4)(B)(i)(I).
68 Section 279.
69 Section 163(e)(5).
70 Section 163(l).
71 Section 267A.
72 Section 265.
73 8 Del C, Section 170.
74 Sections 312 and 316.
v Return of capital

Distributions are treated first as taxable ‘dividends’ to the extent the distributing corporation has ‘earnings and profits’; distributions beyond this amount are tax-free ‘return of capital’ distributions; any distribution amounts greater than a taxpayer’s capital are treated as capital gain (generally not taxable for a non-US person). 75

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Taxable acquisitions of US corporations are frequently structured as cash mergers, whereby a non-US acquiring corporation funds a transitory US merger subsidiary with equity and debt, after which the merger subsidiary merges with and into the US target corporation, with the latter surviving. The acquisition debt resides with the US target corporation after the transaction, providing a means to reduce the US tax base.

Generally, there is no US withholding tax when a non-US corporation acquires a US corporation. However, if the US corporation fails (or is unable) to certify to the acquiror that it is not a ‘US real property holding corporation’, then the acquiror generally would be obliged to withhold 15 per cent of the consideration paid to any non-US sellers. 76

ii Reorganisation

The United States has very flexible rules that permit merging and demerging (or ‘spinning off’) corporations on a tax-free basis. 77 Mergers, stock combinations or asset acquisitions generally can be implemented on a tax-free basis within the United States. If a non-US entity acquires the stock or assets of a US corporation, there are several requirements that must be satisfied. These rules are focused on preventing an ‘inversion’, whereby a US corporation moves to a non-US jurisdiction with substantial continuity of its existing shareholder base, and, somewhat related, the loss of US taxing jurisdiction over corporate assets. If a transaction violates anti-inversion rules, the US shareholders or the US target could be subject to tax or, in certain cases, the non-US acquiring corporation could actually be treated as a US corporation for all US federal income tax purposes. 78 Generally, foreign-to-foreign reorganisations do not give rise to US tax, except in certain cases where there is significant (i.e., controlling) US ownership of the acquired or target foreign corporation before but not after the transaction. 79

iii Exit

Under prior law, relocating outside the United States was an issue of great interest to many US taxpayers, given the relatively high US corporate tax rates and broad tax base. Although less attractive after the TCJA’s reduction of US corporate income tax rates, a US corporation may nevertheless wish to exit the United States. To do so, either its stock or assets must be transferred to a non-US corporation. Two different sets of rules limit a US corporation’s ability to ‘invert’ to a non-US jurisdiction.

75 Section 301(c).
76 Section 1445.
77 Sections 368 and 355.
78 Section 367(a); Section 7874(b); Treasury Regulation, Section 1.367(a)-3(c).
79 Treasury Regulation, Section 1.367(b)-4.
The Section 367 rules tax US shareholders on gain in stock of a US corporation that is transferred to a foreign corporation, unless several requirements are met. These requirements include that the foreign acquiring corporation be at least as valuable as the US target corporation, and conduct an active foreign trade or business. Further, a US parent corporation generally will recognise gain on assets that it transfers to a foreign acquiring corporation even if the transaction otherwise qualifies as a non-taxable asset reorganisation. For this reason, it generally is necessary to transfer the stock, rather than assets, of a US corporation that wishes to exit the US.

The Section 7874 rules apply at the entity level, and can treat a foreign acquiring corporation as a US corporation for all US federal income tax purposes if:

- the foreign acquiring corporation acquires substantially all the assets (either directly or through a stock acquisition) of the US target corporation (or substantially all the properties constituting a trade or business of a US partnership);
- at least 80 per cent of the stock of the foreign acquiring corporation is owned by former shareholders of the US target corporation (or US partnership) by reason of having owned the US target; and
- the foreign acquiring corporation's expanded affiliated group lacks 'substantial business activities' in the jurisdiction in which the foreign parent corporation is incorporated. Treasury Regulations require that at least 25 per cent of a foreign acquiring corporation's expanded affiliated group's employees, assets and income be located or derived from the relevant foreign jurisdiction for there to be substantial business activities in such foreign jurisdiction. 80

Alternatively, if the above requirements are satisfied but the ownership continuity is at least 60 per cent (but less than 80 per cent), then the foreign acquiring corporation is respected as a foreign corporation; however, the US target will not be able to use any tax attributes (such as losses or foreign tax credits) against any gain that the US target corporation recognises (or royalty income it receives from affiliates) by reason of property transfers during the 10 years that follow the inversion. Under the TCJA's new recapture provision, a corporation that undergoes such a 60 per cent inversion during the 10 years after 22 December 2017 may also have to increase its tax by an amount equal to the difference between 35 per cent and the actual rate of tax paid on its foreign earnings that were subject to the one-time transition tax under the TCJA. 81 Such corporations are also subject to more onerous rules under the BEAT regime and dividends paid by such corporations are not eligible for the reduced rate of taxation otherwise applicable to 'qualified dividend income'. 82 In addition, Treasury Regulations generally make it more difficult to satisfy the above-mentioned ownership thresholds and recent law changes make it more difficult for such corporations to efficiently integrate their non-US operations. 83

A special excise tax may also apply to certain stock compensation of insiders or large shareholders of a US corporation that inverts to a foreign jurisdiction. 84

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80 Treasury Regulation, Section 1.7874-3. Treasury Regulations also require that the foreign parent's tax residence be located in the relevant foreign jurisdiction.
81 Section 965(j)(1) as amended by the TCJA.
82 Section 59A(d)(4); Section 1(h)(11)(C)(iii)(II).
83 Section 958(b)(4) repealed by the TCJA; Treasury Regulation, Section 1.7874-5 et seq.
84 Section 4985.
A non-US person’s disposition of assets used in a US trade or business will be subject to US tax; however, a disposition of stock in a US or foreign corporation conducting a US business will generally not give rise to US tax unless, in the case of stock of a US corporation, the corporation is considered a US real property holding corporation.

Entities operating in partnership form are generally able to relocate their business to a foreign partnership without US tax.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Anti-avoidance doctrines developed through common law (i.e., court decisions) include the ‘step transaction’ doctrine, the ‘business purpose’ requirement (imposed on reorganisations and spin-offs) and the ‘economic substance’ doctrine. In 2010, Congress codified the common law ‘economic substance’ doctrine with substantial penalties for transactions subject to the provision (discussed further below). Anti-deferral rules discussed immediately below are generally aimed at income received in low-tax jurisdictions. The United States also seeks to police treaty shopping in low-tax jurisdictions by negotiating for a strict ‘limitation on benefits’ in its treaties.

ii Controlled foreign corporations (CFCs)

The US CFC regime is expansive and imposes current US tax on ‘subpart F income’, an umbrella term that comprises:

- passive income (foreign personal holding company income);
- income earned in a jurisdiction resulting from related party transactions where there may be little activity and value added in the foreign jurisdiction where the CFC is created or organised (sales and service income);
- certain insurance income; and
- certain other types of income.

With respect to foreign personal holding company income, a key exception is the ‘same country exception’ whereby certain payments of dividends, interest and royalties between corporations in the same jurisdiction do not give rise to current tax in the United States. A further exception is available for ‘qualified banking or financing income’. An additional temporary exception is provided for payments received from related CFCs that are not attributable to subpart F income.

85 Sections 871(b), 882 and 864(c)(7).
86 Sections 897 and 1445.
87 Section 7701(o).
88 Section 952.
89 Section 954(c).
90 Section 954(d) and (e).
91 Section 953.
92 Section 954(h).
93 Section 954(c)(3), (4) and (5).
94 Section 954(b).
95 Section 954(c)(6).
A foreign corporation generally is a CFC if more than 50 per cent of the vote or value of the foreign corporation is owned by ‘United States shareholders’, which are defined as US persons owning at least 10 per cent of the total vote or value of all classes of stock of the foreign corporation. The US has an extensive constructive ownership attribution regime. Under this regime, a shareholder that does not directly hold a 10 per cent interest may still be classified as a United States shareholder if the shareholder is attributed stock of other shareholders and, as a result, that shareholder indirectly holds a 10 per cent interest. Another anti-deferral regime applies, without regard to the level of US ownership, to a foreign corporation classified as a ‘passive foreign investment company’ (PFIC). A foreign corporation is classified as a PFIC with respect to any US shareholder if at least 75 per cent of its gross income is passive income or if at least 50 per cent of its assets are passive assets.

iii Transfer pricing

The US transfer pricing regime is based upon the familiar tax principle that transactions between commonly controlled entities must be priced at ‘arm’s length’. There is no precise definition of what constitutes common control. Penalties of up to 40 per cent may apply if a taxpayer’s price deviates significantly from the ultimately determined arm’s-length price. Taxpayers can avoid penalties by preparing contemporaneous documentation of a reasonable choice of method to determine the appropriate price. Treasury Regulations also provide detailed descriptions of methods, and the taxpayer is required to use the ‘best method’ to determine the appropriate price. For sales of tangible property, these methods include:
a the comparable uncontrolled price method;
b the resale price method;
c the cost-plus method;
d the comparable profits method;
e the profit-split method; and
f unspecified methods.

For transfers of intangible property, a fundamental principle is that the income received must be ‘commensurate with the income attributable to the intangible’. The methods include:
a the comparable uncontrolled transaction method;
b the comparable profits method;
c the profit-split method; and

d unspecified methods.

Guidance has also been provided regarding transfer pricing of controlled services transactions. The methods include:
a the services cost method;
b the comparable uncontrolled services price method;
c the gross services margin method;

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96 Section 957.
97 Section 951(b) as amended.
98 Sections 1291 to 1298.
99 Section 6662(e) and (h).
100 Treasury Regulation, Section 1.482-3.
101 Treasury Regulation, Section 1.482-4.
d the cost of services plus method;
e the comparable profits method;
f the profit-split method; and
g unspecified methods.  

A very significant element of the transfer pricing Treasury Regulations pertains to ‘cost sharing’, where parties develop and own IP based on their share of cost and risk. The major benefit of a qualified cost sharing agreement is that the IRS is limited to adjusting the ‘inputs’ or allocated costs of the IP development, and cannot adjust the potentially much larger ‘outputs’ (i.e., income) attributable to the cost-shared IP.

As discussed in further detail below, many taxpayers find it advantageous to enter into an APA with the IRS, which generally precludes the IRS from challenging the relevant transfer pricing for a specified period contained in the agreement.

iv GILTI

A US shareholder of a CFC must include in gross income its share of each of its CFC’s GILTI using mechanics similar to other Subpart F income inclusions. GILTI is the excess of ‘net CFC tested income’ over the shareholder’s ‘net deemed tangible income return’. Net deemed tangible income return is generally equal to 10 per cent of a CFC’s basis in tangible depreciable property. Broadly, net CFC tested income is equal to gross income, excluding ECI, Subpart F income, foreign oil and gas extraction income, certain related-party dividends, and non-economic transactions intended to affect tax attributes of US shareholders and their CFCs, less any allocable deductions and foreign taxes. A US corporation is allowed to claim foreign tax credits for foreign income taxes paid with respect to GILTI, but such credits are limited to 80 per cent of foreign income taxes paid and cannot be carried forward or back or used to offset any other income. In addition, while both corporate and non-corporate US shareholders must include their GILTI in income, generally only domestic corporations are entitled to a 50 per cent deduction on the included GILTI (effectively cutting the applicable tax rate on GILTI in half for domestic corporations).

v Tax clearances and rulings

Taxpayers may seek private letter rulings when there is uncertainty regarding the treatment of a transaction or an item of income. Each year the IRS publishes a revenue procedure that details the steps to be taken in requesting a private letter ruling; the revenue procedure also describes those areas in which the IRS normally will not issue a private letter ruling. Tax clearances are not required for the acquisition of a US business.

The IRS will also enter into APAs with taxpayers to ensure that transfer pricing is not challenged. A taxpayer may also be able to enter into a pre-filing agreement, which ensures that the IRS will not challenge how a taxpayer reports certain positions on its return for

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102 Treasury Regulation, Section 1.482-9.
103 Treasury Regulation, Section 1.482-7.
104 Section 951A.
105 Section 904(c).
106 Section 250.
a specified number of years. US tax treaties generally contain a provision that allows for a ‘competent authority agreement’, which grants the benefit of a treaty article the terms of which are not otherwise technically satisfied.

X YEAR IN REVIEW

The TCJA, which was signed into law in late December 2017, introduced the most dramatic changes in US federal income taxation in the past three decades. In addition to the massive overhaul of the US outbound taxation regime, the TCJA made several significant changes relevant to inbound investors, such as the BEAT and expanded interest expense limitations. As a result of the changes, the clear focus of both tax administrators and taxpayers in 2019 has been on interpreting the provisions of this new tax regime. Numerous questions have been raised as to the proper interpretation of, and as to technical errors in, the TCJA, and the Treasury and the IRS have been working diligently to release guidance, particularly in those areas most critical to taxpayers. At the time of writing, certain proposed and final Treasury Regulations have been released with regard to the new provisions under the TCJA, with more expected.

XI OUTLOOK AND CONCLUSIONS

The Treasury and the IRS have been focused on drafting and finalising guidance relating to the TCJA, and several packages of proposed and final Treasury Regulations have been issued, with additional final Treasury Regulations expected in the coming year. In addition, Congress is expected to work towards certain technical corrections, and potentially even additional tax reform. There can be no certainty, however, as to what additional tax legislation, if any, Congress may pass in the coming year. In addition, because of the novelty of many of the tax reform provisions, such as the BEAT, FDII, GILTI, etc., there may be some uncertainty as to the long-term prospects for these and other provisions all remaining in their current form.
Appendix I: Domestic and treaty rates for dividends, interest and royalties

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<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
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<td>Domestic rates</td>
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<td>Dividends</td>
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<td>Venezuela</td>
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* Generally, the lower non-zero rate applies if the corporate shareholder owns at least 10 per cent of the voting stock of the US corporation. The text of the treaty should be consulted.
† The treaty concluded between the United States and the former USSR.
‡ The zero per cent rate generally applies if the corporate shareholder owns 80 per cent or more of the voting stock of the US corporation for a 12-month period and qualifies under certain provisions of the limitation on benefits article of the treaty. The text of the treaty should be consulted.
I INTRODUCTION

The Venezuelan market has been less active than other Latin American markets, mainly because of its political and economic instability. Investments in Venezuela mainly continue to involve infrastructure, energy projects and regional or worldwide M&A transactions, which include the purchase of subsidiaries in Venezuela and the purchase of companies by local or international investors willing to bear the high risks of doing business in Venezuela in exchange for potential significant rewards if the current situation improves.

The government lifted most of the foreign exchange controls and the Venezuelan economy is increasingly dollarised, with many transactions being carried out in US dollars and other foreign currencies.

The most recent tax measures include the creation of a wealth tax, which taxes individuals and legal entities with a rate of 0.25 per cent on the value of their net wealth as of 30 September of each year.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

The most commonly used forms of business organisations are:

- the corporation (SA);
- the partnership (SNC);
- the limited liability partnership (SCS);
- the limited stock partnership (SCA); and
- the limited liability company (SRL).

Corporate

Investors generally prefer a corporate business form, and the SA is the most commonly used corporate form. The SA limits the liability of the shareholders to the subscribed capital.

The SA must have a stated or subscribed capital, which is the amount of capital that the shareholders of the corporation agree to subscribe. The SA’s stated capital is represented by shares of stock in registered form (bearer shares are not permitted), with a par value. The shares must be subscribed by the shareholders. At least 20 per cent of the subscribed capital must be paid at the time of incorporation. In addition, under the Public Registry Law, the Commercial Registry Office may deny registration of the articles of incorporation in the

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1 Alberto Benshimol and Humberto Romero-Muci are partners at D’Empaire.
event that it considers the capital insufficient for the purpose of the SA. Although there are no statutory minimum capital requirements applicable to the stated capital, each Venezuelan commercial registry sets out a minimum stated capital requirement on a case-by-case basis or depending on the purpose of the SA. The stated capital of the SA can be paid in cash or in kind. In the case of payment in cash, at least 20 per cent of the stated capital must be paid by the shareholders at the time of the registration of the shareholders’ meeting approving the incorporation of the SA or the corresponding capital increase (the amount of stated capital already paid by the shareholders is known as ‘paid-in capital’). Payment in cash of the stated capital must be made by a deposit in bolivares in a bank account opened with a Venezuelan bank under the name of the SA. In the case of payment in kind, assets of a value equal to 100 per cent of the stated capital must be contributed to the SA.

The initial and any subsequent issuance of capital stock is subject to a tax of 1 per cent levied on the stated capital, plus other registration fees and expenses. Certain commercial registries of the Capital District apply a registration tax equal to 10 per cent of the stated capital. However, to mitigate the effects of this tax, shares may be subscribed at a premium. Although the SA must initially have at least two shareholders, it may subsequently become a wholly owned subsidiary of one shareholder.

The SA is a separate taxpaying entity. The SA’s worldwide net income is levied with Venezuelan income tax at a corporate rate of up to 34 per cent. Dividends paid by an SA to either a resident or non-resident are subject to a dividends tax levied at a flat rate of 34 per cent to the extent that ‘financial earnings’ exceed ‘net taxable earnings’. The transfer of an SA’s shares by a legal entity is subject to 5 per cent Venezuelan income tax withholding, regardless of the legal entity’s domicile. Sales of shares made by individuals are subject to a 34 per cent Venezuelan income tax withholding if the individual is not domiciled in Venezuela, or to a 3 per cent withholding if the individual is domiciled in Venezuela. Special tax treatment applies if shares are listed on a Venezuelan stock exchange.

The other corporate business form used in Venezuela is the SRL. The SRL is rarely used because its stated capital cannot currently exceed 2,000 bolivares. Like the shareholders of a corporation, members of the SRL enjoy limited liability. The capital of the SRL is represented by quotas. In the case of the transfer of a quota owned by a member, the other members have a preferential right to acquire such quota, and the transfer of the quota to third parties requires the approval of three-quarters of the SRL’s capital. The process to incorporate an SRL is similar to that of setting up a corporation. Its by-laws may provide for mandatory cash contributions of the members, which will not be considered capital contributions. The SRL is subject to the same income tax treatment as the SA.

ii Non-corporate

The SNC, the SCS and the SCA are the most commonly used non-corporate entities in Venezuela. The SNC is the Venezuelan partnership. The partners of an SNC are personally, jointly and severally liable for the debts, obligations and liabilities of an SNC. The contributions of the partners in an SNC are not represented by shares. The initial and subsequent capital contributions made by the partners to the SNC are subject to a 1 per cent tax. The SNC is fiscally transparent for income tax purposes. The SNC will report its taxable income in accordance with the Venezuelan Income Tax Law; however, it will not be taxed on that net income. The SNC’s partners will be subject to income tax on their portion of SNC’s taxable
income and will have to report that income on an accrual basis. The assignment of the SNC's interest to an entity is subject to a 5 per cent Venezuelan income tax withholding levied on the cash consideration paid.

An SCS is the Venezuelan limited liability partnership. The SCS must be organised by one or more general partners, plus one or more limited partners. The general partners of an SCS are jointly and severally liable for the debts, obligations and liabilities of the SCS, whereas the limited partners are not liable for those debts, obligations or liabilities. The liability of the limited partners is limited to the amount they agree to contribute to the SCS. The contributions of the limited and general partners in the SCS are not represented by shares. A 1 per cent tax is levied on capital contributed by the limited partners. The SCS is fiscally transparent and taxed like the SNC as described above. The assignment of the SCS’s interest by an entity is subject to a 5 per cent Venezuelan income tax withholding levied on the cash consideration paid.

The SCA must be organised by one or more general partners and one or more limited partners. The SCA is similar to the SCS, but the limited partners’ interests in the SCA are represented by shares, which may be transferred as the shares of an SA.

The assignment of shares of the SCA by an entity is subject to a 5 per cent Venezuelan income tax withholding levied on the cash consideration paid. The SCA is treated as an SA (corporation) for Venezuelan income tax purposes.

The fiscally transparent entities (SNCs and SCSs) are used to achieve tax consolidation through fiscal transparency, as Venezuelan income tax law does not contain tax consolidation rules.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

Venezuelan-resident entities are generally subject to Venezuelan tax on their worldwide income at rates of up to 34 per cent set out in the progressive schedule provided in the Venezuelan Income Tax Law.

In general, income tax is levied on net taxable income, which is calculated by subtracting from the annual gross revenue costs and allowable deductions (e.g., salaries, interest, amortisation, depreciation, technical assistance, and any expense that is ‘normal and necessary’ to generate income).

Expenses that are ‘normal and necessary’ to produce income may be deducted. Expenses are ‘normal’ if the amount of the disbursement made is in accordance with amount of income produced and the amount of disbursements customarily made by other taxpayers in the same line of business for similar expenses. Expenses are ‘necessary’ if there is a reasonable relationship with the business of the taxpayer.

In general, any reasonable depreciation or amortisation charge for fixed assets located in Venezuela assigned to income-producing activities is admissible. In general, the units of production depreciation method and straight-line depreciation method are admissible, among others. The ‘exhaustion’ amortisation method of depletion is allowed.

Taxable income must be reported on an accrual basis, except for income from leased property, royalties, dividend distributions, professional fees, wages, salaries and transfer of real estate, which is taxed on a cash receipt basis.
Calculation of taxable income tax liability also entails ‘inflation adjustment’, which is calculated as follows. The nominal value of a corporation’s shareholders’ equity at the closing of its fiscal year is multiplied by the Caracas consumer price index (the CPI), as published by the Central Bank of Venezuela. This adjustment is deductible as a loss in the calculation of the corporation’s final tax liability. For example, if a company’s shareholders’ equity is 100 and the CPI was 25 per cent, the company will be allowed to deduct 25 per cent in the calculation of its final income tax liability.

The nominal value of a corporation’s ‘non-monetary assets’ (e.g., buildings, machinery, equipment and foreign currency amounts) is also multiplied by the Caracas CPI. The adjustment becomes a taxable gain that must be included in the calculation of its final income tax liability.

Taxpayers designated as special taxpayers by the tax authorities, as well as banks, insurance and financial companies, may not apply the adjustment for inflation for income tax calculation purposes.

**Capital and income**

There is no distinction between capital gains and ordinary income.

**Losses**

Foreign and domestic losses may be carried forward for three years and offset up to 25 per cent of the taxpayer’s yearly taxable income. Losses may not be carried back. The losses can survive a change of ownership.

**Rates**

The schedule of income tax rates for corporate residents contains three rate-brackets:

- \( a \) 15 per cent on taxable income up to 2,000 tax units;
- \( b \) 22 per cent on additional taxable income up to 3,000 tax units; and
- \( c \) 34 per cent on taxable income above 3,000 tax units.

The tax unit is a value for measurement set by the tax administration (SENIAT) before 15 February every year, and published in the Official Gazette. The adjustments to the tax units are made upon the variations of the CPI, as published by the Central Bank of Venezuela. Each tax unit is currently equivalent to 300 bolivares.

**Administration**

Income tax returns must be filed within three months of the end of the tax year of the taxpayer. SENIAT administers income tax and other national taxes such as VAT, and municipal tax agencies administer municipal taxes such as the business activities tax, real property tax and vehicles tax. There are no regular routine audit cycles. Rulings may be requested on uncertain tax issues. Tax assessments may be appealed before the tax administration or challenged before tax courts.

**Tax grouping**

There are no rules on consolidated tax grouping.
ii Other relevant taxes

Value added tax

VAT applies to sales of all goods and services throughout the chain of distribution, except certain exempted items such as food, medicine, telephones, domestic electricity and domestic natural gas. VAT is levied at a rate of 16 per cent. VAT taxpayers are charged VAT on all their purchases of goods and services (input credits). In turn, they have to charge and collect VAT in their sales of goods and services (output debits), effectively passing down the VAT to the end consumers. VAT liability (excess of output debits over input credits) is paid each week by VAT taxpayers to the Venezuela national tax administration.

Certain designated VAT taxpayers must (1) pay VAT advance payments on a weekly basis, based on the VAT payable the previous week, and (2) withhold 75 per cent of the VAT charged on all their purchases of goods and services, and pay the withheld amounts to the Venezuelan treasury on a weekly basis. Likewise, such designated VAT taxpayers are also subject to said VAT withholding on every sale of goods or services they make to other designated VAT taxpayers. This regime puts enormous pressure on such designated VAT taxpayers’ cash flows.

A municipal tax on business activities is levied by the local municipalities on gross revenue (i.e., no deductions are allowed). The applicable rates vary from municipality to municipality and according to the business activity in which the taxpayer is engaged. The rates range from 0.5 per cent, and may reach as high as 2 per cent (or more).

Financial transactions tax (FTT)

The FTT applies to legal persons (not individuals) appointed as special taxpayers who are: (1) making payment transactions through Venezuelan banks or financial accounts, and (2) paying debts outside the financial system by means of payments, novation, offsetting and forgiveness of debts.

The FTT also applies to legal persons legally related to special taxpayers and to legal persons or individuals making payments on behalf of special taxpayers. The FTT rate is 2 per cent, and its tax base is the amount of the transaction.

Contribution to the National Organisation Against Drugs

Commercial or industrial businesses that employ 50 or more workers must pay a special contribution to the National Organisation Against Drugs equal to 1 per cent of their ‘business profits’, which are defined as net profits obtained from business transactions. This tax is calculated and paid annually.

Contribution to the National Fund of Science, Technology and Innovation

Both companies domiciled in Venezuela and non-domiciled companies that carry out activities in Venezuela generating gross revenues in excess of 100,000 tax units must pay a special contribution to the National Fund of Science, Technology and Innovation. This contribution ranges between 0.5 per cent and 2 per cent of their gross revenues, depending on the type of business activity carried out. This tax is calculated and paid annually.
**Contribution to the National Sports Fund**

Both companies domiciled in Venezuela and non-domiciled companies that carry out activities in Venezuela obtaining net profits of at least 20,000 tax units must pay a special contribution to the National Sports Fund equal to 1 per cent of their net profits. This tax is calculated and paid annually.

**Contribution to the Venezuelan Institute of Social Security**

Employees must pay a contribution to the Venezuelan Institute of Social Security (IVSS), equal to 9 per cent, 10 per cent or 11 per cent of the lower of each employee's salary or five times the minimum monthly urban salary, for each employee (the IVSS salary base). The applicable percentage (9, 10 or 11 per cent) depends on the level of risk of the business activities (the higher the risk, the higher the percentage). Employees must also pay a contribution to IVSS equal to 4 per cent of the IVSS salary base, such contribution being withheld by the employer and paid by the employer to IVSS. These contributions must be paid on a weekly basis.

**Contribution to the National Institute of Educational Cooperation**

Employers with five or more employees must pay a contribution to the National Institute of Educational Cooperation (INCES) equal to 2 per cent of total wages, salaries, daily payments and remuneration of any kind, but excluding occasional payments such as extraordinary bonuses (normal salary). Employees must also pay a contribution to INCES equal to 0.5 per cent of any profit-sharing, such contribution being withheld by the employer and paid to INCES. These contributions must be paid by the employer within the first five days of each quarter.

**Contribution to the Housing Saving Fund**

Employers must pay a contribution to the Housing Saving Fund (FAOV) equal to 2 per cent of the monthly integral salary of each employee. Employees must also pay a contribution to FAOV equal to 1 per cent of their monthly integral salary, such contribution to be withheld or deducted by the employer and paid to the national housing bank, Banavih. These contributions must be paid on a monthly basis.

In a recent decision, the Constitutional Chamber of the Supreme Court of Justice stated that the mandatory contribution to FAOV shall not be considered a tax and shall not be subject to Venezuelan tax laws.

**Unemployment or lay-off contingency**

Employers must pay a contribution to IVSS for an unemployment or lay-off contingency equal to 1.7 per cent of the IVSS base salary, and employees must pay a similar contribution equal to 0.5 per cent of the IVSS base salary, such contribution being withheld or deducted by the employer and paid to IVSS. These contributions must be paid on a weekly basis.

**Gifts tax**

Donations or gifts of assets located in Venezuela are generally subject to the Venezuelan gift tax levied at the rates of up to 55 per cent set out in the progressive schedule applicable depending on the relationship between the beneficiaries of the gift and the donor.
Wealth tax

The wealth tax is applicable to ‘special taxpayers’ formally designated by the Venezuelan tax authority whose net wealth is equal to or higher than 150 million tax units (approximately US$361,508).

Individuals and legal entities considered tax residents are taxed on a worldwide basis. Non-residents taxpayers are taxed on assets located in Venezuela. Permanent establishments in Venezuela are taxed on the assets attributable to such permanent establishments. Venezuelan branches of foreign companies are considered permanent establishments.

The wealth tax is levied on the property and possession of wealth attributable to the taxpayers in accordance with the rules set forth in the Wealth Tax Law.

The wealth tax is caused annually, based on the value of the wealth at the closing of each 30 September.

The taxable base is the net wealth of the taxpayer, defined by the Wealth Tax Law as the total value of the assets less the liabilities and any encumbrances and liens over such assets and less any exempt assets or rights. The value of the assets is determined following the rules set forth in the Wealth Tax Law.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

An entity is considered a Venezuelan resident if it is organised in accordance with Venezuelan laws or domiciled in Venezuela.

A non-locally incorporated entity may not become resident in Venezuela because it has a local seat of management or because of other factors, but it may have a permanent establishment in Venezuela if its place of effective management is in Venezuela.

ii Branch or permanent establishment

Foreign entities may operate in Venezuela through a permanent establishment. A branch, a fixed place of business, place of effective management and an agent with authority to enter into contracts will be considered a permanent establishment. The threshold for a foreign entity to have a permanent establishment in Venezuela is lower under the income tax law in comparison with the tax treaties in effect in Venezuela. Therefore, foreign entities entitled to the benefits of a tax treaty may be protected in certain situations from having a permanent establishment in Venezuela.

The permanent establishment is taxed on income attributable to the permanent establishment’s activities. Income that the permanent establishment might be expected to make if it will be a separate and distinct entity will be attributable to the permanent establishment. Deductions of expenses incurred for the purpose of the permanent establishment are allowed, including executive and general administrative expenses. Interest, technical assistance fees or royalties payments made to the head office and its affiliates are not deductible, but interest, fees and royalties paid to other entities are deductible.

The Venezuelan branches of foreign legal entities are subject to a deemed dividend tax on their earnings. The deemed dividends tax is levied at a flat rate of 34 per cent on the excess amount of the branch’s ‘financial earnings’ over the branch’s ‘net taxable income’. The deemed dividends tax is exempted if the branch reinvests in Venezuela the amount subject to the deemed dividends tax and the investment is maintained in Venezuela for five years.
V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
No special holding company regimes are available in Venezuela.

ii IP regimes
No special IP regimes are available in Venezuela.

iii State aid
The tax incentives for new investments were eliminated in the 2015 Income Tax Law amendment.

iv General
Venezuela has signed treaties for the avoidance of double taxation with Austria, Barbados, Belarus, Belgium, Brazil, Canada, China, Cuba, the Czech Republic, Denmark, France, Germany, Indonesia, Iran, Italy, Korea, Kuwait, Malaysia, the Netherlands, Norway, Palestine, Portugal, Qatar, Russia, Spain, Sweden, Switzerland, Trinidad and Tobago, the United Arab Emirates, the United Kingdom, the United States and Vietnam. These agreements provide significant protection to investors against changes in tax legislation.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)
Dividends paid by a Venezuelan corporate entity to either a resident or non-resident are subject to a 34 per cent withholding levied on the distributed excess amount of the corporate entity's 'financial earnings' over its 'net taxable earnings'.

Interest payments made to non-resident entities are subject to a withholding levied at a progressive corporate rate of up to 34 per cent on 95 per cent of the payment. Interest payments made to qualified financial institutions domiciled outside Venezuela are subject to a withholding tax of 4.95 per cent.

Payments of royalties to a non-domiciled entity are subject to a withholding levied at the progressive corporate rate of up to 34 per cent on 90 per cent of the gross payment.

Payments of technical assistance fees to a non-domiciled entity are subject to a withholding levied at the progressive corporate rate of up to 34 per cent on 30 per cent of the gross payment.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments
Interest payments on bonds issued by the Republic of Venezuela are exempted from withholding, whereas payments in kind are not.

iii Double tax treaties
The table in Appendix I summarises the withholding rates on dividends, interest and royalty payments under each of the tax treaties currently in effect in Venezuela.
iv Taxation on receipt
Dividends paid by a Venezuelan corporation to either a resident or non-resident are subject to a dividend tax levied at a flat rate of 34 per cent to the extent that the ‘financial earnings’ of the Venezuelan corporation exceed its ‘net taxable earnings’. Dividends paid by a Venezuelan corporation out of dividend distributions received from other Venezuelan corporations are not subject to the dividend tax.

There is no indirect credit for local or foreign underlying taxes. Therefore, dividends paid by a foreign corporation to Venezuelan residents out of dividend distributions received by such foreign corporation from Venezuelan corporations are subject to 34 per cent dividends tax.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation
Under the thin capitalisation rules, interest on related-party debt will be deductible for tax purposes provided the 1:1 debt-to-equity ratio is not exceeded. In calculating whether the amount of debt exceeds the taxpayer’s net equity, the taxpayer’s annual average net equity must be subtracted from the annual average related party debt.

ii Deduction of finance costs
Finance costs are generally deductible. Interest expenses incurred in connection with income production should be deductible, provided that the interest paid is in accordance with the amount of income produced.

iii Restrictions on payments
Dividends must be distributed from liquid and collected earnings.

iv Return of capital
Equity capital can be repaid by a reduction or return of capital, and it is tax-neutral.

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition
Non-local companies acquiring local businesses generally structure the transaction using a local entity. Buyers generally structure financing through loans, because interest payments under such loan will be deductible. It is common that the consideration for sellers is paid with negotiable instruments to avoid the income tax withholding applicable to cash considerations.

ii Reorganisation
Mergers are generally considered tax-neutral. There are no rules on demerging. A merger between a local and a non-local entity is not contemplated in the law, but could be implemented through the domestication of one of the entities in the jurisdiction of the other entity.
Exit

Entities may be deregistered in Venezuela and relocated in another jurisdiction. There are no applicable taxes on the relocation of a Venezuelan entity.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

General anti-avoidance provisions grant the tax administration the power to disregard legal forms adopted by the taxpayer with the main intention of evading taxes. The isolated court decisions on abuse of legal forms in the tax context provide that legal forms with a prevailing ‘business purpose’ should not be disregarded by the Venezuelan tax administration.

ii Controlled foreign corporations (CFCs)

The Income Tax Law generally requires reporting of income, and imposes disclosure obligations on Venezuelan residents with direct or indirect controlled interests in foreign entities and other investments organised, located or resident in any of the jurisdictions considered as low tax jurisdictions when a resident exercises management or control over such investments. Control over investments is defined as the ability to decide the timing of the distribution of profits, yields or dividends derived from the investment. The control requisite is presumed, but the taxpayer may rebut such presumption.

Venezuelan taxpayers are required to accrue into their Venezuelan taxable income the gross income derived from an investment in a low-tax jurisdiction (either directly or indirectly) without any deductions taken by the latter in computing net income. However, such amounts may be deducted in computing a Venezuelan resident’s taxable income if the accounting records of the investment in a low tax jurisdiction are maintained in Venezuela, and made available to the Venezuelan tax authorities.

iii Transfer pricing

SENIAT has created a transfer-pricing department formed by professionals specialised in transfer-pricing issues. Since its creation, SENIAT has become very strict about and aware of transactions made by Venezuelan companies with related parties.

In fact, SENIAT has been auditing Venezuelan companies undertaking transactions with foreign related parties to verify if such transactions comply with the existing arm's-length standards. Tax audits have been undertaken to verify if interests and royalties paid by a foreign company to its related company in Venezuela, or vice versa, were agreed at fair market value.

The transfer pricing methods that are currently in force in Venezuela are basically identical to those contained in the Organisation for Economic Co-operation and Development Guidelines:

- the comparable uncontrolled price (CUP) method;
- the resale price method;
- the cost-plus method;
- the profit-split method; and
- the transactional net margin method.
There is a preferred method rule that requires the taxpayer to document the rationale for its choice of methodology. The first method that must be evaluated for use by the taxpayer must be the CUP method.

iv Tax clearances and rulings
There are no tax clearances or rulings generally required to acquire a local business. Rulings may be requested on uncertain tax issues.

X YEAR IN REVIEW
Over the past year, the government has tried to implement measures to ease the exchange control regime and certain tax measures to increase revenue. However, high levels of inflation, maxi-devaluation of the currency and estimations that gross domestic product will continue shrinking in 2020 have led to a poor economic forecast for 2020. However, the increased dollarisation of the Venezuelan currency and other measures have caught the attention of investors with risk appetite, seeking to profit if the current situation improves.

XI OUTLOOK AND CONCLUSIONS
The tax burden of Venezuelan and foreign companies carrying on economic activities in Venezuela has significantly increased. Income obtained by the Venezuelan government has become insufficient to subsidise public expenses. By creating a new wealth tax and by increasing tax rates, the government aims to obtain more resources to meet public expenses and subsidise social projects.

Despite its economic setback, Venezuela continues to be a country with significant business opportunities for foreign investors willing to assume risks for a number of reasons:

a Venezuela has the fifth-largest proven oil reserves in the world (and the largest in the western hemisphere) and the second-largest proven natural gas reserves in the western hemisphere;

b the devaluation of the local currency has made Venezuela very competitive in terms of labour and other local costs if compared with other countries of the region; and

c the Venezuelan government has engaged in infrastructure and other strategic projects with foreign investors under contract, providing for payments in foreign currency and in certain cases for international arbitration to settle potential disputes.

In light of this political and economic environment, doing business in Venezuela involves significant risk, but continues to provide opportunities for high returns.
## Appendix I: Treaty rates for dividends, interest and royalties

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<tr>
<th>Country</th>
<th>Dividends</th>
<th>Interest</th>
<th>Royalties</th>
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<tbody>
<tr>
<td>Austria</td>
<td>5 per cent if the shareholder is an entity that directly controls at least 15 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>4.95 per cent on interest paid to banks; 10 per cent on other interest payments</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Barbados</td>
<td>5 per cent if the shareholder directly controls at least 5 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent on interest payments to banks; 15 per cent other interest payments</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Belarus</td>
<td>5 per cent if the shareholder directly or indirectly owns at least 25 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>5 per cent</td>
<td>5 per cent copyright and leases 10 per cent other royalties</td>
</tr>
<tr>
<td>Belgium</td>
<td>5 per cent if the shareholder directly or indirectly owns at least 25 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Brazil</td>
<td>10 per cent if the shareholder is a corporation that directly or indirectly controls at least 20 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>15 per cent</td>
<td>15 per cent</td>
</tr>
<tr>
<td>Canada</td>
<td>10 per cent if the shareholder controls 25 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>5 per cent copyright except on videos; 10 per cent other royalties</td>
</tr>
<tr>
<td>China</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent on interest payments to banks; 10 per cent other interest payments</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Cuba</td>
<td>10 per cent if the shareholder is a corporation that directly controls at least 25 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 15 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>12 per cent</td>
</tr>
<tr>
<td>Denmark</td>
<td>5 per cent if the shareholder controls 25 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>5 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>France</td>
<td>5 per cent or exempted if the shareholder directly or indirectly owns at least 10 per cent of the capital of the distributing entity</td>
<td>5 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Germany</td>
<td>5 per cent if the shareholder owns at least 15 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>5 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Indonesia</td>
<td>10 per cent if the shareholder directly controls at least 10 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>20 per cent royalty payments; 10 per cent technical assistance fees</td>
</tr>
<tr>
<td>Iran</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 15 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Italy</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>7 per cent copyright; 10 per cent other royalties</td>
</tr>
<tr>
<td>Korea</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent on interest payments to banks; 10 per cent on other interest payments</td>
<td>5 per cent lease payments; 10 per cent on other distributions</td>
</tr>
<tr>
<td>Country</td>
<td>Dividends</td>
<td>Interest</td>
<td>Royalties</td>
</tr>
<tr>
<td>-----------------</td>
<td>---------------------------------------------------------------------------</td>
<td>--------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Kuwait</td>
<td>5 per cent if the shareholder is a corporation that directly owns at least 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent</td>
<td>20 per cent</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>15 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Netherlands</td>
<td>10 per cent or exempted if the shareholder controls at least 25 per cent of the capital of the distributing entity</td>
<td>5 per cent</td>
<td>5 per cent leases and other royalty payments; 7 per cent trademarks; 10 per cent copyright</td>
</tr>
<tr>
<td>Norway</td>
<td>5 per cent if the shareholder directly controls 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent interest paid to banks; 15 per cent other interest payments</td>
<td>12 per cent royalties; 9 per cent technical assistance fees</td>
</tr>
<tr>
<td>Palestine</td>
<td>10 per cent if the shareholder directly controls 10 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>5 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Portugal</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>12 per cent royalties; 10 per cent technical assistance fees</td>
</tr>
<tr>
<td>Qatar</td>
<td>5 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity; 10 per cent in all other cases</td>
<td>5 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Russia</td>
<td>10 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity and invested at least US$100,000 in such entity; 15 per cent in all other cases</td>
<td>5 per cent interest paid to banks; and 10 per cent on other interest payments</td>
<td>15 per cent royalties; 10 per cent technical assistance fees</td>
</tr>
<tr>
<td>Spain</td>
<td>10 per cent or exempted if the shareholder controls 25 per cent of the capital of the distributing entity</td>
<td>4.95 per cent on interest payments to financial institutions or 10 per cent other interest payments</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Sweden</td>
<td>10 per cent or exempted if the shareholder controls at least 25 per cent of the capital of the distributing entity</td>
<td>10 per cent</td>
<td>10 per cent copyright; 7 per cent other royalties</td>
</tr>
<tr>
<td>Switzerland</td>
<td>10 per cent or exempted if the shareholder controls at least 25 per cent of the capital of the distributing entity</td>
<td>5 per cent</td>
<td>5 per cent</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) that holds directly or indirectly at least 25 per cent of the capital of the company paying the dividends; 10 per cent in all other cases</td>
<td>15 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) that holds directly at least 10 per cent of the capital of the company paying the dividends; 10 per cent in all other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>10 per cent or exempted if the shareholder directly or indirectly controls at least 10 per cent of the voting rights of the distributing company</td>
<td>5 per cent</td>
<td>7 per cent copyrights; 5 per cent other royalties</td>
</tr>
<tr>
<td>United States</td>
<td>5 per cent if the shareholder owns at least 10 per cent of the voting shares of the distributing company; 15 per cent in all other cases</td>
<td>4.95 per cent on interest paid to financial or insurance institutions and 10 per cent on other interest payments</td>
<td>5 per cent lease payments; 10 per cent other royalty payments</td>
</tr>
<tr>
<td>Vietnam</td>
<td>10 per cent if the shareholder is a corporation that directly controls at least 10 per cent of the capital of the distributing entity; 15 per cent in all other cases</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
</tbody>
</table>
INTRODUCTION

In the first nine months of 2019, GDP growth was approximately 6.98 per cent, the highest growth in the past nine years, and the total amount of registered foreign investment reached US$26.16 million. Major investors include Korea, Japan, Singapore, Taiwan, Hong Kong and China. The investment mostly focused on the processing and manufacturing sector with the total capital of US$18.09 billion, accounting for 69.1 per cent of the total registered investment capital. In addition, Vietnam has welcomed the investment in renewable energy.

Trade war between US and China not only poses a challenge but also creates an opportunity for Vietnam. However, the biggest challenges are the underlying problems for the economy such as low-tech skills, exhausted lands and natural resources, low productivity and competition. To improve the business environment and attract investment, the government has been focusing on reforming the administration and reducing the obstacles to investment. According to the independent review on business conditions of ministries and sectors conducted by the Central Economic Management Research Institute as at the beginning of July 2019, the abolition rate and simplification of business conditions reached 32 per cent on average.

On 12 November 2018, the Vietnam National Assembly officially ratified the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) which entered into force for Vietnam from 14 January 2019. According to the General Department of Customs, after the effectiveness of CPTPP, Vietnam’s exports to markets in CPTPP countries such as Japan, Canada and Mexico achieved significant increases in the first 7 months of 2019. In addition, up to September 2019, Vietnam’s export to CPTPP countries amounted to more than 15 per cent of Vietnam’s total exports. CPTPP economies account for 6 out of the 27 export markets of Vietnam with a value exceeding US$1 billion, a sizable contribution in comparison to other free trade agreement (FTA) deals Vietnam has signed.
II  COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

i  Corporate

Inward investors may choose to establish a limited liability company (LLC) or a joint-stock company (JSC) for investment in Vietnam.

There are two different types of LLC: a single-member LLC (SMLLC) and a multi-member LLC (MMLLC). SMLLCs are owned by one organisation or an individual member (company owner) who is liable for the debts and liabilities of the company to the extent of the amount of the charter capital of the company. An MMLLC is an enterprise that has more than one but no more than 50 members, which may be organisations, individuals or a combination of both. MMLLCs have the same legal status as SMLLCs. However, in SMLLCs, the company owner has more autonomy with regard to decisions made about the company than those of MMLLCs. With MMLLCs, capital transfers are limited in the sense that capital may be sold to external investors only after all other members of the MMLLC have decided not to purchase that capital. The new Enterprise Law, which took effect on 1 July 2015, also limits the duration for capital contributions in LLCs to within 90 days of the issuance of the enterprise registration certificate. In the event of failing to meet the deadline, the enterprise is required to adjust its charter capital to be settled at the amount actually contributed. 9

The corporate form of JSC is more flexible and does not have limitations for the number of shareholders. With the development of two stock exchanges (i.e., the Ho Chi Minh Stock Exchange and the Hanoi Stock Exchange) and over-the-counter markets, JSCs are the appropriate choice when there is a higher capacity of capital mobilisation, and tend to be the more popular option for foreign investors looking into M&A deals.

ii  Non-corporate

A partnership is a form of enterprise set up by at least two partners, who are personally liable for its debts (partnership). Limited liability partners may also join in the partnership, and are only liable to the extent of their capital contribution. This form of business is not common for inward investment.

A private enterprise is established by an individual, who is the owner of the enterprise. Such individual is liable by all of his or her assets for the enterprise’s debt. However, in practice, inward investors are not able to establish private enterprises owing to complications with identifying foreign assets.

For these reasons, non-corporate entities are not commonly chosen for inward investment in Vietnam.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

**Determination of taxable profit**

Enterprises established under Vietnamese law are subject to enterprise income tax (EIT) on their worldwide income. Such enterprises are allowed to deduct income tax paid overseas against the EIT payable in Vietnam in accordance with the provisions of the EIT Law. 10

A permanent establishment (PE) of a foreign enterprise is subject to EIT on its income derived from Vietnam and on its income derived outside Vietnam related to the PE’s activities.

Foreign companies that are located abroad but are engaging in business activities in Vietnam or deriving income in Vietnam are also subject to EIT.

Taxable profit (or actual assessable income) is based on an accrual basis and is subject to adjustments of non-deductible expenses for the purposes of calculating the EIT payable, except for the deemed tax rates applicable to the income of business entities established under foreign laws or of enterprises established under Vietnamese law, which can determine revenue but cannot determine expenses and business profits. Taxable income is made up of the taxable turnover minus tax-deductible expenses plus other taxable incomes. Assessable income is equal to the taxable income minus the tax-exempt income and the losses carried forward. In addition, funds for scientific and technological development set up by enterprises can be deducted against the assessable income before multiplying the tax rate for calculating the EIT payable.

‘Tax-deductible expenses’ means expenses incurred for business purposes and supported by appropriate documents, invoices or payment vouchers proving that payments were made on a non-cash basis (non-cash payment is a requirement for tax deductibility with respect to payments from 20 million dong or more), except for certain expenses subject to limitations on deduction (e.g., depreciation expense subject to the statutory depreciation rates, contributions of voluntary pension funds, voluntary pension premiums for employees).

Enterprises can use the straight-line method in calculating the depreciation of tangible fixed assets and amortisation of intangible fixed assets. Accelerated depreciation can be applicable to enterprises in business sectors that require fast changes or rapid development.

**Capital and income**

To the extent that capital profits mean the profits gained from the transfer of capital or from the transfer of securities, generally capital profits will be considered as other taxable income of the enterprise, which will be included in the taxable income used as a base to calculate assessable income. However, with respect to enterprises eligible for EIT incentives, capital profits are not subject to tax incentives, but they are permitted to be offset against the losses from the business enjoying EIT incentives.

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10 Law No. 14/2008/QH12 dated 12 June 2008 of the National Assembly on Enterprise Income Tax, as amended by Law No. 32/2013/QH13 passed by the National Assembly on 19 June 2013 and Law No. 71/2014/QH13 passed by the National Assembly on 26 November 2014 (the EIT Law).
Losses
Enterprises can carry forward the loss from a fiscal year entirely and consecutively for a maximum of five years, and the loss carry-forward years must be counted consecutively. This means that the loss must be carried forward ‘entirely’ and ‘consecutively’ even when enterprises are in a period of enjoying a tax holiday or tax reduction.

In cases where an enterprise undergoes a conversion, merger or consolidation, losses that occurred prior to such conversion, merger or consolidation can be offset against the taxable income of the year when such conversion, merger or consolidation occurs, or the loss may be permitted to continue to carry forward in the following years, but not exceeding five years from the year when the loss arose.

Rates
The current standard rate is 20 per cent, applicable to corporate forms and non-corporate forms beginning 1 January 2016.¹¹

Investment projects that meet incentive conditions regarding industry, location or large-scale investment capital may enjoy preferential tax rates of 10, 15 or 17 per cent.

Administration
There are three levels of tax authorities in Vietnam. The General Department of Taxation (GDT) is the central tax authority. The GDT implements tax laws and provides the Ministry of Finance (MOF) with feedback on enterprises and assists it in creating tax policy. The provincial-level tax department manages district-level sub-tax offices. The tax departments and the sub-tax offices are responsible for collecting all types of tax, except for duties and taxes relating to import and export, which are under the management of the customs authorities. Depending on the scale of its investments, an enterprise may either be administered by the tax department or the sub-tax office.

Enterprises must make provisional EIT payments on a quarterly basis, by the 30th day after the end of each quarter. Enterprises are also required to conduct annual EIT returns and pay any tax deficits by the 90th day after the end of the fiscal year. The fiscal year is usually the calendar year. If taxpayers choose a fiscal year different from the calendar year, the fiscal year must start on the first day of a quarter and must last for 12 months.

Tax authorities routinely conduct tax audits. A tax audit may be conducted at a tax authority if there are some unclear points in the tax documents submitted by an enterprise. Tax audits may be scheduled to be conducted at the enterprise’s premises, or may occur when such enterprise has a tax refund or is suspected of being in breach of tax regulations.

When enterprises have tax issues, they may seek guidance on such issues by coming to the tax authority in person or by sending a letter to the tax authority. In practice, it may take the tax authority one month to reply to an enterprise’s letter. However, there is no formal procedure provided by law regarding the responsibility of tax authorities to provide guidance or reply to enterprises.

Enterprises in Vietnam may challenge the tax authority’s assessment by appealing to the tax authority that issued the tax assessment. If the enterprise is not satisfied with the initial tax authority’s conclusion on the appeal, it may then appeal to the higher level of such tax

¹¹ Decree No. 218/2013/ND-CP dated 26 December 2013 of the government detailing and guiding the implementation of the Enterprise Income Tax Law and its amended decrees.
authority. Enterprises are also permitted to bring a case to court upon the receipt of the tax authority's assessment or after receiving the conclusions on the appeals of the tax authority that issued the tax assessment or of the higher level of such tax authority.

**Tax grouping**

A parent company is required to prepare and submit consolidated financial statements to the tax authorities in which the figures on assets, payable accounts, owner's equities, revenues, other incomes and costs stated in the consolidated financial statement reflect the amount added from the figures of the parent company and those stated in the financial statements of the subsidiaries. The names of the subsidiaries must be stated in the consolidated financial statement.¹³

There are no specific provisions regarding tax treatments applicable to a group comprising a parent company and its subsidiaries. However, in principle, a parent company and its subsidiaries are independent and equal in contracts, transactions and other interactions.¹⁴ Each entity of a group is responsible for its own tax obligations and those of its shareholders.

**ii Other relevant taxes**

**Business fee/licence fee**

Enterprises and their branches, being business entities, are required to pay a business fee once a year. The annual business fee, as detailed below, will be applied based on the charter capital stated in the enterprise registration certificate or business registration certificate of the enterprise or branch.¹⁵

<table>
<thead>
<tr>
<th>Charter capital</th>
<th>Annual business fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than 10 billion dong</td>
<td>3 million dong</td>
</tr>
<tr>
<td>From 10 billion dong or less</td>
<td>2 million dong</td>
</tr>
<tr>
<td>For branches, representative offices, business location, public service providers and other business organisations</td>
<td>1 million dong</td>
</tr>
</tbody>
</table>

If an enterprise has no charter capital, it will depend on the investment capital stated in the investment registration certificate.

Branches of enterprises that do not state their registered capital in their business registration certificate must pay a business fee of 1 million dong annually.

**Value added tax (VAT)**

VAT applies to the supply of goods and services that are deemed to be used ‘for production, business or other consumption in Vietnam’. A number of goods and services are exempt from VAT.

The VAT Law provides three rates of tax: zero, 5 and 10 per cent. The standard VAT rate is 10 per cent. Exported goods and services are zero-rated if goods or services are provided to customers overseas and consumed outside Vietnam or within tariff-free zones.

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¹² Article 191 of the Enterprise Law.
¹³ Points 12 and 28 of Vietnamese Accounting Standard No. 25.
¹⁴ Article 190 of the Enterprise Law.
¹⁵ Decree No. 139/2016/ND-CP dated 4 October 2016 of the government regulating licensing fees.
Foreign companies located abroad and engaging in business activities in Vietnam or deriving income in Vietnam are also subject to VAT regardless of whether they have a PE in Vietnam or not.

**Special consumption tax (SCT)**

Enterprises that produce or import goods or provide services subject to SCT are required to declare and pay SCT in addition to VAT. SCT does not apply to subsequent stages in the distribution of goods. However, from 1 January 2016, imported goods, except for gasoline, are subject to SCT at the importation stage based on the import price (import SCT) and at the distribution stage based on the distribution price (distribution SCT). Import SCT can be offset against distribution SCT for the purpose of calculating the distribution SCT payable. As a result, the SCT amount payable for imported goods is higher from 2016, because SCT is eventually calculated based on the distribution price rather than on the import price.

Goods and services subject to SCT include:

a. cigarettes and cigars;
b. spirits and beer;
c. automobiles with fewer than 24 seats, motorcycles with a capacity of over 125cc, aircraft and yachts (except those used for business in the transportation or tourism sector);
d. gasoline of all kinds;
e. air conditioners with a capacity of 90,000BTU or less;
f. playing cards and votive paper; and
g. the operation of dancehalls, massage lounges, karaoke parlours, casinos, electronic prize games, betting businesses, golf and lotteries.

**Land rental and non-agricultural land use tax**

Enterprises are subject to land rental for land areas leased from the state or from companies developing industrial zones and export processing zones. Enterprises can also be subject to non-agricultural land use tax when using non-agricultural land for business purposes, such as for industrial zoning, mining and commercial use.

**Registration fee**

Ownership of the following assets is subject to a registration fee:

a. houses and land;
b. ships;
c. boats;
d. aircraft;
e. automobiles;
f. motorcycles; and
g. hunting and sporting rifles.

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16 Decree No. 108/2015/ND-CP dated 28 October 2015 of the government on 28 October 2015 detailing a number of articles of the Law on SCT and the amended Law on SCT and its amended Decree No. 100/2016/ND-CP.
**Personal income tax (PIT)**

PIT is imposed on the income of employees of enterprises. However, enterprises being income payers are required to withhold PIT on employment income and then declare and pay PIT to the tax authority on behalf of their employees.

Residents are subject to progressive tax rates ranging from 5 to 35 per cent on worldwide employment income. Non-residents are subject to a flat tax rate of 20 per cent on Vietnam-derived employment income.

**IV TAX RESIDENCE AND FISCAL DOMICILE**

i **Corporate residence**

The tax laws neither define the term 'corporate residence', nor provide the conditions under which a non-locally incorporated entity (or foreign enterprise) can be a resident in Vietnam. According to the current provisions of the EIT Law, it may be interpreted that an enterprise would be considered fiscally resident in Vietnam if it is established under Vietnamese law.

ii **Branch or permanent establishment**

PEs of foreign enterprises are determined in accordance with the EIT Law, which defines PEs as including the following:

a. a branch, management office, factory, workshop or means of transportation;

b. a mine, oil or gas well, or place of extraction of natural resources;

c. a building site, construction, assembly or installation project;

d. an establishment furnishing services, including consultancy services, through employees or other personnel;

e. an agency of the offshore company; and

f. a representative in Vietnam in the following instances: he or she has the authority to enter into contracts in the name of the offshore company; or he or she does not have the authority to enter into contracts in the name of the offshore company, but regularly carries out deliveries of goods or provision of services in Vietnam.

If foreign enterprises are residents of a country that Vietnam has an effective tax treaty with, PE assessment will be in accordance with the tax treaty. Foreign enterprises from those countries may seek exemption from EIT on business income in Vietnam in accordance with the relevant tax treaty provisions, subject to certain procedures, provided that the concerned activities do not constitute a PE.

Currently Vietnam's World Trade Organization commitments allow foreign enterprises in certain service areas to set up branches in Vietnam, while such allowance for other service areas may be later phased in (e.g., non-life insurance, securities, computer and related services, management consultant services, construction and franchising). However, as a matter of practice, the government has only allowed foreign law firms and banks to set up branches in Vietnam. Branches in Vietnam are dependent units of foreign companies that operate under an establishment certificate issued by the competent licensing authority.\(^{17}\)

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\(^{17}\) Decree No. 07/2016/ND-CP dated 25 January 2016 of the government detailing regulations of the Commercial Law on representative offices, branches of foreign businesses in Vietnam.
Foreign contractors engaging in construction works in Vietnam can obtain contractor permits issued by the competent licensing authority and then can set up management offices in Vietnam.

Foreign enterprises having PEs in Vietnam, adopting the Vietnamese accounting system and having a tax code (i.e., branches, foreign contractors having contractor permits) issued by the tax authorities are subject to EIT at a rate of 20 per cent of the actual assessable income, which is the same rate for enterprises established under Vietnamese law. Otherwise, tax rates deemed at a rate of 1, 2 or 5 per cent will be imposed on a foreign enterprise’s revenue derived from Vietnam, and on its revenue derived outside Vietnam relating to the PE’s activities.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes
There is no particular tax incentive for holding company regimes. The general rule is that if a local holding company receives after-tax profits or dividends from its local subsidiaries, such after-tax profits or dividends will not be taxed again at the level of the holding company.\(^{18}\)

ii IP regimes
Investment in R&D is entitled to special tax treatment. Particularly, revenues derived from new investment projects in the fields of scientific research and high technology development and application will enjoy an EIT rate of 10 per cent within the 15 years from the licensing date. Venture investment in high technologies and high-tech start-ups is also entitled to this tax regime.

In addition, R&D income derived from scientific research and technology development of products under testing production, or products made from new technology applied in Vietnam for the first time, or technology transfer to individuals and entities in areas of special hardship, are tax-exempt.\(^{19}\)

iii State aid
State aid is found mainly in the form of tax incentives to facilitate the development of certain sectors (e.g., R&D, infrastructure development, education, training and healthcare) or to develop geographically disadvantaged areas by granting special tax regimes to business entities established in such areas.

The government also provides financing aid to projects of special importance and social development projects. The Vietnam Development Bank (VDB), a non-profit stated-owned institution, finances the industries of infrastructure, mechanical engineering and business development at a subsidised rate of interest.\(^{20}\)

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\(^{18}\) Article 4.6 Law No. 14/2008/QH12 dated 3 June 2008 of the National Assembly on Enterprise Income Tax and its amended law.


\(^{20}\) Circular No. 18/2010/TT-NHNN dated 16 September 2010 of the State Bank of Vietnam (SBV) detailing the provision of interest rate support for organisations and individuals borrowing medium or long-term loans from the Vietnam Development Bank.
By raising capital from Vietnamese and foreign sources, and through receiving funds from the state budget, the VDB is able to provide loans at a reduced rate thanks to certain special mechanisms, such as a compulsory reserve ratio of zero per cent, and its solvency being guaranteed by the government.

iv General

At the start of 2016, the EIT rate was reduced by 2 per cent to its current rate of 20 per cent.

Tax incentives with respect to new investment projects include preferential tax rates, tax exemption and tax reduction. Preferential tax rates of 10, 15 or 17 per cent may be granted if a new investment project meets incentive conditions regarding the investment sector, location and scale of the project. New investment projects may enjoy tax exemptions for two or four years, and 50 per cent tax reductions for four, five or nine years.

Investment sectors entitled to tax incentives will be limited to high-tech industries, scientific research and technological development, infrastructure development, software product production, education and training, medical services, sports and cultural activities, and environmental activities.

Tax incentives are also granted to enterprises established in industrial zones (except industrial zones located in geographical areas with advantageous socioeconomic conditions), economic zones, high-tech zones, geographical areas with difficult socioeconomic conditions and geographical areas with especially difficult socioeconomic conditions.

Since 1 January 2014, under the amended EIT Law, tax incentives are granted to large-scale manufacturing projects (except for production of goods subject to special consumption tax and exploitation of mineral resources) with investment capital at least 6 trillion dong.

No tax incentives are applicable to capital gains, interest income, foreign currency trading, recovered bad debts, income from business activities outside Vietnam, precious mineral resources, oil and gas exploration and exploitation, or electronic games of chance and betting.

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

Interest payable to foreign companies is subject to a withholding EIT rate of 5 per cent.

Royalties paid to foreign companies for transfer of ownership of intellectual property are subject to a withholding EIT rate of 10 per cent. There will be additional 5 per cent withholding VAT levied in case of a licensing arrangement (i.e., transfer of use right).

Dividend payments to offshore investors other than individual investors are not subject to any further withholding tax. From 2009, individual investors are subject to a 5 per cent PIT on distributed profits or dividends.

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

There is no particular domestic law exclusion or exemption from withholding on outward-bound payments except for dividend payments as mentioned above.
iii Double tax treaties

Vietnam has tax treaties with 75 countries currently in force. In addition, five tax treaties have been signed but are not yet in force, including the tax treaty between Vietnam and the United States, which was officially concluded in July 2015. Except for the tax treaty with the United States, which is based on a US model from 2006, all other tax treaties are based on Organisation for Economic Co-operation and Development (OECD) and UN Model Conventions.

The current domestic withholding tax rate is lower than or equivalent to those of most treaties.

<table>
<thead>
<tr>
<th></th>
<th>Dividend</th>
<th>Interest</th>
<th>Royalty</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic standard tax rate</td>
<td>Zero per cent (foreign companies)</td>
<td>5 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td></td>
<td>5 per cent (individuals)</td>
<td>5 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Australia</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
<tr>
<td>Canada</td>
<td>5 to 15 per cent</td>
<td>10 per cent</td>
<td>7.5 to 10 per cent</td>
</tr>
<tr>
<td>China</td>
<td>10 per cent</td>
<td>10 per cent</td>
<td>10 per cent</td>
</tr>
</tbody>
</table>

iv Taxation on receipt

A local holding company will not be subject to tax on receipt of local after-tax profits or dividends.

Foreign tax credit is allowed subject to supporting documents. The tax credit may not exceed the amount of the Vietnamese tax (before application of the credit) that is attributable to the income derived from the foreign country.

VII TAXATION OF FUNDING STRUCTURES

i Thin capitalisation

There is currently no restriction on debt-to-equity ratios. However, there are restrictions applicable to specific sectors, such as the wind power sector, where the law requires that equity be equal to at least 20 per cent of the total investment capital. In addition, there is a minimum charter capital (i.e. equity) requirement in certain sectors, such as securities, banking and multi-level sales. In practice, the licensing authority, at its discretion, may question the feasibility of the project if the equity is deemed too low. In addition, total interest expenses allowed to be deductible for EIT purposes must not exceed 20 per cent of earnings before interest, tax, depreciation and amortisation (EBITDA). This 20 per cent cap on interest is supposed to apply to interest expenses incurred from loans from related parties only, but according to the current controversial interpretation by the tax authorities, the cap is applicable to any interest expense if the taxpayer has related-party transactions. The MOF is considering amending this rule to address the issue.

21 Decree No. 20/2017/ND-CP dated 24 February 2017 of the government providing guidelines on the tax management of enterprise with related party transaction, Article 8.3.
ii  **Deduction of finance costs**

Interest expenses incurred with respect to debt capital (i.e., the difference between the investment capital and the charter capital as stated in the investment certificate) are fully deductible if the investors have contributed the registered charter capital in compliance with the agreed schedule, and the loan agreements are properly supported and offshore medium or long-term loans are properly registered with the SBV. For interest to be tax deductible, the interest rates charged by lenders other than credit institutions and corporate lenders (i.e., the rates charged by individual lenders) must not be more than 1.5 times the basic interest rate announced by the SBV at the time the borrower obtains the loan.

iii  **Restrictions on payments**

Payment of dividends of a foreign-owned company can be done based on the year-end profit after the company has fulfilled its statutory tax and financial obligations.

If the company has accumulated loss according to its annual audited financial statements, then payment of dividends is not allowed.

iv  **Return of capital**

Equity capital may be reduced by means of return of registered capital. In principle, a return of charter capital can be done only after more than two years of consecutive operation from the date of incorporation, and the company must ensure that it can pay the outstanding liabilities even after such return of capital.

VIII  **ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES**

i  **Acquisition**

Acquisition is usually effected either at the onshore level (by using a local or non-local entity as a buyer) or at the offshore level (by using a special vehicle to acquire shares of an offshore company directly or indirectly holding shares or capital in a company incorporated in Vietnam).

Capital gains tax is summarised in the table below:

<table>
<thead>
<tr>
<th>Transferor</th>
<th>Transferee</th>
<th>LLC (capital contribution)</th>
<th>Private JSC (shares)</th>
<th>Public company (shares)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resident legal entity</td>
<td>Resident/non-resident</td>
<td>20 per cent of net gain</td>
<td>Transferor to declare and pay tax</td>
<td></td>
</tr>
<tr>
<td>Non-resident legal entity</td>
<td>Resident</td>
<td>20 per cent of net gain</td>
<td>Transfer to withhold tax</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-resident</td>
<td>20 per cent of net gain</td>
<td>Target to declare and pay tax</td>
<td></td>
</tr>
</tbody>
</table>

Until the introduction of Decree 12/2015/ND-CP with effect from 1 January 2015 (Decree No. 12), Vietnamese tax law did not address capital gains tax on indirect transfers. According to Decree No. 12, taxable incomes (or gains) derived in Vietnam by a foreign or offshore company (regardless of whether it has a PE in Vietnam and its location of doing business) are any incomes (or gains) derived from certain M&A activities, including transfers of contributed capital, investment projects, the right to contribute capital and the right to
participate in investment projects. However, Decree No. 12 and other relevant tax regulations do not specifically address how the taxable gain would be calculated and which party would be liable for tax declaration and payment in the context of indirect transfers. This gives rise to uncertainty in its implementation.

ii Reorganisation
Mergers, demergers, separations and consolidations are allowed and stipulated under the Enterprise Law, but such reorganisation occurs between locally established entities. There is no particular tax treatment for these types of reorganisation. Generally, if any party derives gains under such reorganisation, capital gains tax would be triggered on such party.

iii Exit
A foreign investor can exit from its investment in Vietnam by transferring its shareholding in its Vietnamese subsidiary or liquidating such subsidiary. The transfer of capital or shares is subject to capital gains tax as mentioned in Section VIII.i. The transfer of assets for liquidation purposes is subject to VAT (at the standard rate of 10 per cent) and EIT on the difference between the transfer price and the net book value of the assets.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance
Vietnam does not have comprehensive general anti-avoidance rules. However, it addresses the issue through other separate tax rules, such as transfer pricing rules and beneficial ownership requirements for the purposes of claiming a tax treaty benefit.

ii Controlled foreign corporations
Vietnamese law does not yet have any rules for controlled foreign corporations.

iii Transfer pricing
Transfer pricing issues have attracted more attention from Vietnamese policymakers in recent years. In an effort to strengthen existing transfer pricing rules and enforcement, the government issued Decree No. 20/2017/ND-CP (Decree No. 20) regulating tax administration with respect to enterprises having transactions with related parties. Decree No. 20 took effect on 1 May 2017 and creates a new legal framework for related-party transactions in Vietnam, and provides certain changes to the current transfer pricing rules toward a more consistent approach with the OECD’s base erosion and profit shifting (BEPS) Action Plan. Decree No. 20 provides detailed guidance on the determination of arm’s-length pricing of related-party transactions, rights and obligations of taxpayers, tax authorities and other relevant authorities. Prices in related-party transactions are determined through comparability analysis, which requires the elimination of significant differences by evaluating criteria comprising product characteristics, asset and operation functions, business risk, contractual terms of the transaction and economic conditions of the transaction. In June 2019, the National Assembly issued a new law on tax administration that codifies transfer pricing rules.

In principle, Decree No. 20 continues to maintain five methods of determining market prices, including comparable uncontrolled price, resale price method, cost plus
method, profit comparable method and profit-split method. There is no hierarchy among the methods. The most appropriate method will be adopted based on the conditions of the transaction, information and data for a comparability analysis. Furthermore, Decree No. 20 also introduces the substance over form principle, which relies on data and actual transactions of related parties for comparison with independent transactions under similar conditions regardless of the form of transactions presented in the agreements of related parties. The tax authorities’ power to scrutinise related party transactions from a transfer pricing perspective will, therefore, go beyond the form of contracts and agreements.

Decree No. 20 adds more reporting and documentation obligations in addition to the existing ones, which require intensive information and documentation from taxpayers, which must be submitted together with the annual enterprise income tax finalisation return. For ultimate parent company taxpayers in Vietnam, further documentation and report are required when the consolidated global revenue during the tax period is 18 trillion dong or more. For taxpayers having the ultimate parent company in a foreign country, taxpayers are required to provide a copy of the declaration on transnational profit of the ultimate parent company in the event the ultimate parent company is required to submit this declaration to the tax authority where it is incorporated. If taxpayers cannot provide this declaration, taxpayers must explain in writing the reason, legal basis and regulations of the foreign country that do not allow taxpayers to provide this declaration.

Taxpayers are partly or fully exempt from preparing and maintaining transfer pricing reports or transfer pricing documentation in the following cases:

- related-party transactions between local taxpayers that apply the same income tax rate and do not enjoy income tax incentives;
- the total revenue in a tax period is lower than 50 billion dong and the total value of related-party transactions in a tax period is lower than 30 billion dong;
- the taxpayers signed an advanced pricing agreement (APA); and
- the taxpayers perform business with simple functions with revenue of lower than 200 billion dong without generating revenue or incurring expenses related to the exploitation and usage of intangible assets and apply a net profit margin before interest and income tax over revenue as follows:
  - distribution: 5 per cent or more;
  - production: 10 per cent or more; and
  - toll manufacturing: 15 per cent or more.

The Amended Tax Administration Law effective from July 2013 provided for the concept of the APA for the first time. Enterprise income taxpayers are allowed to initiate the five-step APA procedure:

- a taxpayer must file a request on consulting to the GDT as to whether an APA is principally an appropriate solution for the transfer pricing issues of the transactions in question;
- after securing approval of the GDT, a formal application can be submitted to the GDT;
- evaluation of the application will follow;
- the tax authorities and taxpayer will negotiate the terms of the APA; and
- if the GDT agrees to the terms discussed and negotiated with the transaction parties, the final draft will be concluded with a duration of at least five years and can be extended for no more than five years.
The procedure is under the supervision of the MOF and subject to its approval. The GDT will be responsible for receiving the application, conducting the negotiation, concluding the APA and monitoring the implementation, and the respective local tax authorities may also be involved in the negotiation and implementation of the APA.

iv Tax clearances and rulings
Advance tax rulings are not specifically provided under the law. However, as a matter of practice, taxpayers can write to the tax authorities to request confirmation or clarification on particular tax issues. The tax authorities’ response may not be always helpful or address the issue, but in certain cases it is helpful to gain more clarity and confirmation. The new law on tax administration (which will go into force from July 2020) provides that taxpayers will not be subject to administrative penalty and late payment interest if they have already complied with guidelines and decisions of the tax authorities or other competent authorities in relation to their tax liabilities. This would imply that taxpayers still need to pay tax additionally assessed by the tax authorities even if the assessment is not in line with the previous guidance of the tax authorities.

A taxpayer can also request the tax authority to confirm the status of the tax payment (i.e., no tax debt). However, such confirmation or clearance is based on the records available to the tax authority, and the tax authority takes the position that it can retroactively assess additional tax if violations are found later. The statute of limitations for tax assessment and imposing interest is 10 years from the date when the violation is detected.

X YEAR IN REVIEW
Transfer pricing continues to be one of the hot topics of the year. With the participation in the BEPS inclusive framework as an official member, Vietnam will continue its effort to address the BEPS minimum standards in its legislation. Capital gains tax with respect to offshore indirect share transfer remains a controversial issue in the absence of a thorough technical and legal basis. The increasing volumes of e-commerce and online transactions continue to pose challenges regarding the tax regulatory framework for tax authorities and tax compliance for businesses. Guidelines for e-invoicing have been issued to prepare for compulsory use of e-invoices from November 2020.

XI OUTLOOK AND CONCLUSIONS
Pressure for further reform will continue as a key element for changes in the taxation environment. Phase-ins of free trade deals will lead to stricter management in tax compliance and an increase in indirect taxes.

With the new law on tax administration adopted in June 2019 and taking effect from 1 July 2020, it is expected that implementing guidelines will be issued in early 2020. The MOF has released a draft circular to amend regulations on EIT.
ABOUT THE AUTHORS

BIJAL AJINKYA
Khaitan & Co

Bijal is a partner in the tax, private client and investment funds practice in Mumbai. With over 18 years of experience on the tax side, Bijal primarily focuses on structuring of inbound and outbound investments, M&A tax negotiations, writing opinions on complex tax issues of GAAR, POEM, PE, etc. On the tax litigation front, she has immense experience in providing advice on unique litigation strategies and has been a lead adviser in many successful and groundbreaking tax litigations in India. She has also served as an expert witness on Indian tax matters in an international arbitration.

On private client matters, she has varied experience in advising individuals and family businesses both from a legal, regulatory and tax perspective, on succession planning and asset protection. She has pioneered tax structures for investment funds and managers and has been nominated by the IFA, India as the India country reporter in the global IFA Congress to provide a report in the International Cahiers Edition, 2019 on the topic of investment funds.

MAFALDA ALVES
SRS Advogados

Mafalda Alves is the leading partner of the tax department at SRS Advogados. She is a former deputy for the Secretary of State for Tax Affairs and was appointed as independent member of the Portuguese Green Tax Reform Committee.

She has solid experience in the tax area, advising in domestic and international tax law, including financing operations, restructuring of corporate and high net worth individuals’ assets, mergers and acquisitions, real estate transactions and tax litigation.

JAKOB SKAADSTRUP ANDERSEN
Gorrissen Federspiel

Jakob Skaadstrup Andersen is head of tax at Gorrissen Federspiel, where he has been a partner since 2003. He studied law at the University of Copenhagen (1992), was admitted to the Danish Bar in 1996 and gained the right of audience before the Danish High Court in 1998.

Mr Andersen is an expert in international tax matters, and his focus is multinationals involved in tax controversies with the Danish tax authorities, in particular transfer pricing matters.
Over the years he has assisted a number of international clients establishing themselves in Denmark, and has also assisted foreign and Danish clients with the acquisition of Danish and foreign entities by providing structural and due diligence advice.

Mr Andersen holds rankings from, inter alia, Chambers Global, Chambers Europe and The Legal 500.

**JOSHUA ATKINSON**

*Skadden, Arps, Slate, Meagher & Flom (UK) LLP*

Joshua Atkinson is an associate in the London office of Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates. He works within the firm’s tax practice, advising on international and domestic corporate transactions for a wide range of clients, including multinational corporations, private equity funds and financial institutions, credit operations, employee compensation and share scheme matters, as well as group reorganisations and restructurings. Together with Alex Jupp, Joshua recently co-authored an article for the *Bulletin for International Taxation* entitled ‘Fowler v. HMRC and the Murky Waters of Treaty Interpretation’.

**RHYS BANE**

*DLA Piper Nederland NV*

Rhys Bane advises clients on Dutch and international (corporate) taxation aspects of international tax planning, corporate restructurings and M&A. He also focuses on tax policy and legislation in the area of Dutch, European and international (corporate) taxation. He received his LLM in tax law *cum laude* from Leiden University in 2018. His award-winning thesis titled ‘Mandatory and Binding Arbitration in the MLI: An Improvement of Taxpayers’ Legal Status in International Tax Law?’ was published by Wolters Kluwer.

**EDUARDO BARRÓN**

*Deloitte Impuestos y Servicios Legales, SC (Deloitte México)*

Eduardo Barrón has a CPA degree from the Universidad Anahuac, and a postgraduate degree in international taxation by the Universidad Panamericana and the International Fiscal Association, Grupo Mexicano, AC. He has over 17 years’ experience in corporate tax, transfer pricing and international taxation. He currently leads the international tax practice for Deloitte in Mexico and is part of the Latin American international tax group. In this role, he actively participates in the design and implementation of international tax solutions involving Mexico from inbound and outbound perspectives, including efficient investment and debt structures, and advice on structuring and restructuring operations for multinational enterprises.

**MAURÍCIO BARROS**

*Gaia Silva Gaede Advogados*

Maurício Barros’ focus is on tax law and international trade/customs, with solid experience in the consulting and foreign investments areas. He frequently advises in the sectors of information technology (IT), retail, e-commerce, direct sales, agribusiness, telecommunications, services and in the automotive, pharmaceutical, food and capital goods industries. Mauricio advises national and international clients on all matters involving taxes, especially in corporate
About the Authors

restructuring, mergers and acquisitions, inbound and outbound investments and tax planning. He is also the head of the innovation area in São Paulo, where he coordinates the office’s operations in technology companies and start-ups.

He is a former adjunct professor in the graduate school programme at Mackenzie Presbyterian University and the Getúlio Vargas Foundation in São Paulo, as well as Coordinator of the Tax Working Group of the Italian-Brazilian Chamber of Commerce, Industry and Agriculture (ITALCAM) Legal Committee, a member of the International Fiscal Association (IFA), a member of the Brazilian Financial Law Association (ABDF) and a former São Paulo State Tax Court Contributing Judge (2014–2019).

He has a PhD in Economic, Financial and Tax Law, Universidade de São Paulo – USP; Master of Laws, Pontifica Universidade Católica de São Paulo – PUC/SP; Bachelor of Laws, Pontifica Universidade Católica de São Paulo – PUC/SP.

He is fluent in Portuguese, English, Spanish and Italian.

ALBERTO BENSHEMOL

D’Empaire

Alberto Benshimol received his law degree summa cum laude from Universidad Católica Andres Bello (1996). He has a master of laws degree (LLM) in international taxation from New York University (1997). He is a professor of finance law at UCAB (since 2002). Alberto was a member of the Venezuelan team that conducted and completed the negotiations of the US–Venezuela tax treaty (1998). Alberto is admitted to practise law in Venezuela and in the state of New York. Alberto has been a tax partner at D’Empaire since 2005.

JAROSŁAW BIEROŃSKI

Sołtysiński Kawecki & Szlęzak

Jarosław Bieroński has provided counselling services to a number of Polish businesses, including within the Warsaw office of Ernst & Young, where he specialised in tax and foreign exchange law. He joined SK&S in 1993 and has been a partner at the firm since 2000. He established the firm’s tax, customs and foreign exchange practice, and has been coordinating it ever since. He is a highly regarded specialist in international tax law, and has extensive experience in representing clients in tax disputes before tax authorities and administrative courts, in tax planning and implementation – M&A, real estate, business restructuring, tax audits, transfer pricing documentation and wealth tax management. Apart from tax law, he deals with customs and foreign exchange law, company transformation and debt restructuring.

In the ranking of tax firms and tax advisers published by the daily newspaper Dziennik Gazeta Prawna, in 2010–2016 he was placed second and first in Poland in the category of the ‘best tax adviser’ in M&A transactions and in international taxation. He provides advice to international and local clients, such as General Electric, Lone Star Funds, Goodyear, Gillette, Autodesk, Philips, Toyota, Sony Computer Entertainment, Viacom Global, Bakoma, Bank BPH, BlackRock Investment Management, MassMutual, SallieMae, ING Bank Śląski SA, ING Bank Hipoteczny SA, Carlo Tassara and Alior Bank SA.

Mr Bieroński graduated with a law degree from Poznań University Law School in 1990. He is admitted to practise as a legal and tax adviser. He is also a member of the International Fiscal Association and other international tax organisations.
JUANITA BROCKDORFF

KPMG Malta

Juanita, a lawyer, read her master's in tax law at the University of Leiden, the Netherlands. She provides advice and assistance to multinationals, typically household names and major global brands, with a presence in Malta with international corporate tax and cross-border tax planning in both direct and indirect taxation. A member of the International Fiscal Association (IFA), the International Bar Association (IBA) and the Malta Institute of Taxation, and an honorary member of the Malta Institute of Management, she serves on the Council of the Institute of Financial Services Practitioners (IFSP) and chairs the IFSP’s Tax Committee making representations to the Executive directly, including suggestions on the tax treatment of distributed ledger technology transactions, blockchain and cryptocurrencies. Juanita has almost two decades of experience in providing advice in financial services clients, notably asset managers and insurance and reinsurance underwriters, in connection with their obligations at law for tax and commercial law matters. She has been involved in M&A transactions, drafting the legal bibles of documentation supporting such transactions and advising her clients on their positions. Juanita is frequently invited to speak at international tax conferences, such as the American Bar Association (ABA)’s annual US and Europe conference, and the STEP (Society for Trust and Estate Practitioners) annual international conference. Her work has been published in international journals. She also advises the government on legislation, in particular in EU-related matters.

FRED BURKE

Baker McKenzie Vietnam

Mr Fred Burke is managing partner of the Baker McKenzie offices in Vietnam. Recognised as one of Vietnam's most prominent lawyers, Mr Burke has extensive experience in international trade; WTO and customs; M&A, foreign investment and securities; banking and finance; international employment; real estate; construction/projects; taxation; and dispute resolution.

Having served in the firm's offices in New York, Shanghai and Hong Kong, Mr Burke came to Vietnam in 1991, where he became the first American to study at the University of Ho Chi Minh City after 1975. He helped found the American Chamber of Commerce in Vietnam, and has served as chairman and board member of its Ho Chi Minh City chapter for many years. He serves on the Prime Minister’s Advisory Council on Administrative Reform, chairs the Manufacturing & Distribution Working Group of the Vietnam Business Forum and has been recognised by the Ministry of Justice for his ‘Outstanding contributions in the field of international legal cooperation’. Among his many other publications, Mr Burke is the co-author of the Bloomberg/BNA Business Operations in Vietnam (2013), the author of the Guide to Banking & Finance Law in Vietnam (2000) and the editor of the Indochina Law Quarterly (since 1991).

WENWEN CHAI

Baker McKenzie

Wenwen is an associate of the tax group at Baker McKenzie Hong Kong. Her practice areas include Hong Kong and Asian regional contentious and advisory tax work, as well as trust
and private client matters. She received her bachelor of laws/economics double degree from the Australian National University, and is also admitted as a lawyer in New South Wales, Australia.

MARIA CHANG  
*Bae, Kim & Lee LLC*  
Maria Chang is a senior foreign attorney in the firm’s tax practice group. Her main practice areas involve cross-border transactions, including structuring, planning, treaty issues and tax dispute resolutions. Prior to joining BKL in 2009, Maria Chang worked at the Seoul office of PricewaterhouseCoopers from 2006 to 2009, specialising in various tax and customs matters relevant to multinational clients.

CHRISTIAN CHÉRUY  
*Loyens & Loeff*  
Christian Chéruy is a member of Loyens & Loeff’s general tax practice group in Brussels. He is the former head of tax and partner.

Mr Chéruy’s practice covers a broad range of international and domestic corporate tax issues. These issues include inward investments, holding and financing structures (including the notional interest deduction), corporate restructurings (including cross-border reorganisations), transfer pricing and thin capitalisation rules, withholding tax requirements, double tax treaty matters, corporate and structured finance projects, mergers and acquisitions, real estate and private equity partnerships. He advises on the taxation of intellectual property and the availability of tax relief in respect of R&D. He also advises individuals on wealth optimisation techniques.

Mr Chéruy also heads the Belgian tax controversy and litigation team. He provides assistance at every stage of the resolution process from audit examination to tax appeals and, where necessary, tax litigation. He frequently acts on behalf of taxpayers in negotiations with the Belgian revenue services, and particularly with the special Tax Investigation Brigade. He also has considerable experience in handling alternative dispute resolution processes (i.e., ruling requests and advance pricing agreements).

He is consistently ranked as one of the leading tax lawyers in Belgium by *Chambers Europe* and *The Legal 500*.

Mr Chéruy is a regular speaker at conferences on a wide range of (international) tax issues and the author of a leading treatise analysing the legal, accounting and tax aspects of Belgian holding companies. He is a member of the Brussels Bar.

JULIE COLDEN  
*Davies Ward Phillips & Vineberg LLP*  
Julie Colden is a tax partner at Davies. She has more than twenty-two years’ experience practising tax with an emphasis on corporate reorganisations, mergers and acquisitions, and financings. She is a member of the Law Societies of Upper Canada, the Canadian Tax Foundation (CTF) and the International Fiscal Association (IFA). She is the past executive of the Ontario Bar Association taxation section. She has spoken and written frequently about various corporate income tax topics, and is an instructor with the CPA In-depth Corporate Reorganization Course.
Ms Colden graduated from the University of Western Ontario with a BSc (Hon (1991)), and from the University of Ottawa with an LLB (1995, *magna cum laude*).

**BENJAMIN CUBIDES**  
_Cuval Abogados_

Benjamin Cubides is a law graduate of Javeriana University, who studied tax law at post-graduate level at Rosario University and gained a Master of Laws (LLM) in tax law from Ruprecht-Karl University, Heidelberg, Germany. He has been a member of the executive committee of the Colombian Institute of Tax Law since 2005 and president of the Institute for the period 2015–2016. He was president of the Colombian branch of the IFA for the period 2010–2011. He is a lecturer on international taxation at various Colombian universities and a speaker at local and international conferences and events. Benjamin is the author of various articles on international taxation and of a book on double taxation treaties published by CETA in Colombia in February 2010. From July 2013, he has been founder-partner at Cuval Abogados in Colombia.

**JIBRIN DASUN**  
_ÆLEX_

Jibrin Dasun is an associate in the tax practice group of ÆLEX. He is a member of the Taxes Committee of the International Bar Association and regularly advises on Nigerian companies’ income and petroleum profits tax issues, tax implications of M&A, corporate structures and tax restructuring schemes. He is an international tax affiliate of the Chartered Institute of Taxation UK (CIOT) and holds an Advanced Diploma in International Taxation (ADIT) from the CIOT. Jibrin is a Chartered Tax Practitioner in Nigeria and a member of the International Fiscal Association.

**MARC DHAENE**  
_Loyens & Loeff_

Marc Dhaene is a member of Loyens & Loeff’s general tax practice group in Belgium. His practice covers a broad range of international and domestic corporate tax issues such as inward investments, holding and financing structures, corporate restructuring (including cross-border reorganisations), transfer pricing, tax treaty issues, withholding tax requirements, corporate and structured finance projects, and mergers and acquisitions.

Mr Dhaene is also a member of the Belgian tax controversy and litigation team. He provides assistance at every stage of the resolution process from audit examination to tax appeals and, if necessary, tax litigation. Mr Dhaene acts frequently on behalf of the taxpayer in negotiations with the Belgian revenue services, and especially with the special Tax Investigation Brigade. He also has considerable experience in handling alternative dispute resolution processes (i.e., ruling requests and advance pricing agreements).

Mr Dhaene has written extensively on tax-related subjects, and has given several lectures and seminars on various aspects of corporate tax law such as the Belgian holding regime, transfer pricing, anti-abuse provisions, undervaluation of assets, tax treatment of partnership structures and tax treatment of mergers.

Mr Dhaene has been a member of the Brussels Bar since 1998.
SUMANTI DISCA FERLI
*Mochtar Karuwin Komar*

Sumanti Disca Ferli is an associate at Mochtar Karuwin Komar, Jakarta, Indonesia, and joined the firm in 2011. She specialises in tax litigation and other dispute resolution matters, and advises on various legal issues, including corporate matters, financing and international trade. In cooperation with tax advisers from tax consulting firms, she has handled and represented companies in tax disputes at the level of the Supreme Court on various cases. She obtained her bachelor’s degree in law with *cum laude* predicate from the Faculty of Law of the University of Indonesia, majoring in litigation, in 2008, and her master’s degree with *cum laude* predicate from the same university, majoring in business law, in 2010. She also obtained an LLM from the University College London, majoring in international commercial law, in 2016.

NOUR EL HADDAD
*Abou Jaoude & Associates Law Firm*

Nour El Haddad is an attorney at Abou Jaoude & Associates Law Firm practising in the area of Corporate Law.

She regularly counsels clients on their corporate structures and regulatory compliance matters in the context of their operations and corporate transactions. Her experience also includes representing foreign clients in establishing a corporate presence in Lebanon, and obtaining all relevant administrative approvals.

Ms El Haddad holds a Masters in French and Lebanese Law from the Holy Spirit University of Kaslik in Lebanon, as well as a Master of Laws (LLM) from the Queen Mary University of London. She is admitted to the Beirut Bar Association, and is fluent in Arabic, French and English.

HACHEM EL HOUSSEINI
*Abou Jaoude & Associates Law Firm*

Hachem El Housseini is a senior associate at Abou Jaoude & Associates Law Firm practising in the areas of Corporate Law, Media, Agency, Licensing & Distributorship, Intellectual Property, and Aviation.

He has more than 15 years of experience and a wide-spanning legal know-how advising major companies and private clients on corporate structurings, corporatisations and reorganisations. He regularly represents investors and target entities on the tax and regulatory aspects of a wide range of inward investments.

Mr El Housseini holds a Master in French and Lebanese Law from the Lebanese University-Filière Francophone, and an MBA from ESA/ESCP (Ecole Supérieure des Affaires/Ecole Supérieure de Commerce de Paris). He is a lecturer at the American University of Beirut.

He is admitted to the Beirut Bar Association and the International Bar Association, and he is an associate member of the Chartered Institute of Arbitrators, London. He is fluent in Arabic, French and English.
SIMON EL KAI

Abou Jaoude & Associates Law Firm

Simon El Kai is a partner at Abou Jaoude & Associates Law Firm, and heads the Corporate Law practice. He previously worked with two leading law firms in Lebanon, and at Shearman & Sterling in Paris.

Mr El Kai has more than 20 years of experience and an extensive multidisciplinary expertise covering advisory, transactional and dispute-resolution matters. He has a long-standing record advising high-profile clients on market-entry conditions, corporate structuring, and contemplated investments and acquisitions.

He is recommended as a Leading Lawyer by prominent international directories, including Chambers & Partners, and The Legal 500.

Mr El Kai holds a Masters in French and Lebanese Law from the St Joseph University in Beirut, as well as an Advanced Graduate Degree (DEA) in Private Law from the University of Paris II-Assas in Paris. He also holds a Master of Laws (LLM) from Columbia in New York.

He is admitted to the Beirut Bar and the International Bar Association, and is fluent in Arabic, French and English.

THEOPHILUS I EMUWA

ÆLEX

Theophilus I Emuwa is a partner at ÆLEX and head of the firm’s tax practice. He studied engineering at Imperial College London before qualifying as a barrister in England and then qualifying to practise in Nigeria and in Ghana. He has more than 25 years of corporate and commercial law experience, and is widely recognised as one of Nigeria’s leading tax practitioners. His practice extends to advising on direct as well as indirect taxes, including personal income tax, companies’ income tax and petroleum profits tax issues as well as VAT, capital gains tax, customs duty and stamp duty. His practice also covers tax appeals.

He is a fellow of the Chartered Institute of Taxation of Nigeria (CITN) and served as the vice chair of the Tax Law Review Committee of the Institute. He contributed the chapter on international taxation in the CITN Nigerian Tax Guide and Statutes. He was formerly the deputy editor of Nigerian Tax Notes.

SERGEI EREMIN

Herbert Smith Freehills CIS LLP

Sergei Eremin is a Russian-qualified lawyer specialising in national and cross-border corporate and individual taxation. Sergei’s experience includes tax advice, tax litigation and international tax structuring. Sergei has significant experience in anti-corruption and anti-bribery matters, including FCPA and Bribery Act compliance and investigations. Also, Sergei has been involved in a number of high-profile aviation projects and frequently advises on sanctions matters.

Sergei graduated from the Moscow State Academy of Law. Before joining the firm in 2007 he worked at another international law firm and a leading Russian law firm. Sergei has been practising law for over 15 years.
ELENA FERRER-SAMA

_Roca Junyent_

Elena has more than 20 years’ experience in the field of general tax advice and planning, especially for companies in multinational groups, having developed extensive knowledge in the field of direct taxation and, more particularly, in the field of corporate reorganisations and tax inspections.

She has published several specialised articles and collaborated in several publications on tax matters. She has also participated on numerous occasions in tax seminars and courses.

Prior to joining Roca Junyent, Elena developed her career at Baker McKenzie and PwC.

PAOLO GIACOMETTI

_Chiomenti_

Paolo Giacometti is a tax partner at Chiomenti; he was former head of the tax practice, and is currently one of the managing partners of the firm. His areas of specialisation are domestic and international tax planning, cross-border transactions, corporate reorganisations and restructurings, and taxation of financial products. He also has extensive experience in tax litigation connected to the above areas.

Mr Giacometti joined Chiomenti in 1998 and worked from 2003 to 2005 in Chiomenti’s New York office. He was educated at Bocconi University of Milan and is a qualified chartered accountant. He is a frequent lecturer on fiscal matters in several postgraduate courses and seminars, and is the author of various publications on Italian and international law reviews.

GIUSEPPE ANDREA GIANNANTONIO

_Chiomenti_

Giuseppe Andrea Giannantonio graduated in economics _cum laude_ from La Sapienza University in Rome in 1992 and was admitted to practise before the tax courts in 1993. He joined the tax department of Chiomenti in 1997 and became a partner in 2003. His areas of specific expertise are real estate, sophisticated structured finance, international taxation, structured and cross-border M&A, private equity funds and financial products.

He is the author of a large number of publications on tax matters, and a frequent speaker at conferences and lectures.

SIRIRASI GOBPRADIT

_Baker McKenzie_

Sirirasi Gobpradit has practised in the corporate, commercial and tax areas since 2007. She has assisted many clients in various industries in dealing with business structure planning, tax planning, compliance and audits, and general commercial matters, including general tax advice, particularly regarding offshore and onshore investments.

LEONARD I GREENBERG

_Skadden, Arps, Slate, Meagher & Flom LLP_

Leonard I Greenberg is an associate in the Boston, MA office who received his JD and LLM in taxation from Boston University, and whose practice focuses on domestic and cross-border mergers and acquisitions and post-acquisition restructuring and integration transactions.
ENIYE IGBANIBO
ÆLEX

Eniye Igbanibo is an associate at ÆLEX. She is a member of the corporate/commercial practice group with emphasis on corporate taxation. She has a deep understanding of Nigeria’s tax and corporate regulatory framework and regularly provides advice on a broad range of corporate tax issues. She is a member of the Taxes Committee of the International Bar Association and the International Fiscal Association.

SUNG DOO JANG
Bae, Kim & Lee LLC

Sung Doo Jang is a partner in the firm’s tax practice group. His practice focuses on tax investigations, tax appeals and tax litigation. As a key tax attorney in the tax team, he has handled various tax cases for foreign investment companies and foreign investors. He earned his LLB from Seoul National University Law School. He passed the 46th Korean bar examination and completed the 36th Judicial Research and Training Institute course. Also, he is a member of the New York State Bars.

ALEX JUPP
Skadden, Arps, Slate, Meagher & Flom (UK) LLP

Alex Jupp’s practice covers a broad range of UK and cross-border tax matters, with a particular focus on the tax aspects of corporate acquisitions, financings and restructurings, group structure planning, corporate relocations, asset management structures, and the resolution of disputes on related matters. Alex is a member of the team named ‘Best International Tax Team of the Year’ at the 2019 Tolley’s Taxation Awards. Alex is also part of the Skadden Tax Group ranked in Band 1 in Chambers Global for Global Tax, in Band 2 in World Tax for UK Tax and named Tax Group of the Year for 2018 by Law360. He also is recommended as a leading practitioner in World Tax and Chambers UK, with clients describing him as ‘efficient, thorough and responsive’ and as ‘one of the most considered and thoughtful tax lawyers’ they have encountered. Alex was a UK branch reporter for the IFA Global Congress 2013 and a member of the Organising Committee for the IFA Global Congress 2019 in London and now chairs the British branch of the International Fiscal Association.

BENCE KÁLMÁN
Wolf Theiss Faludi Erős Attorneys-at-Law

Bence Kálmán is a member of the tax team in the Budapest office. He completed his studies at the Faculty of Law of Eötvös Loránd University, during which he was a member of Bibó István College for Advanced Studies. As a fresh graduate, he joined the tax team in Budapest in 2017 with a main focus on general corporate tax, indirect tax and tax litigation. He also contributes to tax due diligence processes connected to mergers and acquisitions.
FUMIAKI KAWAZOE

_Fordham University & Tohoku University_

Fumiaki Kawazoe advises on various areas of law, including tax regulations and tax litigation; international and domestic tax; M&A transactions; finance; labour and employment; and energy.

He gained a bachelor of commerce from Keio University (2010) and a JD from Hitotsubashi University Law School (2012), attended the Legal Training and Research Institute of the Supreme Court of Japan (2012–2013) and gained an LLM from Leiden University, International Tax Center Leiden (2018).

He was admitted to the Japan Bar in 2013.

PAUL KIBUUKA

_Isidora & Company_

Paul Kibuuka is a tax and corporate lawyer, tax policy analyst and the chief executive of Isidora & Company. He also serves as the executive director of the Taxation and Development Research Bureau. For over a decade, Mr Kibuuka has provided strategic tax and legal solutions to foreign, Tanzanian and multinational companies, including handling tax and commercial litigation in Tanzania. An effective communicator, with both governmental authorities and clients, Mr Kibuuka is adept at explaining complex tax and legal or regulatory scenarios in a range of sectors. He has also acted for clients in various corporate, investment and shareholder disputes. With a deep interest in issues at the interface of law and economics and business, Mr Kibuuka offers his clients an interdisciplinary and valuable perspective on tax and deal transactions. He writes a weekly column ‘Tanzania in International Tax Law’ for _The Citizen_, Tanzania’s leading English daily newspaper. Mr Kibuuka is admitted as an Advocate of the High Court of Tanzania, and is a member of the Tanganyika Law Society, the East African Law Society and the International Bar Association. He graduated from the University of Dar es Salaam in 2006 with a Bachelor of Laws (Upper Second Class Honours) degree and received the Tanzania Ministry of Science, Technology and High Education Prize; the Mondlane International Law Prize; the Sheikh Zulfikar Khan Prize; and the Tanzania Breweries Limited Prize, for being the best student in his 256-student member law class.

ASTRID EMMELINE KOHAR

_Mochtar Karuwin Komar_

Astrid Emmeline Kohar is an associate at Mochtar Karuwin Komar, Jakarta, Indonesia, and joined the firm in 2016. She specialises in tax litigation, mining and corporate matters, and advises on various legal issues, including commercial litigation, antitrust and regulatory matters. She obtained her bachelor’s degree in law with _cum laude_ predicate from the Faculty of Law of Gadjah Mada University in 2014. She also obtained an LLM with Honours from the University of Cambridge, United Kingdom, majoring in international commercial law, in 2015.
OLEG KONNOV

*Herbert Smith Freehills CIS LLP*

Oleg Konnov has been practising law since 1993 and has developed a reputation as one of the best tax advisers in Russia. Oleg has been consistently ranked in the 1st tier by *Chambers Europe* for tax in Russia. He advises on national and cross-border corporate and individual taxation, and represents clients in all stages of disputes with tax authorities, including tax audits, and administrative and court appeals against tax inspection decisions.

Oleg frequently writes about international and domestic taxation matters for the leading publications. He is a member of the International Fiscal Association and lectures on international tax law and tax law of foreign countries at the Moscow State University.

In addition, Oleg has considerable experience in corporate matters. His corporate practice focuses on M&A and joint ventures in a variety of sectors including oil and gas, metals and mining, telecommunications and infrastructure.

Oleg graduated from the international law department of the Moscow State Institute of International Relations and received a Candidate of Sciences from the Institute of State and Law at the Russian Academy of Sciences. He joined the firm in 2007 as a partner. Prior to that, he worked at another international law firm and at a major consultancy firm.

JIAN-CHENG KU

*DLA Piper Nederland NV*

Jian-Cheng Ku advises on international tax law and transfer pricing with a particular focus on international tax planning, M&A and private equity transactions, corporate reorganisations and planning and design of transfer pricing policies. His clients include multinational companies, financial institutions and private equity firms. He has (co-)authored several articles on aspects of international taxation and Dutch taxation.

DENNIS LEE

*Baker McKenzie*

Dennis Lee specialises in structuring Taiwan operations and transactions, including representative offices, branches and subsidiaries of foreign enterprises. He provides clients with valuable tax advice in relation to pre-acquisition modelling and post-acquisition restructuring.

He is also an expert on intercompany transfer pricing and tax incentives offered to encourage investment and transfer of technology, and also provides advice on value added tax issues.

In addition to advising various private equity funds and strategic corporate buyers on tax issues related to pre-acquisition modelling and post-acquisition restructuring, he advises various multinational companies on value added taxes and treaty protection as well as on tax dispute matters (e.g., withholding tax and tax assessment).

He is named a ‘Recommended Individual’ by *The Legal 500 Asia-Pacific* (2020).
SOURAYA MACHNOUK
Abou Jaoude & Associates Law Firm

Souraya Machnouk is a partner at Abou Jaoude & Associates Law Firm, and heads the M&A practice. She previously worked at Norton Rose Fulbright in Paris.

She has more than 15 years of experience advising prominent clients across industries, with a practice distinguished by an in-depth specialisation and a particular expertise on complex cross-border transactions. She has considerable experience advising clients on tax-efficient structures for multi-jurisdictional operations and investments.

She is consistently recognised as a Leading Lawyer by prominent international directories, including Chambers & Partners, The Legal 500 (Hall of Fame), and IFLR 1000.

Ms Machnouk holds a Masters in French and Lebanese Law from the St Joseph University in Beirut with a double major in private and public law, as well as an Advanced Graduate Degree (DEA) accredited by the University of Paris II-Assas. She also holds a Master of Laws (LLM) from GW (in partnership with Georgetown University) in Washington, DC.

She is admitted to the Beirut Bar and the International Bar Association, and is fluent in Arabic, French and English.

PETER MAHER
A&L Goodbody

Peter Maher is a partner with A&L Goodbody, and is the former head of the firm’s tax department. He represents clients in every aspect of tax work, with a particular emphasis on inbound investment, cross-border financings and structuring, capital market transactions and US multinational tax planning and business restructurings.

Mr Maher is ranked as one of the 10 ‘most highly regarded’ individuals globally in corporate tax by Who’s Who Legal: Corporate Tax. In 2013 and 2015 he was named ‘Global Corporate Tax Lawyer of the Year’ at the Who’s Who Legal Awards. He is also regularly listed as a leading adviser in Euromoney’s Guide to the World’s Leading Tax Lawyers, The Legal 500, Chambers Global and PLC Which Lawyer?: ‘Top tier expert Peter Maher’ (The Legal 500 2015) ‘retains a strong reputation among market sources’.

He is a former co-chair of the taxes committee of the International Bar Association and of the Irish Chapter of the International Fiscal Association. He lectures regularly, including at various IBA, IFA and ABA tax conferences, and has written extensively, including contributing chapters for The Inward Investment and International Taxation Review published by Law Business Research, The International Comparative Legal Guide to Corporate Tax published by Global Legal Group, Tax Treatment of Islamic Finance Products, a Comparative Survey published by IBFD. He has also written articles for Tax Management Financial Products Report, World Securities Law Report and Finance, and the Treasury weekly report. He is also one of the contributing editors of Lexology Getting the Deal Through: Tax on Inbound Investment published by Law Business Research and one of the two Irish contributors to the Tax Management International Forum.

BOBBY CHRISTIANTO MANURUNG
Mochtar Karuwin Komar

Bobby C Manurung is an associate at Mochtar Karuwin Komar, Jakarta, Indonesia, and joined the firm in 2012. He specialises in commercial and tax litigation and other dispute
resolution matters, and advises on various legal issues, including commercial and criminal litigation, intellectual property, labour, bankruptcy and regulatory matters. In cooperation with tax advisers from tax consulting firms, he has handled and represented companies in tax disputes at the level of the Supreme Court on various cases. He obtained his bachelor's degree in law from the Faculty of Law of the University of Indonesia, majoring in litigation, in 2008, and his master's degree in law from the Pelita Harapan University in 2017.

RATNA MARIANA  
*Mochtar Karuwin Komar*

Ratna Mariana is an associate at Mochtar Karuwin Komar, Jakarta, Indonesia, and joined the firm in 2016. She specialises in tax litigation and other dispute resolution matters, and advises on various legal issues, including corporate matters and telecommunication law. In cooperation with tax advisers from tax consulting firms, she has handled and represented companies in tax disputes at the level of the Supreme Court on various cases. She obtained her bachelor's degree in law with *cum laude* predicate from the Faculty of Law of Tarumanagara University in 2011. She also obtained an LLM from the Erasmus University Rotterdam, the Netherlands, majoring in commercial and company law, in 2016.

GREGORY J MAYEW  
*Afridi & Angell*

Gregory J Mayew is a partner in Afridi & Angell's Abu Dhabi office. Mr Mayew joined the firm in 2004, and is primarily involved in the firm's corporate, commercial and regulatory compliance practices. A considerable portion of his practice relates to advising foreign companies on their inward investments in the UAE. He also represents local businesses in connection with their dealings with foreign companies, as well as other corporate and commercial matters. Prior to joining the firm, Mr Mayew was an associate for five years with the law firm Dewey Ballantine in New York and London.

KARI-ANN MOSTI  
*Advokatfirmaet Grette AS*

Kari-Ann Mosti is an associate partner and lawyer. Kari-Ann has extensive experience advising clients with indirect taxes, mainly related to VAT. She particularly works with VAT issues relating to the VAT exemption pertaining to financial services, VAT regulation concerning real estate, cross-border transactions, and optimisation of VAT deduction. She has also substantial experience providing VAT advice in relation to M&A, including mergers, demergers, acquisitions, as well as providing general VAT advice. Kari-Ann assists clients with administrative procedures against the VAT authorities, and has litigated VAT cases before the courts.

MULYANA  
*Mochtar Karuwin Komar*

Mulyana is a partner at Mochtar Karuwin Komar, Jakarta, Indonesia, and joined the firm in 1995. He advises on various legal issues, including tax disputes, corporate matters, anti-corruption, administrative and constitutional law issues, air law, international law,
arbitration and dispute resolutions. In cooperation with tax advisers from tax consulting firms, he has handled and represented companies in tax disputes at the level of the Supreme Court on various cases since 2002. He has also advised clients on tax disputes at the levels of the Director General of Tax, the Director General of Customs and Excise, and the Tax Court. He obtained his law degree at the Faculty of Law, Parahyangan Catholic University, in Bandung, Indonesia (1987), and an LLM at Columbia Law School in New York City (1994). He has also taught courses on international business transactions, air law and international law at the Faculty of Law, Tarumanagara University in Jakarta for several years.

YOSHIKO NAKAMURA
Anderson Mōri & Tomotsune

Yoshiko Nakamura advises on various areas of law, including international and domestic tax; general and tax litigation; corporate and commercial law; and M&A transactions.

She gained a bachelor of laws from Chuo University (2015) and a JD from the University of Tokyo School of Law (2017), and attended the Legal Training and Research Institute of the Supreme Court of Japan (2017–2018).

She was admitted to the Japan Bar in 2018.

LADISLAO PALACIOS NAVARRO
Roca Junyent

Ladislao is an associate lawyer with extensive experience in tax advice to companies in both national and international taxation.

He regularly advises multinational and national companies on matters such as corporate income tax, international taxation, foreign investment and divestment operations, as well as transfer pricing. He also advises on indirect taxes and local taxes.

He has expertise in specific taxation applicable to the aviation and construction sectors.

He also has experience in personal income taxation, particularly in wealth management and expatriate and impartriate employees.

FRÉDÉRIC NEUKOMM
Lenz & Staehelin

Frédéric Neukomm is a certified tax expert in the Geneva office. His main areas of work are company tax law and tax law for high net worth individuals. He also works in the fields of banking and finance.

Enjoying a ‘strong experience of transactional tax matters’, Frédéric Neukomm is praised by clients for being ‘very collegial – truly a team player’, ‘his experience is extremely extensive’ (Chambers, 2017). Sources highlight his ‘positive attitude and drive for successful outcomes’ (Chambers, 2018).

THANH VINH NGUYEN
Baker McKenzie Vietnam

Mr Thanh Vinh Nguyen is a partner based in the Ho Chi Minh City office. His practice areas include tax and customs, corporate work and general commercial matters. Prior to joining Baker McKenzie’s Ho Chi Minh City office in 2004, he practised tax advisory work for two
international accounting firms for eight years and worked in the compliance function of an international insurance company. He has written a number of articles on Vietnamese tax issues and is co-author of the Bloomberg/BNA tax management portfolio *Business Operations in Vietnam*. Vinh is an award-winning practitioner, recently recognised by the *International Tax Review* in the categories of Indirect Tax Leader (2018) and Tax Controversy Leader (2018 and 2019) as well as a Leading Lawyer for Taxation in *The Legal 500 Asia Pacific* (2019).

**JANOS PASZTOR**  
*Wolf Theiss Faludi Erős Attorneys-at-Law*  
Janos Pasztor is a senior associate heading the tax practice group at Wolf Theiss Budapest. He completed his studies at the Faculty of Law of Eötvös Loránd University and has an LLM degree in international taxation (WU Vienna). He is also a qualified and chartered tax adviser in Hungary. Prior to joining Faludi Wolf Theiss in 2014, Janos worked at Ernst & Young Hungary as a tax manager and attorney-at-law. Janos specialises in domestic and international tax planning, tax restructuring and also provides comprehensive tax and legal advisory for high net worth individuals. He regularly represents clients in tax litigation proceedings relating to all major types of taxes. Janos also frequently presents at domestic and international events on cross-border taxation, tax litigation and tax restructuring, as well as providing lectures on tax matters. Janos speaks fluent English and German.

**FLORAN PONCE**  
*Lenz & Staehelin*  
Floran Ponce is a lawyer and certified tax expert. He advises Swiss and foreign banks, investment funds and corporations on a broad range of domestic and international tax as well as commercial law matters. He advises them on matters relating to mergers, acquisitions, divestitures, financing transactions and restructurings, as well as on the management of tax affairs and controversies before Swiss tax authorities. He also assists private clients on complex tax matters.

Floran Ponce is a frequent speaker at professional conferences on tax matters. He also teaches specialised tax courses for the master’s degree programmes of the University of Lausanne and of the University of Geneva, as well as in the specialised training for the federal tax expert diploma.

**ALEJANDRO PONCE MARTÍNEZ**  
*Quevedo & Ponce*  
Alejandro Ponce Martínez, a senior partner at Quevedo & Ponce (established in 1941), where he has worked since 1963, is a doctor of jurisprudence from the Catholic University of Ecuador (1970) and a master of comparative jurisprudence from New York University (1973). He has practised in all branches of the law, including taxation, in most of the courts of Ecuador and in two international tribunals, as well as in arbitration both domestically and internationally. He has presided over an average of 10 to 12 arbitration cases per year. He has been a law professor at the Catholic University of Ecuador, Universidad Central del Ecuador, Catholic University of Santiago de Guayaquil, Universidad del Azuay and Universidad Andina Simón Bolívar. He has written a wide range of legal articles and legal textbooks, and
was chief legal adviser to the president of Ecuador, León Febres Cordero (1985 to 1987) and associate judge of the Superior Court of Quito (1988 to 1992 and 2000 to 2004), as well as of the Administrative Tribunal (2011 to 2012). He a member of the Ecuadorian Group of the Permanent Court of Arbitration, an ICSID arbitrator and a WIPO arbitrator, as well as a correspondent of UNCITRAL. Since August 2008, he has been the director of the section on juridical sciences of the Casa de la Cultura Ecuatoriana Benjamín Carrión. Together with important jurists from South America, he founded the Sociedad Internacional de Derecho Comunitario e Integración. He is also part of the arbitration section of the International Bar Association. He is a member of the Academy of Lawyers of the Quito Bar Association.

SILVIA A PRETORIUS  
_Afridi & Angell_

Silvia A Pretorius is a senior associate in Afridi & Angell’s Abu Dhabi Office. Prior to joining the firm, she was a senior member in the English law department of the law offices of Gebran Majdalany in Doha, Qatar, where she advised on project finance, oil and gas purchase, offtake and supply agreements, facility construction and sharing arrangements, finance and corporate mergers and reorganisations. Ms Pretorius is involved in the firm’s corporate, commercial, telecommunications, banking and financial services practices. Ms Pretorius has spent a significant portion of her career as an attorney in South Africa, working on litigation for major financial institutions and telecoms issues.

ALEX RIGBY  
_Skadden, Arps, Slate, Meagher & Flom (UK) LLP_

Alex Rigby is an associate in the London office of Skadden, Arps, Slate, Meagher & Flom LLP & Affiliates. He works within the firm’s tax practice, advising on international corporate transactions, credit operations, group structures and reorganisations, employment taxation, tax-related disclosure and compliance regimes, and dispute resolution. In September 2019, Alex acted as the panel secretary of a seminar on the ‘Taxation of Space’ at the IFA’s London Congress, one of the key global events dedicated to taxation.

HUMBERTO ROMERO-MUCI  
_D’Empaire_

Dr Romero-Muci received his law degree _summa cum laude_ from Universidad Católica Andres Bello in 1985, a master’s degree in law (LLM) and a diploma in international taxation from Harvard Law School in 1986 and a PhD in law from Universidad Central de Venezuela in 2003. Dr Romero-Muci has been named as one of the most distinguished tax specialists in Venezuela by _Chambers and Partners_ and the _International Tax Review_. He is chair professor of tax law at Andres Bello Catholic University and the Central University of Venezuela. He is also a member of the Venezuelan Academy of Jurisprudence and was an alternate Supreme Court of Justice between 1996 and 2000. Before joining D’Empaire, Dr Romero-Muci was head of legal tax at Deloitte. He is fluent in Spanish and English. Humberto Romero-Muci has been a tax partner at D’Empaire since 2012.
RAÚL SALAS LÚCIA

Roca Junyent

Raúl is the tax partner leading Roca Junyent’s Madrid tax practice.

With over 20 years’ experience, he has participated in some of the most relevant M&A and real estate operations in the Spanish and European market.

Raúl has advised several large international groups when litigating with the Spanish tax authorities and the tax authorities from other European countries. His areas of specialisation include, besides M&A, tax advice for financial institutions, energy and infrastructure companies.

Raúl has been recognised as one of the leading tax lawyers in Spain by independent directories such as Chambers and Partners and The Legal 500. In addition, the prestigious British publisher Euromoney has recognised him as a Leading Tax Lawyer in Spain.

Before joining Roca Junyent, he was the leading partner of Baker McKenzie Corporate Tax practice where he was awarded the Spanish Transfer Pricing Firm of The Year in 2011, 2013, 2014 and 2017 by International Tax Review. He has published numerous articles in specialist magazines, as well as in financial newspapers, has contributed to various publications, and has been a guest speaker in seminars and courses on tax issues.

TIM SANDERS

Tim Sanders is an English-qualified solicitor and fellow of the Chartered Institute of Taxation. After 35 years working in private practice, he retired as Head of the European Tax Practice of Skadden, Arps, Slate, Meagher & Flom LLP and currently works as an in-house international tax adviser to a NYSE listed company. He continues to work on a wide range of corporate and finance taxation matters.

KEI Sasaki

Anderson Mōri & Tomotsune

Kei Sasaki advises on a wide range of areas, including international and domestic tax; banking, structured finance and project finance; financial regulation; energy and resources; and customs duties. Mr Sasaki has also successfully represented a client at the Supreme Court of Japan in a landmark case regarding an investment scheme using the Cayman exempted limited partnership structure.

He gained a bachelor of laws from the University of Tokyo (2004), attended the Legal Training and Research Institute of the Supreme Court of Japan (2004–2005) and gained an LLM in international taxation from the New York University School of Law (2012).

During his career at Anderson Mōri & Tomotsune starting in 2005, he was associated with Herbert Smith Freehills in Sydney and Singapore (2012–2013).

He was admitted to the Japan Bar in 2005 and the New York Bar in 2014.

NIKLAS JRM SCHMIDT

Wolf Theiss

Dr Niklas JRM Schmidt, TEP, is a partner at Wolf Theiss, the largest Austrian law firm. He has been admitted as a lawyer and as a tax adviser. His areas of specialisation include tax law and private clients. Mr Schmidt is frequently engaged as a speaker at tax conferences and has
been a visiting lecturer at various universities. Currently, he sits on the editorial board of the *SteuerExpress* magazine. Furthermore, Mr Schmidt is a member of the International Fiscal Association, the International Bar Association, the International Tax Planning Association and the Society of Trust and Estate Practitioners. He has been named one of Austria’s top 10 tax lawyers in the Austrian magazine *TREND* and is ranked in tier 1 by many international legal directories.

**STEVEN SIEKER**

*Baker McKenzie*

Steven has written and contributed to a number of publications in Hong Kong, Canada and internationally. He is a past member of the Hong Kong Inland Revenue Department Board of Review, and has been a part-time instructor in tax and revenue law at the Hong Kong University and City University of Hong Kong. He is a member of the Society of Trust and Estate Practitioners (STEP) and is a former executive director of STEP and the Canadian Chamber of Commerce in Hong Kong. Steven is the chairman of the Revenue Committee of the Law Society of Hong Kong and a member of the Joint Liaison Committee on Taxation. He is also a former clerk to the Supreme Court of Canada.

Steven’s practice focuses on Hong Kong and Asian regional tax advisory work, estate planning and tax litigation. He frequently represents clients in tax disputes with the Inland Revenue Department in Hong Kong. Steven is ranked as a leading individual for tax in Hong Kong by *Chambers Asia*, *Citywealth Leaders List*, *Guide to the World’s Leading Tax Advisers*, *Benchmark Asia-Pacific* and *Who’s Who Legal*.

Steven is the Managing Partner of Baker McKenzie in Hong Kong.

**PANYA SITTISAKONSIN**

*Baker McKenzie*

Panya Sittisakonsin has practised in international tax and international trade since 2002. He is currently a partner in the Tax Practice Group at Baker McKenzie’s Bangkok office. He also leads the International Commercial & Trade Practice Group, and practices in the customs and supply chain areas. While in the tax practice group of Baker McKenzie’s Sydney office, and the trade practice group of the Washington, DC office, he gained extensive experience in international tax planning and US customs valuations.

During his 17-year career, he has assisted many multinational, regional and local clients with tax planning, compliance and audits, particularly regarding offshore and onshore investments, general tax advice, tax privileges, indirect taxes and tax and customs audits. He also advises clients on highly complex tax structures, wealth management and family business planning and restructuring. He is part of a team that has successfully litigated several cases on transfer pricing, customs valuation, excise tax, and investment privileges.

In 2018, Acritas Sharper Insight named Panya a Stand-Out Lawyer. He is ranked Tier 1 by *The Legal 500* and Band 1 by *Chambers Asia-Pacific*. Additionally, *International Tax Review* has named him an Indirect Tax Leader three times; and Tax Controversy Leader six times.
MOSHE SPINOWITZ  
*Skadden, Arps, Slate, Meagher & Flom LLP*

Moshe Spinowitz is a partner in the Boston, MA office and a former Supreme Court clerk who has significant experience in international cross-border mergers and acquisitions.

EVA STADLER  
*Wolf Theiss*

Dr Eva Stadler is a counsel with Wolf Theiss, having been with the firm since 2010. She specialises in taxation of private clients, international tax law, taxation of financial instruments and tax planning of international groups. Further, she regularly publishes articles in international and national tax journals and acts as a speaker at international tax conferences. Eva is involved in the tax activities of the International Association of Young Lawyers and the International Bar Association.

MÉLANIE STAES  
*Loyens & Loeff*

Mélanie Staes is an international tax adviser and senior associate at Loyens & Loeff in Luxembourg, and was based in the New York office of the firm from 2016 to 2018. She specifically focuses on the North American region and specialises in international tax law, focusing on group restructurings, mergers and acquisitions and investment funds. She advises multinational clients, pension funds, private equity firms, as well as other corporates and investment managers, on all aspects of Luxembourg tax law. Ms Staes regularly publishes in legal literature and is a member of the International Fiscal Association (IFA), the American Bar Association (ABA) and the Canadian Tax Foundation (CTF), as well as the Luxembourg Bar.

PIETER STALMAN  
*Loyens & Loeff*

Pieter Stalman is an international tax adviser, partner and member of the executive committee of Loyens & Loeff Luxembourg. He has worked for the Amsterdam and Geneva offices, headed the Tokyo office from 1998 to 2005 and headed the Eindhoven office from 2005 to mid 2007. He specialises in advising multinational clients on cross-border transactions and group restructurings, with particular focus on the Benelux countries, Japan, China and Switzerland. Mr Stalman is a member of the International Fiscal Association and the Inter-Pacific Bar Association.

ROBERT C STEVENSON  
*Skadden, Arps, Slate, Meagher & Flom LLP*

Robert Stevenson is an associate in the Washington, DC office who received his JD and LLM in taxation from Georgetown University and advises both US and international clients on a broad range of tax transactional, planning and controversy matters, which frequently include an international tax component, such as cross-border acquisitions and joint ventures, post-acquisition integration and restructuring transactions, public and private company mergers and acquisitions, capital market offerings, spin-offs and ‘Morris Trust’ transactions,
About the Authors

and subpart F and tax reform planning. Robert Stevenson also frequently advises clients in
the financial services sector on insurance-related corporate transactions, including insurance
company mergers and acquisitions, reinsurance transactions, restructurings and related
matters.

STELLA STRATI
Patrikios Pavlou & Associates LLC

Stella Strati is a partner with the corporate, banking and finance department of Patrikios
Pavlou & Associates LLC. She is also the general manager of Pagecorp Group, a global
provider of corporate administration services based in Cyprus. Stella holds a law degree
from the University of Athens and an LLM in European Union Commercial law from
the University of Leicester. She has extensive experience in corporate and commercial law,
mergers and acquisitions, restructurings, tax law and banking and finance transactions, across
a wide range of industries. She advises important local and international companies and
financial organisations, as well as leading international banking institutions on all aspects of
financial and commercial cross-border transactions and security matters. Stella has assisted
some of the largest developers in Cyprus on landmark projects and she also advises private
clients on estate planning, asset protection and more specifically on Cyprus International
Trusts Law matters. Stella is a member of the Cyprus Bar Association, STEP and IBA. She
is also an International Tax Affiliate of the Chartered Institute of Taxation. She participates
as speaker and panellist in seminars and conferences in Cyprus and abroad, and she has
authored several publications.

MICHAIL TEGOS
KPMG Malta

Michail, a lawyer, read his master's in tax law at the University of Leiden, the Netherlands.
Following graduation from his master's degree, he was handpicked and asked to stay on as the
academic coordinator for the next two-and-a-half years, and he still lectures on the taxation
of shipping and air transport. He is involved in the provision of tax advice to a broad range of
international businesses, including a number of multinationals, in respect of a diverse range
of projects including tax structuring, group restructuring and financing, and in the provision
of advice on international tax issues as regards investments made into, out of or through
Malta. Since arriving in Malta, he has lectured on EU law on the harmonisation of direct
taxes, state aid, non-discrimination, double taxation relief and Malta’s double tax agreements
for the course leading to the advanced diploma in international taxation conferred by the UK
Chartered Institute of Taxation. He assists in providing feedback to the tax authorities as a
member of the Malta Institute of Taxation on various issues.

CECILIE TOLLEFSEN
Advokatfirmaet Grette AS

Cecilie Tollefsen is an associate partner and lawyer. She has extensive experience with national
and international corporate tax. She assists clients within M&A, including tax advice in
relation to mergers, demergers and acquisitions. She also assists clients with administrative
procedures against the tax authorities and provides general tax and corporate advice.
ALEXANDRA TÓTH
Wolf Theiss Faludi Erős Attorneys-at-Law
Alexandra Tóth is an associate in the tax practice group. Before joining the tax team at Wolf Theiss, Alexandra had gained valuable experience at the National Tax and Customs Authority, where she worked for seven years; thus, she has significant experience in the tax authority practice. Her special areas of interest are direct taxes, local taxes and transfer pricing. She has several publications and presentations to her name on this subject. Alexandra completed her studies at the Faculty of Law of Eötvös Loránd University. She speaks English.

CARL-MAGNUS UGGLA
Bird & Bird Advokat KB
Carl-Magnus Uggla has 20 years of experience as an adviser on corporate tax. He has primarily focused on transactions and structuring, but also continuously worked with tax litigation and day-to-day tax advice.

Chambers HNW ranks him in Band 1 and states that he has ‘a very good reputation and is trusted by his clients to provide timely and detailed advice’ (2019), and that ‘he is a very skilful individual, and a brilliant tax lawyer’ (2018). Chambers Europe adds that he is ‘an expert in tax planning matters’ (2019), ‘sources value him for his knowledge and client focus’ (2018), that he ‘gives that little bit extra for his clients [and] is good at understanding complicated structures, seeing the problems and finding ways to handle them with the counterparty’ (2017), that he ‘can definitely be recommended’ (2016) and that he is an ‘increasingly prominent Swedish tax lawyer, who advises on complex restructuring and transactional mandates for Swedish and international clients’ (2015). The Legal 500 ranks him as a leading individual and notes that he is ‘an expert in tax planning, transactional work and tax controversy’ (2019), ‘he has vast experience in tax issues associated with M&A . . . and he also undertakes tax litigation’ and that he is ‘highly experienced’ (2015). He has been featured in ITR/World Tax every year since 2013, when they stated that he has ‘experience in corporate taxation, focusing on M&A, restructurings, and international/EU taxation’ and that ‘he is also an experienced tax litigator, and of course is one of Sweden’s leading real estate experts’. He has also been recommended by Who’s Who Legal in The International Who’s Who of Corporate Tax Lawyers (2010, 2011).


Carl-Magnus holds an LLM from Lund University. He also studied, inter alia, business economics, economics, political science and business law at Lund University, University of Gothenburg and Suffolk University Law School.

CHINYERUGO UGOJI
ÆLEX
Chinyerugo Ugoji is a partner at ÆLEX. His practice focus is corporate and commercial law with an emphasis on tax. He has also advised extensively on fiscal regimes in Nigeria’s oil and gas sector. He regularly advises clients operating in diverse economic sectors on a broad range of Nigerian tax issues. He has provided tax structuring advice in relation to
several cross-border and domestic M&A transactions. He has also advised extensively on fiscal regimes in Nigeria’s oil and gas sector, and has considerable experience with tax-related production-sharing contract disputes.

PILAR VACAS BARGEDA

Roca Junyent

Pilar Vacas’ expertise includes restructuring tax advice, ongoing tax advice and transfer pricing. She has deep knowledge of the tax assessment on direct, indirect, local tax, relations with tax administration and tax audits.

She has published numerous articles in specialist magazines. She has contributed to various publications and has been a guest speaker in seminars and courses on tax issues.

Prior to joining Roca Junyent, she was team leader of the tax department of Baker McKenzie where she was part of the team that was awarded the Spanish Transfer Pricing Firm of The Year in 2011, 2013, 2014 and 2017 by International Tax Review.

MICHAEL WONG

Baker McKenzie

Michael Wong is a leading authority on legal, regulatory and taxation issues involving major cross-border commercial transactions. He is head of the tax, mergers and acquisitions and private equity practice groups in the Taipei office of Baker McKenzie. His unrivalled depth and scope of experience covers a diverse spectrum of handling complex multi-jurisdictional acquisitions, joint ventures, infrastructure projects as well as technology, media and telecoms matters.

He assists financial institutions and independent trustees on cross-border tax and legal compliance issues; structures Taiwan operations and transactions, including representative offices, branches and subsidiaries of foreign enterprises; and prepares requests for tax rulings and assists high net worth families on private wealth management and cross-border legal and tax issues, including the use of trust and foundations, wills and private holding companies.

In addition to assisting several major US Fortune 100 companies in contentious tax matters with Taiwan’s tax authorities and providing advice and implementation on corporate restructuring, he also advises Taiwan’s Ministry of Finance as part of the prestigious panel of industry advisers for Taiwan tax reforms.

He is named an ‘Eminently Practitioner’ by Chambers Asia-Pacific (2020), a ‘Leading Individual’ by The Legal 500 Asia-Pacific (2020) and a ‘Highly Regarded Lawyer’ by IFLR1000 (2020).
Appendix 2

CONTRIBUTORS’ CONTACT DETAILS

ABOU JAOUDE & ASSOCIATES LAW FIRM
OMT Building
266 Sami El Solh Ave
PO Box 116-5079
Beirut
Lebanon
Tel: +961 1 395555
Fax: +961 1 384064
s.elkai@ajalawfirm.com
s.machnouk@ajalawfirm.com
h.elhousseini@ajalawfirm.com
n.elhaddad@ajalawfirm.com
www.ajalawfirm.com

ÆLEX
4th Floor, Marble House
1 Kingsway Road
Falomo Ikoyi
Lagos
Nigeria
Tel: +234 1 2793367 8/+234 1 4617321 3
Fax: +234 1 4617092
tiemuwa@aelex.com
cugoji@aelex.com
jdasun@aelex.com
eigbanibo@aelex.com
www.aelex.com

ADVOKATFIRMAET GRETTE AS
Filipstad Brygge 2
PO Box 1397 Vika
0114 Oslo
Norway
Tel: +47 22 34 00 00
Fax: +47 22 34 00 01
firma.post@grette.no
kamo@grette.no
ceto@grette.no
www.grette.no

AFRIDI & ANGELL
The Towers at the Trade Center
West Tower, Level 12
Abu Dhabi Mall
10th Street
PO Box 3961
Abu Dhabi
United Arab Emirates
Tel: +971 2 610 1010
Fax: +971 2 627 2905
gmayew@afridi-angell.com
spretorius@afridi-angell.com
www.afridi-angell.com
Contributors’ Contact Details

A&L GOODBODY
International Financial Services Centre
North Wall Quay
Dublin 1
Ireland
Tel: +353 1 649 2000
Fax: +353 1 649 2649
pmaher@algoodbody.com
dublin@algoodbody.com
www.algoodbody.com

ANDERSON MÔRI & TOMOTSUNE
Otemachi Park Building,
1-1-1 Otemachi
Chiyoda-ku
Tokyo 100-8136
Japan
Tel: +81 3 6775 1140
Fax: +81 3 6775 2140
kei.sasaki@amt-law.com
fumiaki.kawazoe@amt-law.com
yoshiko.nakamura@amt-law.com
www.amt-law.com/en

BAE, KIM & LEE LLC
133 Teheran-ro
Gangnam-gu
Seoul, 06133
South Korea
Tel: +82 2 3404 0000
Fax: +82 2 3404 0001
sungdoo.jang@bkl.co.kr
maria.chang@bkl.co.kr
www.bkl.co.kr

BAKER MCKENZIE
14th Floor, One Taikoo Place
979 King’s Road, Quarry Bay
Hong Kong
Tel: +852 2846 1888
Fax: +852 2845 0476
wenwen.chai@bakermckenzie.com
steven.sieker@bakermckenzie.com

15F, 168 Dunhua North Road
Taipei 10548
Taiwan
Tel: +886 2 2712 6151
Fax: +886 2 2712 8292
dennis.lee@bakermckenzie.com
michael.wong@bakermckenzie.com

5th, 10th, and 21st–25th Floors
Abdulrahim Place
990 Rama IV Road
Silm, Bangrak
Bangkok 10500
Thailand
Tel: +66 2636 2000
Fax: +66 2636 2111
panya.sittisakonsin@bakermckenzie.com
sirirasi.gobpradit@bakermckenzie.com

12th Floor, Saigon Tower
29 Le Duan Blvd
District 1
Ho Chi Minh City
Vietnam
Tel: +84 28 3829 5585
Fax: +84 28 3829 5618
fred.burke@bakermckenzie.com
thanhvinh.nguyen@bakermckenzie.com

www.bakermckenzie.com
Contributors' Contact Details

**BIRD & BIRD ADVOKAT KB**
Norrlandsgatan 15  
Box 7714  
103 95 Stockholm  
Sweden  
Tel: +46 734 24 20 56  
carl-magnus.uggla@twobirds.com  
www.twobirds.com

**CHIOMENTI**
Via Giuseppe Verdi 2  
20121 Milan  
Italy  
Tel: +39 02 721571  
Fax: +39 02 72157224  
paolo.giacometti@chiomenti.net  
giuseppeandrea.giannantonio@chiomenti.net  
www.chiomenti.net

**CUVAL ABOGADOS**
Carrera 9 No. 94A – 32 Office 206  
Bogotá  
Colombia  
Tel: +571 3032193  
bcubides@cuval.co  
www.cuval.co

**DAVIES WARD PHILLIPS & VINEBERG LLP**
155 Wellington Street West  
Toronto  
Ontario M5V 3J7  
Canada  
Tel: +1 416 863 0900  
Fax: +1 416 861 0624  
jcolden@dwpv.com  
www.dwpv.com

**DELOITTE IMPUESTOS Y SERVICIOS LEGALES, SC (DELOITTE MEXICO)**
Avenida Pasco de la Reforma 505  
Colonia Cuauhtémoc  
Mexico City 06500  
Mexico  
Tel: +52 55 5080 6000  
Fax: +52 55 5080 6001  
edbarron@deloittemx.com  
www.deloitte.com/mx

**D’EMPAIRE**
Edificio Bancaracas, PH  
Plaza La Castellana, Chacao  
Caracas 1060  
Venezuela  
Tel: +58 212 264 6244  
Fax: +58 212 264 7543  
abenshimol@dra.com.ve  
hromeromuci@dra.com.ve  
www.dra.com.ve

**DLA PIPER NEDERLAND NV**
Gebouw Meerparc  
Amstelveenseweg 638  
1081 JJ Amsterdam  
PO Box 75258  
1070 AG Amsterdam  
Netherlands  
Tel: +31 20 541 98 88  
Fax: +31 20 541 99 99  
jian-cheng.ku@dlapiper.com  
rhys.bane@dlapiper.com  
www.dlapiper.com
GAIA SILVA GAEDE ADVOGADOS
Rua da Quitanda
126 – Centro
CEP 01012-010
São Paulo
Brazil
Tel: +55 11 3797 7400
mauricio.barros@gsga.com.br
www.gsga.com.br

GORRISSEN FEDERSPIEL
Axeltorv 2
1609 Copenhagen V
Denmark
Tel: +45 33 41 41 41
Fax: +45 33 41 41 33
jrsa@gorrissenfederspiel.com
www.gorrissenfederspiel.com

HERBERT SMITH FREEHILLS CIS LLP
10 Ulitsa Nikolskaya
109012 Moscow
Russia
Tel: +7 495 363 6500
Fax: +7 495 363 6501
oleg.konnov@hsf.com
sergei.eremin@hsf.com
www.herbertsmithfreehills.com

KHAITAN & CO
One Indiabulls Centre, 13th Floor, Tower 1
841 Senapati Bapat Marg
Mumbai 400 013
India
Tel: +91 22 6636 5000
Fax: +91 22 6636 5050
bijal.ajinkya@khaitanco.com
www.khaitanco.com

KPMG
KPMG Malta
92 Marina Street
Pieta PTA9044
Malta
Tel: +356 2563 1000
Fax: +356 2566 1000
juanitabrockdorff@kpmg.com.mt
michailtegos@kpmg.com.mt
www.kpmg.com.mt

LENZ & STAHELIN
Route de Chêne 30
CH-1211 Geneva 6
Switzerland
Tel: +41 58 450 70 00
Fax: +41 58 450 70 01
frederic.neukomm@LenzStaehelin.com
floran.ponce@LenzStaehelin.com
www.lenzstaehelin.com

ISIDORA & COMPANY
PO Box 38044
Dar es Salaam
Tanzania
Tel: +255 736 217 760
Mob: +255 693 019 481
paulkibuuka@isidoralaw.co.tz
www.isidoralaw.co.tz
LOYENS & LOEFF
Tervurenlaan 2
1040 Brussels
Belgium
Tel: +32 2 743 43 43
Fax: +32 2 743 43 10
christian.cheruy@loyensloeff.com
marc.dhaene@loyensloeff.com
18–20, rue Edward Steichen
Luxembourg 2540
Luxembourg
Tel: +352 466 230
Fax: +352 466 234
pieter.stalman@loyensloeff.com
melanie.staes@loyensloeff.com
www.loyensloeff.com

MOCHTAR KARUWIN KOMAR
World Trade Centre 6, 14th Floor
Jl Jend Sudirman Kav 31
Jakarta 12920
Indonesia
Tel: +62 21 571 1130
Fax: +62 21 571 1162/570 1686
mulyana@mkklaw.net
disca.ferli@mkklaw.net
bobby.manurung@mkklaw.net
ratna.mariana@mkklaw.net
astrid.kohar@mkklaw.net
www.mkklaw.net

PATRIKIOS PAVLOU & ASSOCIATES LLC
Patrician Chambers
332 Agiou Andreou Str.
3035 Limassol
Cyprus
Tel: +357 25 871599
Fax: +357 25 344548
stella.strati@pavlaw.com
www.pavlaw.com

QUEVEDO & PONCE
Torre 1492, Av 12 de Octubre N26-97 y Lincoln, 16 piso
Quito
Ecuador
Tel: +593 2 298 6570
Fax: +593 2 298 6580
alejandro.ponce@quevedo-ponce.com
www.quevedo-ponce.com

ROCA JUNYENT
José Abascal, 56, 7th floor
28003 Madrid
Spain
Tel: +34 917 81 97 60
Fax:+34 917 81 97 64
r.salas@rocajunyent.com
e.ferrer-sama@rocajunyent.com
p.vacas@rocajunyent.com
l.palacios@rocajunyent.com
www.rocajunyent.com

SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP
Skadden, Arps, Slate, Meagher & Flom (UK) LLP
40 Bank Street
E14 5DS, London
United Kingdom
Tel: +44 20 7519 7224
Fax: +44 20 7072 7224
alex.jupp@skadden.com
joshua.atkinson@skadden.com
moshe.spinowitz@skadden.com
robert.stevenson@skadden.com
leonard.greenberg@skadden.com
www.skadden.com
SOŁTYSIŃSKI KAWECKI &
SZLĘZAK
ul Jasna 26
00-054 Warsaw
Poland
Tel: +48 22 608 7052
Fax: +48 22 608 7070
jaroslaw.bieronski@skslegal.pl
www.skslegal.pl

SRS ADVOGADOS
Rua Dom Francisco Manuel de Melo, No. 21
1070-085 Lisbon
Portugal
Tel: +351 21 313 20 00
Fax: +351 21 313 20 01
mafalda.alves@srslegal.pt
www.srslegal.pt

WOLF THEISS
Schubertring 6
1010 Vienna
Austria
Tel: +43 1 51510 5410
Fax: +43 1 51510 665410
niklas.schmidt@wolftheiss.com
eva.stadler@wolftheiss.com
www.wolftheiss.com

Wolf Theiss Faludi Erős Attorneys-at-Law
Kálvin Square 4th floor
Kálvin tér 12–13
1085 Budapest
Hungary
Tel: +36 1 4848 800
Fax: +36 1 4848 825
janos.pasztor@wolftheiss.com
alexandra.toth@wolftheiss.com
bence.kalman@wolftheiss.com
www.wolftheiss.com
For more information, please contact info@thelawreviews.co.uk

THE ACQUISITION AND LEVERAGED FINANCE REVIEW
Marc Hanrahan
Milbank LLP

THE ANTI-BRIBERY AND ANTI-CORRUPTION REVIEW
Mark F Mendelsohn
Paul, Weiss, Rifkind, Wharton & Garrison LLP

THE ASSET MANAGEMENT REVIEW
Paul Dickson
Slaughter and May

THE ASSET TRACING AND RECOVERY REVIEW
Robert Hunter
Edmonds Marshall McMahon Ltd

THE AVIATION LAW REVIEW
Sean Gates
Gates Aviation LLP

THE BANKING LITIGATION LAW REVIEW
Christa Band
Linklaters LLP

THE BANKING REGULATION REVIEW
Jan Putnis
Slaughter and May

THE CARTELS AND LENIENCY REVIEW
John Buretta and John Terzaken
Cravath Swaine & Moore LLP and Simpson Thacher & Bartlett LLP

THE CLASS ACTIONS LAW REVIEW
Camilla Sanger
Slaughter and May

THE COMPLEX COMMERCIAL LITIGATION LAW REVIEW
Steven M Bierman
Sidley Austin LLP
THE MERGER CONTROL REVIEW
Ilene Knable Gotts
Wachtell, Lipton, Rosen & Katz

THE MERGERS AND ACQUISITIONS REVIEW
Mark Zerdin
Slaughter and May

THE MINING LAW REVIEW
Erik Richer La Flèche
Stikeman Elliott LLP

THE OIL AND GAS LAW REVIEW
Christopher B Strong
Vinson & Elkins LLP

THE PATENT LITIGATION LAW REVIEW
Trevor Cook
WilmerHale

THE PRIVACY, DATA PROTECTION AND CYBERSECURITY LAW REVIEW
Alan Charles Raul
Sidley Austin LLP

THE PRIVATE COMPETITION ENFORCEMENT REVIEW
Ilene Knable Gotts
Wachtell, Lipton, Rosen & Katz

THE PRIVATE EQUITY REVIEW
Stephen L Ritchie
Kirkland & Ellis LLP

THE PRIVATE WEALTH AND PRIVATE CLIENT REVIEW
John Riches
RMW Law LLP

THE PRODUCT REGULATION AND LIABILITY REVIEW
Chilton Davis Varner and Madison Kitchens
King & Spalding LLP

THE PROFESSIONAL NEGLIGENCE LAW REVIEW
Nicholas Bird
Reynolds Porter Chamberlain LLP

THE PROJECT FINANCE LAW REVIEW
David F Asmus
Sidley Austin LLP