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Corporate Tax

Contributing Editor
Steve Edge
Slaughter and May

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INTRODUCTION

Contributed by: *Steve Edge,* ***Slaughter and May***

The business world has had to be very agile in changing business models during the last very difficult year. This guide will be helpful to all those facing the challenges of deciding what best to do in responding either to the consequences of the pandemic or in reacting to tax changes that have been made in their basic working environment.

The pandemic has undoubtedly cast a shadow over all the economies in the world and over fiscal management throughout the world.

Not quite unnoticed (but not with as big an impact as we might have had), the UK and the EU have quietly(!) implemented Brexit, the USA has had a rumbustious election (which looks likely to result in a number of consequential tax changes for multinationals based there) and the OECD continues to try to change the tax world.

COVID-19 Recovery Puts Spotlight on Potential Tax Rises and Competition

Commentators are currently speculating whether, with the huge government deficits that have been run up in many developed countries, we are likely to see immediate tax rises and perhaps the introduction of new taxes to put economies back on an even keel again.

Again, commentators differ but the majority view seems to be that, with interest rates as low as they are, governments should continue to borrow (if they can) to try to spur economic growth, which can then be relied on to recoup additional taxes and manage debt. (In truth, of course, relative performance between developed countries as manifested in the currency rates has not changed that much given that very many of them have been borrowing to much the same extent – so the commentators are probably right to say there is no sense of urgency in this.)

The idea that additional taxation will take money out of the pockets of consumers and business tends now to be the focus – and the possibility of increased (or new) taxes may, therefore, be put off for a while. (Though, at some point, governments will have to make it clear that there are sensible limitations to the use of the magic money tree and budgetary discipline will need to re-assert itself.)

Attempts by the OECD and some developed countries to rein in tax competition may also need to be paused or slowed down – Pillars 1 and 2 have been making no or slow progress. Whether the US election result changes that remains to be seen.

In the UK, as it adjusts to its new place in the world outside the EU, there seems to be no sense in moving away from the competitive tax economy approach that has prevailed since it was introduced by the coalition government in 2010 (a small start having been made by Labour at the end of the previous Parliament).

At the time of the recent Budget in the UK, many thought that corporate tax rises were unlikely against the background of both the pandemic and Brexit – the Chancellor thought otherwise. He is still facing wide criticism for sending a fiscal rectitude message by raising the corporate tax rate to 25% in the Budget. In doing that, though, he pointed out that the UK would still be very competitive and he has time, of course, to reflect on that decision before the 25% rate takes effect in 2023. Much will depend on how tax revenues have improved as the economic recovery has progressed – and also, of course, on what has happened elsewhere in the world and/or as a result of Pillar 2. This has all the hallmarks of a game of poker – as regards both the message sent to the UK electorate and how the UK is positioned in the global corporate tax rate context.

The basic regime, however, under which the UK has a pragmatic controlled foreign companies regime, no incremental tax on foreign dividend income remitted to the UK, interest limitations like any other country and no withholding tax on outbound dividends seems still to be the right package to encourage existing UK-based multinationals and tempt others to join them.

If you want evidence of the relative success of this approach, you need only consider the case of Unilever. A few years ago, Unilever looked destined to move to the Netherlands in order to achieve the corporate objectives of its then management. That was firmly rejected by shareholders. A more recent study resulted in the conclusion that unifying management and ownership in the UK under a UK holding company made more sense. That move has then been attacked by left-wing elements in the Dutch Parliament as an attempt simply to avoid withholding tax on Dutch dividends and radical proposals have been put forward to impose an exit tax on retained earnings. Whether those proposals will come to pass remains to be seen, but Unilever has bravely gone ahead with the re-domiciliation in any event.

The Dutch furore illustrates another aspect of international taxation: whether jurisdictions want to retain the use of dividend withholding taxes in their armoury and what impact they have on the ability to access capital markets when funding is needed. Withholding taxes on dividends are, of course, simply another way of taxing corporate profits – and jurisdictions no doubt find it satisfactory to raise tax from people who are not necessarily in their jurisdiction and so have no right to vote on whether they should be subject to tax.

With the Vodafone tax in India, taxes on foreign investors in real estate (particularly in natural resource assets) and the Pillar 1 and other digital tax proposals around the world, extraterritorial taxation seems to be very much in fashion. In the corporate world, this may adversely affect M&A transactions – for example, few M&A transactions will proceed without change of control issues having to be considered or dealt with (such as whether a change prejudices the ability to carry forward tax losses or, much worse, triggers deemed disposals of underlying assets) have to be considered and dealt with.

Possible New Approach to the OECD Pillars under the Biden Administration

Coming back to Pillars 1 and 2, the new US president seems more inclined than his predecessor to participate in multinational discussions. Whether this changes the general stance the USA has had in relation to the BEPS programme remains to be seen, but it seems unlikely that the US government will ever learn to love digital taxation when so many of its national champions are affected.

That is, of course, a great pity because without a low-level Pillar 1-type solution that is accepted internationally, chaos seems likely to reign.

The UK has already introduced a digital service tax – but that was obviously not thought by the Chancellor as being capable of paying off pandemic debt. In truth, of course, any such taxes are more likely than not to be passed on to consumers and so would tend to discourage spending at a time when the opposite is being hoped for.

Transfer pricing continues to be one of the most hotly debated topics between tax authorities and taxpayers around the world. Indeed, most multinationals will have a number of ongoing transfer pricing disputes around the world at any given time. The UK tax authorities seem to be proud of the adjustments they have been able to make since the introduction of diverted profits tax (no real change in the rules but a number of measures to put pressure on the process and encourage compliance).

The so-called destination-based tax proposal has been put forward as a way of achieving greater simplicity. It works on the assumption that you cannot have profits unless you make a sale, so, after allowing for returns on expenditure and investment (particularly on intellectual property) in jurisdictions that are farther up the supply chain, the residual profit from the business gets allocated to the jurisdictions in which sales take place.

This, of course, tends to benefit jurisdictions with very high populations (so maybe the USA will learn to love it) but when the easiest part of any transfer pricing investigation to settle seems to be the distribution return at a relatively low level, one wonders whether turning the supply chain upside down in this way really reflects where value is being added or created. No independent distributor would, of course, expect to get a share of the super profits in the group that had developed a valuable brand or other IT on top of is distribution margin.

Pillar 2 seems to be having a slightly easier time and is likely to be supported by the USA – but it is something that the successful developed countries with many natural economic advantages and a reasonably high tax rate can vote for easily, leaving those who need to go the extra tax mile to attract investment feeling deeply misunderstood.

We will see in the coming months what changes the US government might make to the taxation of multinationals, but recent statements by members of the Biden administration indicate that fairly significant tax increases are likely. Whether then there needs to be some restructuring (particularly in the intellectual property area, where jurisdictions such as the UK are imposing taxes on assets held offshore in tax havens that are deployed in the UK) will no doubt become clearer.

Creative Tax Initiatives Set to Play a Role in Brighter Times Ahead

In the investment fund area, it may be that life is getting a bit easier as, particularly in the post-pandemic era, countries seek to attract investment and avoid imposing tax barriers to this objective (such as withholding taxes on pension funds and other sources of investment).

But, in the UK at least, the idea of imposing a wealth tax on individuals has got some traction (some other countries already have such taxes, of course) and the employment tax area continues to be one where HMRC is pushing the boundaries to bring more things into the scope of tax. Carried interests for private equity employees and partners have, of course, been a controversial area for years – and HMRC seems now to be edging towards a different approach on more conventional company share schemes.

So, as we move into the sunny uplands beyond the pandemic, tax and how businesses should be structured will continue to be a matter for debate. Tax advisers are unlikely to be standing idly by.

Contributed by: *Steve Edge,* ***Slaughter and May***

Slaughter and May is a leading international law firm with a worldwide corporate, commercial and financing practice. The highly experienced tax group deals with the tax aspects of all corporate, commercial and financial transactions. Alongside a wide range of tax-related services, the team advises on the structuring of the biggest and most complicated mergers and acquisitions, the development of innovative and tax-efficient structures for the full range of financing transactions, the documentation for the implementation of transactions so that the desired tax objectives are met, the tax aspects of private equity transactions and investment funds from initial investment to exit, and tax investigations and disputes from opening enquiries to litigation or settlement.

Contributing Editor

Steve Edge advises on the tax aspects of private equity and public mergers, acquisitions, disposals and joint ventures, and on business and transaction structuring (including transfer pricing in all its aspects) more generally. He also advises many banks, insurance companies, hedge funds and others in the financial service sector in a wide range of areas. A large part of Steve's practice involves advising non-UK multinationals (particularly those based elsewhere in Europe and in the USA) on cross-border transactions and tax issues of various types. In that area of his practice, he works closely with other leading international tax advisers around the world.

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ANDORRA

Law and Practice

Contributed by:
Jose María Alfin and Marc Urgell
FINTAX2020 see p.15

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

It is not compulsory to conduct a business through a legal entity in Andorra, but it is normally more efficient in terms of the deductions that apply to legal entities over individuals, who have more limitations for deductions or exemptions, even when they act as business individuals.

Andorra only regulates two kinds of company by law: *Societat de Responsabilitat Limitada* (S.L.) and *Societat Anónima* (S.A.). The main difference is that the minimum capital in the S.L. is much lower (EUR3,000) than the S.A., which has a minimum capital of EUR60,000. Also, the S.A. is more open to foreign shareholders whereas the S.L. is very restrictive according to law in terms of the freedom of transferring participations to third parties (non-original partners).

1.2 Transparent Entities

The typical entity used for investments is regulated by the *Autoritat Financera Andorrana* (AFA) under the form of a SICAV (Collective Investment Vehicle). There are different classes of SICAV in relation to the investment policy but, from the corporate point of view, all of them are incorporated as *Societat Anonima*. The key advantage of these entities is the tax treatment: although they are subject to Corporate Income Tax, the tax rate is equal to 0%.

1.3 Determining Residence of Incorporated Businesses

The residence of companies is determined according to three different criteria:

- if the company has been incorporated according to Andorran laws;
- if the company has its registered office located in Andorra; and
- if the company is effectively managed from Andorra (ie, the effective management headquarters are located in Andorra).

1.4 Tax Rates

The general tax rate is 10%. However, SICAVs are subject to a 0% rate. If individuals receive proceeds as a consequence of an agreement to distribute dividends, they would be also fully exempt, according to law.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The accounting profit is very close to the tax profit, since the Andorra system does not regulate many adjustments to the accounting result. Some relevant adjustments are as follows:

- permanent adjustments: exemptions, fines, gifts, donations and unjustified expenses, double tax relieves, etc; and
- temporary adjustments: amortisation and depreciation, provisions, etc.

2.2 Special Incentives for Technology Investments

There is a specific regime for investments in intangible assets if the following requirements are fulfilled:

- the company must apply those intangible assets to its business activities;
- the intangible assets can only be used by or destined for the business;
- the person trying to apply the regime must have all the records and books duly deposited; and
- the intangible asset must be developed in Andorra.

The application of this regime must be requested from the government, which must authorise it expressly.

2.3 Other Special Incentives

A special treatment is applied to new investments carried out after the Corporate Income Tax Act (CIT) entered into force. The treatment is more than a deduction or relief, and applies different criteria for the amortisation of those assets.

2.4 Basic Rules on Loss Relief

Past tax losses that originated when the CIT was in force can be set off against the profits originated during a maximum term of ten years.

2.5 Imposed Limits on Deduction of Interest

Andorra does not impose any limits on the deduction of interest.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is an option: a group can be taxed globally if all the companies, directly or indirectly, have a minimum percentage of other companies of the group of at least 75%.

2.7 Capital Gains Taxation

Capital gains are taxed at 10%. There is a full relief applicable to gains arising from the sale of shares of subsidiaries if, at the time of the sale, the parent company held at least 5% of the shares during the previous 12 months, and the subsidiary is subject to corporate income tax of at least 4% (ie, 40% of the general 10% corporate tax rate in Andorra).

2.8 Other Taxes Payable by an Incorporated Business

VAT is applicable, at a rate of 4.5%.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses must also consider the fees of the notary and a flat stamp duty tax payable to the government.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Normally, all businesses and entrepreneurs carry out business using a corporate form (either S.L. or S.A.).

3.2 Individual Rates and Corporate Rates

The corporate tax rate is 10%. The rates of Personal Income Tax are as follows:

- 0% up to EUR24,000;
- 5% from EUR24,000 up to EUR40,000; and
- 10% from EUR40,000 upwards.

3.3 Accumulating Earnings for Investment Purposes

There are no tax incentives for accumulating earnings for investment purposes. However, investments in fixed assets in Andorra generate a tax incentive of 5% of the total amount invested (under certain conditions).

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends are fully exempt if they have been distributed by Andorran companies to individuals who are resident in Andorra. Capital gains are exempt if, before the sale, the seller held up to 25%, or had maintained the shares for more than ten years. Otherwise, the capital gain would be subject to tax at a rate of 10%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Normally, investments in stock-quoted corporations will not represent a stake of more than 25%, so the capital gain would be exempt in Andorra. If this is not the case, the gain would be subject to tax at a rate of 10%.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Only royalties are subject to withholding tax, at a rate of 5%.

4.2 Primary Tax Treaty Countries

The primary tax treaty countries used by foreign investors to make investments in local corporate stock or debt are Spain, Portugal, France and Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

As far as is known, local tax authorities have never challenged the use of treaty country entities by non-treaty country entities. However, the Andorran tax authorities could well challenge such cases, since Andorra is a BEPS jurisdiction and is complying with all the duties arising from BEPS. In this case, they have the obligation to check that a transaction is carried out in a normal way, avoiding artificial structures with the aim of avoiding or minimising the tax payable (treaty shopping).

4.4 Transfer Pricing Issues

Linked transactions must be carried out at a fair market value. Taxpayers are obliged to request a valuation report from an independent expert, evidencing that the transaction has respected the standards of the market. There are no specific obligations to document the transfer pricing transaction, but this would be necessary in the case of a tax audit.

4.5 Related-Party Limited Risk Distribution Arrangements

As far as is known, the Tax Agency has not challenged the use of related-party limited risk distribution arrangements for the sale of goods or the provision of services locally, but there is a risk it could because the law is clear in this regard.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Andorra's policy towards local transfer pricing rules is the same as that established by the OECD, and those parameters have been incorporated into the law.

4.7 International Transfer Pricing Disputes

The Tax Agency has confirmed that there have been no international transfer pricing disputes in Andorra resolved through double tax treaties and mutual agreement procedures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The Tax Agency has not been very active in challenging transfer pricing matters, so it is hard to know how it would act in such matters.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

The tax base for local branches of non-local corporations and local subsidiaries of non-local corporations is calculated through the same system, with the tax rate for both being 10%. However, the local branches have certain limitations on deducting expenses related to the parent company.

5.3 Capital Gains of Non-residents

Capital gains arising from the sale of stocks in local corporations by non-residents are taxed at a rate of 10%. However, if the seller has held less than 25% of the company during the last 12 months, the capital gain will be exempt. However, if more than 50% of the company's assets are made up of real estate assets located in Andorra, a special tax for capital gains arising from the stock transactions applies, which is regressive from 15% in the first year down to 0% if the sale is more than ten years after the acquisition.

5.4 Change of Control Provisions

This is not applicable in Andorra.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Any formulas used to determine the income of foreign-owned local affiliates selling goods or providing services are normally determined by an independent expert, who drafts the Master File determining the market price of the transaction.

5.6 Deductions for Payments by Local Affiliates

Transfer pricing rules apply on transactions related to management and administration expenses.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing by foreign-owned local affiliates to non-local affiliates is subject to the same rules as apply to other linked transactions.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local corporations is not exempt from corporate tax per se, but the withholding at the source, if that is the case, is deductible up to a certain limit (effective taxation in Andorra on this income).

6.2 Non-deductible Local Expenses

This is not applicable in Andorra.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are exempted from tax by applying the participation exemption principle, under certain conditions (minimum participation, length of participation and effective taxation or existence of double tax treaty).

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries in their business without incurring local corporate tax, provided that the foreign company pays the linked company the fair market price. The profit for the transferor is taxed at a rate of 5% if the transfer as considered a royalty, or at 10% in all other cases, except for other dispositions under double tax treaties.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Andorra has not yet incorporated any CFC rules into its tax system.

6.6 Rules Related to the Substance of Non-local Affiliates

Andorra has not yet incorporated any CFC rules into its tax system.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains are taxed at 10%. There is a full relief applicable to gains arising from the sale of shares of non-local subsidiaries if, at the time of the sale, the parent company held at least 5% of the shares during the previous 12 months, and the subsidiary is subject to corporate income tax of at least 4% (ie, 40% of the general 10% corporate tax rate in Andorra).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Andorra has a set of anti-avoidance provisions in the General Tax Act. The most important provisions are as follows:

- transactions must be carried out for valid economic reasons and not just for tax reasons;
- transactions with the sole purpose of avoiding the tax applicable to the real business are prohibited; and
- presumptions or valuations are fixed by law.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Audits are carried out without any prior notice, and there is no regular cycle.

9. BEPS

9.1 Recommended Changes

All the BEPS recommendations have been implemented, although the incorporation of CFC rules into the Andorran tax system is still pending, and some other pending items will be implemented very soon. One of the most important amendments that is still pending is the introduction of CFC rules into the Andorran tax system.

9.2 Government Attitudes

Andorra is fully compliant with BEPS, and the government agrees 100% on the spirit of BEPS in order to avoid fraud or artificial transactions with the sole aim of reducing or eliminating taxation in the most expensive jurisdiction.

9.3 Profile of International Tax

International tax has a high profile in Andorra. Andorra did not have any experience in tax matters before 2011, and consequently needs the guidance of the OECD and countries with many years of experience.

9.4 Competitive Tax Policy Objective

It is likely that the tax pressure will be increased, but this decision will be implemented very slowly to avoid internal conflicts.

9.5 Features of the Competitive Tax System

It could be suggested that the 0% taxation of SICAVs makes no sense and the CFC rules must be implemented as soon as possible.

9.6 Proposals for Dealing with Hybrid Instruments

Andorra is following the calendar agreed with the OECD to implement BEPS and is fulfilling the changes at the due time. To date, Andorra has not implemented the item related to hybrid instruments but the government has a timeframe within which to approve the relevant laws.

9.7 Territorial Tax Regime

Andorra does not have a territorial tax regime. Income is taxed following the principle of worldwide income for residents and, in certain cases, non-residents are subject to real taxes when they make deals with real estate properties.

9.8 CFC Proposals

As Andorra does not have a territorial regime, the CFC proposals are not relevant here. The next tax reform will target potential evasion by Andorran residents (individuals or corporations) through companies located in countries where passive entities owned by non-residents are not subject to tax.

9.9 Anti-avoidance Rules

All the double tax conventions are the same in terms of following the OECD model and, in some cases, the UN model.

9.10 Transfer Pricing Changes

The transfer pricing rules are very clear in the law, and no relevant changes in this regard are expected.

9.11 Transparency and Country-by-country Reporting

The proposals for transparency and country-by-country reporting are essential for tax justice and a more efficient distribution of tax resources among countries.

9.12 Taxation of Digital Economy Businesses

Andorra has not implemented any criteria in this matter, but it will follow the relevant recommendations of the OECD.

9.13 Digital Taxation

Andorra fully supports the proposals made by the OECD.

9.14 Taxation of Offshore IP

All the provisions regarding the taxation of offshore IP that were originally included in the law have been abolished as a consequence of the amendments introduced to the law following the BEPS recommendations.

FINTAX2020 is a very young firm, having been created in September 2020, but is the only law firm in Andorra focused exclusively on tax matters. The firm provides services for many local clients, and also advises foreign companies in relation to investments in Andorra and companies relocating to the country or individuals who want to relocate to Andorra for several reasons. FINTAX2020 focuses on its specialist area of tax, and has an agreement with Spanish law firm Gomez, Acebo & Pombo on a basis of exclusivity. Due to the experience of the partners in international investments, acquisitions and restructurings, the firm has a vast number of clients who are not Andorran residents but want to invest in IT, digital services and related matters.

Authors

Jose María Alfin started his career as a legal representative before the European Union, and later became head of the legal area for General Motors for Spain. He relocated to Andorra in 2008, where he was appointed general counsel of the largest bank by assets under management, before joining Cases Lacambra as a partner in charge of Tax and Wealth Planning at the Escaldes-Engordany office. He recently launched FINTAX2020 with the goal of focusing on tax, international tax, corporate tax and compliance matters. Jose María is the lecturer for the Tax Compliance Programme at ESADE Business School in Barcelona, and is regularly invited to speak at business schools, professional associations, banks, family offices and other specialist forums about tax compliance, international tax, CRS, BEPS and related matters. He is admitted to practice in Spain and Andorra, and is a member of the Spanish Association of Tax Advisors, the Andorran Association of Tax Advisors, the International Fiscal Association and the Association of Financial Law.

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ANGOLA

Law and Practice

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Contributed by:** Nuno de Miranda Catanas, Ana Martins de Carvalho and Laura Maia Lucena, **MC Jurist Angola Advogados

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Angolan businesses generally adopt a corporate form, notably a company, a branch or a representative office, depending on the type of activity to be carried out. The most common corporate form for long-term businesses is a duly incorporated company.

In this context, and although Angolan corporate law sets forth two types of unlimited liability companies, the types of companies that are typically used for business purposes in Angola are private limited companies or limited companies by quotas (*sociedades por quotas*) and joint-stock companies (*sociedades anónimas*). It is also possible to incorporate a sole-shareholder company.

From a tax perspective, companies and branches are subject to the same tax treatment. Angolan taxation may vary depending on the type of activities carried out (there are special business sectors subject to specific taxation regime), the type of companies – notably whether they are micro, small or medium companies – and the location of the companies within the Angolan territory.

1.2 Transparent Entities

Angolan tax legislation does not set forth a tax transparency regime under which the revenues/profits of a given entity are deemed to be profits of its members/shareholders, even if no distribution of profits has occurred, and shall be deemed to be their individual taxable income and subsequently be taxed as individuals' or companies' revenue.

1.3 Determining Residence of Incorporated Businesses

For Angolan tax purposes, Angolan taxpayers have a specific tax domicile included in their taxpayer card, which is the registered head office of the incorporated companies/branches or otherwise the place of "effective direction" – ie, the place in which the management of the companies normally effectively occurs. Companies that are non-resident entities and have appointed a tax representative are deemed to be domiciled in the typical place of residence/registration of the tax representative. Lastly, and by default, if it is not possible to determine the residence of incorporated businesses, entities will be deemed to be domiciled in the area of the First Tax Department of Luanda.

1.4 Tax Rates

Incorporated businesses (companies and branches) are subject to a general 25% Industrial Income Tax, notwithstanding specific regimes and incentives better detailed below.

Individuals carrying out business directly (without incorporated businesses) are subject to a 6.5% Personal Income Tax (not Industrial/Corporate Income Tax) subject to a withholding mechanism, and are subject to a 25% tax rate over revenues and income not subject to withholding.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Angolan taxable income corresponds to the difference between the revenues and costs reflected in the relevant accounting records subject to the Angolan General Accounting Plan.

Resident businesses will be subject to tax on their profits, whether they are obtained in Angola or abroad (worldwide taxation). The taxation is divided into two regimes:

- the General Regime; and
- the Simplified Regime, for taxpayers that are subject to Industrial Tax but not VAT.

The taxable income of a business is broadly defined to include all earnings and gains resulting from any activity carried out by a business, of ordinary or occasional nature, deemed principal or secondary, with the deduction of all costs and losses required to obtain such revenues, except for taxpayers in the Simplified Regime.

2.2 Special Incentives for Technology Investments

The Angolan tax system does not set forth special incentives for technology investments, such as patent box or R&D expenses. Such costs shall be included as tax-deductible costs related to the activity of the taxpayer.

This being said, any profits declared as reserves for reinvestment that are effectively used within the subsequent three years for premises or new equipment allocated to the activities of the taxpayer may be deducted from the taxable income within the five years after the completion of the investment, up to a maximum limit of 40% of the reinvestment if made in the Province of Luanda, Lobito or a Province capital and up to a maximum of 80% of the reinvestment if made outside any Province capital.

2.3 Other Special Incentives

A reduced tax rate of 10% applies to agriculture, aquaculture, aviculture, livestock, fishing and forestry activities.

Certain types of companies and/or activities may be subject to different Industrial Income Tax rates, as follows:

- investment funds (7.5% tax rate);
- real estate funds (15% tax rate); and
- micro (2% tax rate), small and medium companies may be subject to tax rates ranging from 12.5% to 22.5%, depending on the location of the company.

Companies incorporated and/or acquired by non-resident entities may also be subject to a special regime of tax incentives under investment project legislation, including a range of Industrial Income Tax from 2.5% to 20% (depending on the location) and for a period of time from two to eight years.

2.4 Basic Rules on Loss Relief

Losses generated in the previous five fiscal years may be deducted from the taxable income of the relevant fiscal year, unless such losses are generated in an activity and/or during a period in which the company has benefited from tax exemption or reduction.

2.5 Imposed Limits on Deduction of Interest

Interest on loans, in any form, of the holders of the share capital or shareholder loans is acceptable as a deductible cost, except for the portion exceeding the average annual reference rate established by the Angolan Central Bank (which will be accrued to the taxable income).

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping qualifies as a special tax regime in Angola, and is applicable if one of the members of the group is deemed to be a Large Taxpayer included in a list regularly published by the Angolan Ministry of Finance. In this context, the Large Taxpayer, as a member of a group of entities, may be taxed by the algebraic sum of positive or negative results of the entities that comprise the group.

A group of companies exists in a scenario in which one of the entities is dominant, holding at least 90% of the share capital of the other(s), directly or indirectly, provided that such majority participation entails the majority of voting rights.

The tax group special regime is subject to the verification of the following requirements:

- all entities included in the group must have a head office or effective direction in Angola;
- the participation of the dominant entity in the dependent entities must be registered for more than two years, unless the dominant entity originally incorporated the dependent entities; and
- the dependent entities may not be deemed to be dependent on any other entity with a head office or effective direction in Angola.

The group of companies may not be composed of entities that do not carry out any activity for more than one year or that have bankruptcy or insolvency judicial actions pending, nor of entities that registered losses in the previous two years or that benefit from tax incentives granted under investment project legislation.

2.7 Capital Gains Taxation

Sale of Shares

The positive balance between the sale price and the original acquisition price of shares resulting from the sale of shares is subject to a 10% withholding of Investment Income Tax.

Dividends

The payment of dividend shares is subject to a 10% withholding of Investment Income Tax. If dividends are related to shares admitted to negotiation in a regulated market, the tax rate is reduced to 5%. Dividends paid to resident companies in respect of a participation of at least 25% held for more than one year are exempt from withholding tax.

Capital Gains

Capital gains are subject to a 10% tax rate for investment income tax purposes; in some specific circumstances this tax rate is reduced by 50% to an effective tax rate of 5%.

Interest

The payment of interest in respect of bonds or financial instruments is subject to a 10% withholding of Investment Income Tax. Interest from shareholder loans or any sort of allowance made by shareholders to the companies is also subject to a 10% withholding of Investment Income Tax. Interest from shares admitted to negotiation in a regulated market are subject to a reduced 5% withholding of Investment Income Tax. Interest for late payment or general loan agreements is subject to a 15% rate of Investment Income Tax – interest is presumed to be at 6% annually, unless another interest rate has been agreed between the parties, in writing with recognised signatures.

Royalties

The payment of royalties is subject to a 10% withholding of Investment Income Tax. Consideration for the use of industrial, commercial or scientific equipment is regarded as a royalty payment.

2.8 Other Taxes Payable by an Incorporated Business

In addition to Industrial Income Tax, Angolan companies are also subject to Value Added Tax (VAT), effective as of 1 October 2019, subject to different regimes. Companies may also be subject to Stamp Duty in specific transactions.

Companies are also subject to taxation on immovable property, depending on whether the immovable property has been leased (15% withholding of Real Estate Property Tax settled by the tenant and VAT if the lease has a commercial nature/purpose) or acquired (0.1% or 0.5% Real Estate Property Tax settled by the holder of the property title, depending on the declared value of the property).

Also, companies that process payments to non-resident entities under technical assistance and management services agreements are no longer subject to the 10% special contribution over the net amount to be transferred outside Angola, as this was suspended by the 2021 State Budget.

2.9 Incorporated Businesses and Notable Taxes

Depending on the type of activity, the following distinctive taxation may be applicable:

- oil and gas companies are subject to a special tax regime, with different types of taxes on petroleum income, profit oil and other charges; and
- soft drinks distributors and tobacco distributors are subject to Excise Duty Tax enacted with VAT, effective in Angola as of 1 October 2019.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most small businesses related to small retail (ie, directed to private consumers) may operate in a non-corporate form, subject to Personal Income Tax on individuals. However, there is a micro/small/medium companies special tax regime that has been used by small businesses. Sole-shareholder entities are also allowed to be created in Angola, which is gradually being considered for small businesses.

In general, larger businesses (which may be subject to local content/angolanisation requirements) operate as incorporated businesses.

3.2 Individual Rates and Corporate Rates

There is no general rule that prevents individual professionals from performing activities through an incorporated company. Until the enactment of the tax reform of 2020, the individual/personal income tax rate was lower than the corporate tax rate, and this was a determining factor in choosing how to pursue business opportunities. Nevertheless, the trend is still based upon the business model under which small businesses typically decide to pursue their activities through an incorporated company if and when the business expands and there is a need to hire personnel or to pursue a specific activity that is subject to a corporate legal format.

3.3 Accumulating Earnings for Investment Purposes

There are no specific provisions that may prevent accumulating earnings (which will be deemed as taxable income subject to the general 25% tax rate over profits after the deduction of costs) for investment purposes. However, as mentioned in **2.2 Special Incentives for Technology Investments**, any profits declared as reserves for reinvestment that are effectively used within the subsequent three years for premises or new equipment allocated to the activities of the taxpayer may be deducted from the taxable income within the five years after the completion of the investment, up to a maximum limit of 40% or 80% of the reinvestment, depending on the location.

3.4 Sales of Shares by Individuals in Closely Held Corporations

The taxation of individuals on dividends and on gains resulting from the sale of shares corresponds to 10% on Capital Gains Tax (or Investment Income Tax – IAC).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends of shares admitted to negotiation in a regulated market will no longer be subject to a 5% tax rate as the five-year period after enactment of the Capital Gains Tax Code has already elapsed. As a result, such dividends will be subject to the general tax rate of 10%.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

As mentioned in **2.7 Capital Gains Taxation**, interest, dividends and royalties are subject to Capital Gains Tax (IAC). Angolan Income Tax rules set forth that any revenues or profits subject to IAC shall be deducted from the taxable income of Industrial Income Tax.

By the same token, the amount of IAC settled to Angolan tax authorities is not accepted as a tax-deductible cost.

Furthermore, under approved investment projects, the Angolan local entity may benefit from tax reductions, notably on IAC due and payable for the distribution of dividends.

4.2 Primary Tax Treaty Countries

Angola has ratified two tax treaties – one with Portugal and the other with the United Arab Emirates (UAE) – that are already in force and have started to be implemented by investors from those jurisdictions.

Until now, Angola has been targeted by investors based upon specific industry sectors, notably oil and gas, mining, fishing and other manufacturing industries, irrespective of the investors' place of origin.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

As the tax treaties in Angola have recently entered into force, the tax authorities have not yet started to scrutinise the use of entities in treaty countries that are held and/or controlled by non-resident entities/citizens of those treaty countries.

4.4 Transfer Pricing Issues

Tax authorities introduced transfer pricing rules in October 2013, with the following two main principles:

- taxable income may be subject to corrections insofar as there are transactions between entities with special relationships with different conditions from those that would have been agreed between independent entities generating profits above or below what would be expected if such special relationships did not exist ("arm's-length" principle); and
- taxpayers with annual profits exceeding AOA7 billion shall prepare and submit a transfer pricing dossier evidencing pricing structures practised with companies with which they may have special relationships.

Special relationships exist if any of the following requirements are verified:

- direct or indirect shareholding control;
- powers to appoint the managers of the local entity;
- existing commercial relationships that represent more than 80% of the business volume of the local entity; or
- corporate funding of more than 80%.

The assessment of standard conditions agreed between independent entities is based upon the method of comparable market price, the method of reduced resale price, or the method of increased cost.

4.5 Related-Party Limited Risk Distribution Arrangements

Tax authorities may challenge an arrangement on the sale of goods or the provision of services with a related party based upon its effects, notably if the use of such type of arrangement provides (or is expected to provide) a tax advantage, and tax authorities would thus be expected to conduct a more thorough review and to potentially challenge such arrangements.

In a scenario in which there is evidence of attempted or concrete tax evasion and/or tax advantage in terms that no actual goods or services have been supplied, then tax authorities will be empowered to review and reassess the taxable income of the companies involved.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Although Angola is not included in the OECD country profiles on transfer pricing, the existing legislation reflects OECD standards and guidelines on transfer pricing (without making explicit reference to the OECD). The transfer pricing principles have accrued increasing significance as a result of the complex operations carried out by Large Taxpayers (defined and listed as companies that represent a significant portion of tax revenue in the country – mainly foreign investors with a legal or tax presence in Angola).

As a result, Angola does not have any transfer pricing rules that may differ from OECD standards. However, the country may still need to develop action plans for the enforcement and scrutiny of the application of transfer pricing rules.

4.7 International Transfer Pricing Disputes

Under Angolan tax regulations, the only obligation related to transfer pricing is for large taxpayers to annually present a transfer pricing report/dossier reflecting the major suppliers and clients and corresponding special corporate and commercial relationships.

The Angolan tax authorities have already initiated tax inspections and procedures for the review of transfer pricing reports of large taxpayers, notably international entities that are reflected in such transfer pricing reports of Angolan-based entities. The main focus of such inspections has been to verify the market conditions between the targeted entities so that transfer pricing principles are duly complied with, notably the arm's-length transaction principle.

The Angolan tax authorities have been making additional tax assessments of Industrial Income Tax (Corporate Tax) by not accepting costs charged by special related entities included in the transfer pricing reports that are not deemed to be in compliance with market conditions. This means that the taxable income of large taxpayers is increased and therefore additional taxes, interests and fines are applicable by the tax authorities.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Angola has not been enforcing transfer pricing claims, but rather correcting taxable income annual returns from previous fiscal years under investigation procedures. Compensation/offset adjustments may only be accepted if they are duly recognised by the tax authorities.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

In general, local branches of non-resident entities in Angola are subject to the same taxation as corporate entities, as a local branch is deemed to be the permanent establishment (PE) of the non-resident entity and all profits allocated to such PE are subject to Angolan income taxation.

Furthermore, a local subsidiary will be able to declare a portion of the interests paid on loans to a parent company as tax deductible costs, but the branches will not, as this regime is only relevant to shareholder loans, and is not applicable to branches.

5.3 Capital Gains of Non-residents

Subject to the rules of subjective application, capital gains on the sale of shares held directly by a non-resident entity in a local entity shall only apply if the shares are sold to a local entity. Otherwise, it will be a challenge to apply and enforce the capital gains taxation as the entity that will transfer the shares and the entity that will acquire the shares are not resident in Angola, and capital gains taxation on the sale of shares operates by way of withholding. Nevertheless, the capital gains generated by the transfer of shares (the positive balance between the price of sale and the price of acquisition) would be subject to 10% withholding insofar as it is related to a direct transfer of shares in a local entity.

Only the tax treaty with Portugal states that the taxation on the sale of shares may be taxed in Angola and the amount of tax settled shall be deducted from the taxable income of the foreign shareholder based in Portugal. The UAE treaty does not make any reference to the capital gains generated by the sale of shares.

5.4 Change of Control Provisions

The Angolan tax system does not set forth change of control provisions, other than those that apply to the direct transfer of shares.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In principle, there are no specific formulas to determine the income of foreign-owned local affiliates that provide goods or services to local entities, as in such scenarios the sale of goods corresponds to an importation operation subject to Angolan taxation and the supply of services is subject to a withholding of 6.5% to be settled by the local entity before the tax authorities.

This being said, in an investigation, tax authorities may scrutinise the prices offered by the non-resident entity based on an industry comparison (if possible) or such other appropriate formulas to determine whether the cost of the goods or the services is in line with effective costs practised as a standard practice. Ultimately, the taxable income of the local entity may be subject to adjustments by the tax authorities if the prices practised are higher than standard practice.

5.6 Deductions for Payments by Local Affiliates

Angolan Industrial Income Tax sets forth a provisional regime for the payment of Industrial Income tax, whereby the provision of services is subject to a 6.5% withholding of anticipated payment of income tax that will be deducted in the annual tax return to the aggregate amount of tax due. However, this 6.5% withholding will not apply to related entities if the Angolan taxpayer is in a position to evidence that the transaction constitutes a mere recharge/reimbursement of costs. Only the overheads/margins that may be included to support the management and administration will be subject to the 6.5% withholding.

Pursuant to Article 18 of the law that enacted the 2021 State Budget, the withholding rate approved for the fiscal year 2021 in respect of international services (ie, services provided by non-resident service providers) rendered to petroleum companies is of 6.5%. This means that only the services rendered by overseas entities to petroleum companies will be subject to this "reduced" withholding rate of 6.5%; all other services rendered by non-resident providers to local companies (which are not petroleum companies) seem to be subject to the new withholding 15% rate for non-resident services providers.

5.7 Constraints on Related-Party Borrowing

From a tax perspective, there is no specific tax constraint on related party borrowing, the interest on which is subject to Capital Gains Tax at a 10% withholding tax rate. Interest amounts are then acceptable as tax-deductible costs, subject to the comments under **2.5 Imposed Limits on Deduction of Interest**.

However, under any investigation process, tax authorities may at all times proceed with taxable income corrections and non-acceptance of interest amounts as tax-deductible costs if there is evidence that the loan arrangements are intended to achieve tax avoidance, notably as a way of avoiding taxation on dividends.

Nevertheless, loan arrangements with non-resident entities (irrespective of whether they are a shareholder or not) face significant foreign exchange control restrictions, notably prior licensing requirements. This means that loan agreements with non-resident entities are typically not used for the purposes of funding local entities.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The Industrial Income Tax Code sets forth the principle under which entities with a head office and effective direction/management in the Angolan territory are subject to Industrial Income Tax for the aggregate amount of their revenue/profits, earned either in the country or abroad. As a result, there is no difference between the taxation of foreign income that is subject to Industrial Income Tax and in-country income, provided that such profits are duly invoiced and recorded in the accounting records and balance sheets of the local entities.

6.2 Non-deductible Local Expenses

Foreign income generated by local entities is not exempt from Industrial Income Tax, and will be considered for purposes of the assessment of taxable income in Angola. Regarding the deductibility of local expenses, although not related to the location of the income, there are certain rules related to the acceptance of expenses as tax-deductible costs.

The following costs are not acceptable for purposes of Industrial Income Tax:

- Industrial Tax, Real Estate Property Tax, Personal Income Tax and IAC;
- Social Security contributions;
- penalties and fines related to infractions;
- indemnities paid over insured events;
- conservation and repair costs for immovable property;
- taxable income corrections from previous years; and
- life and health insurance, which is not granted to the majority of the workforce.

Further undocumented costs and confidential costs are also not accepted as tax-deductible costs, and are no longer subject to autonomous taxation. Only costs incurred with confidential expenses are subject to autonomous taxation at a rate between 30% and 50%, and will accrue in the corresponding percentage to the taxable income.

6.3 Taxation on Dividends from Foreign Subsidiaries

There is no difference between the taxation of dividends paid to local shareholders from foreign or local subsidiaries. Investment Income Tax on dividends will apply if the income is either paid or earned by an entity with a head office or effective direction/management in the Angolan territory. As a result, the payment of dividends is subject to a 10% rate of Investment Income Tax.

Dividends paid to an Angolan entity by its foreign subsidiary are subject to a 10% Investment Income Tax. Tax must be reported and assessed directly by the local entity (not subject to a withholding mechanism). Dividends subject to Investment Income Tax are not subject to Industrial Tax (the local entity may fully deduct the amount of the dividends received as there is no differentiation between dividends originated from a foreign subsidiary and dividends originated from a local subsidiary).

6.4 Use of Intangibles by Non-local Subsidiaries

There are no specific provisions for the taxation of intangibles allocated by local entities to non-resident subsidiaries, except if qualified as royalties and subject to Capital Gains Tax. Typically, the use of intangibles is inverted in terms whereby the non-resident entities allocate the intangibles to the local entities in Angola.

However, Industrial Income Tax clearly sets forth that revenue generated from IP rights or other similar revenue shall qualify as profit to be allocated to the taxable income, as well as scientific or technical services.

This means that companies are free to allow the use of intangible property within the group, subject to general transfer pricing principles and IP rights taxation. Tax authorities may require an examination and subsequently challenge and correct taxable income that includes intangibles if no payments are received and/or paid for the use of intangibles.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Angola has no specific “controlled foreign company” rules. As a result, the income of non-resident subsidiaries incorporated in special jurisdictions with a more favourable tax system is not taxed in Angola. The only applicable taxation will be on dividends that may be distributed to the local entity.

Non-resident branches of local corporations may fall under the worldwide income general principle, under which Angolan entities may be taxed on the income earned abroad, as a branch is not a standalone entity.

6.6 Rules Related to the Substance of Non-local Affiliates

From a tax perspective, there are no specific provisions related to the substance and effective existence of non-resident affiliates of Angolan entities, provided that the costs that are intended to be recorded are duly supported and qualify as tax-deductible costs (ie, costs that are imperative to pursue activities in Angola). This being said, under tax investigation processes, tax authorities may require additional information/documentation related to the corporate substance of the non-resident affiliate, as well as evidence of the effective supply of goods or provision of services, especially if such goods and/or services would not be available within the Angolan territory at a competitive price. However, this topic has a more significant impact on foreign exchange control regulations in order to prevent the use of foreign currency to settle payments outside Angola related to non-performed services.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

There is no difference between the taxation of the sale of shares in non-local affiliates and local affiliates, provided that the income will be earned by the Angolan entity/individual in its capacity as transferor. As a result, the positive balance between capital gains (sale price) and capital losses (price of original acquisition/subscription) resulting from the acquisition or sale of shares is subject to a 10% withholding of Investment Income Tax, provided that such transfer is not included in the ordinary activities of the taxpayer (local entity) and thus is not subject to Industrial Income Tax. If the operation is executed under a regulated market, only 50% of the gain on the sale of shares will be deemed to be subject to the 10% withholding of Investment Income Tax.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are no general anti-avoidance or anti-abuse rules in Angola but any action, arrangement or agreement that is put in place to obtain an unlawful advantage that generates the non-payment of taxes is deemed to be punishable as a tax transgression.

However, there is a general legal provision related to punitive interests of 2.5% to be applicable in case of non-effective actions and businesses whose purpose is solely to obtain a tax advantage in addition to the enforcement of all applicable taxation to the relevant actions without benefiting from the abusive tax advantage.

The Angolan tax system also sets forth special clauses that may be deemed to be anti-avoidance provisions – notably, the transfer pricing principle of arm's-length transactions, and the limitation of interest deductibility as a cost. However, to date there are no provisions related to payments to non-resident entities of low tax rate jurisdictions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The type of companies outlined below are subject to mandatory audits by qualified accountants registered at the relevant Professional Bar of Registered Accountants in Angola:

- state-owned companies;
- joint-stock companies (ie, *Sociedades Anónimas*);
- limited liability companies whose structure includes an Audit Board (*Conselho Fiscal* in Portuguese);
- limited liability companies in respect of which the sum of the gross assets and the aggregate revenues equals or exceeds the amount of AOA6 million; please note that this amount is updated automatically every calendar year in accordance with a formula indexed to the USD/AOA exchange rate;
- companies incorporated under investment projects for the purposes of licensing the repatriation of dividends;
- companies operating under a special tax and foreign exchange legal framework – notably, petroleum and mining companies; and
- companies that are subject to the obligation of preparing audit accounts by special provisions applicable to the relevant sector of activity.

Furthermore, the following penalties would be applicable for a material breach of the obligation set forth above:

- immediate examination of the relevant accounts by the authorities by way of inspection;
- termination of any tax incentives granted to the relevant company under the scope of an investment project (or such other legal framework); or
- suspension of the payment of dividend repatriation or other revenues due and payable to the non-resident shareholder.

9. BEPS

9.1 Recommended Changes

Although Angola has been invited and included as a member of the OECD/G20 Inclusive Framework on BEPS, Angola is not an OECD member state and has not implemented any specific changes related to Base Erosion and Profit Shifting (BEPS).

9.2 Government Attitudes

The Angolan tax system currently focuses on the enactment and implementation of VAT and Excise Duty Tax, which have been requested notably for purposes of increasing the sophistication of the Angolan tax system. For that purpose, tax authorities have also been implementing legislation related to the optimisation of the exchange of communication between taxpayers and the authorities, notably by way of electronic communication systems and electronic software for invoicing procedures. This means that the tax system seems to be gradually moving towards a more sophisticated system, in line with other more developed African jurisdictions. However, it would still take a significant change in the tax system towards the BEPS recommended changes.

9.3 Profile of International Tax

As mentioned above, the tax system has been gradually implementing new taxes that are more in line with international tax, notably VAT and Excise Duty Tax, and will be increasingly directed to absorb international tax practices and guides. However, it seems that the degree of tax sophistication required in terms of procedures, the preparation of authorities and the profile of the taxpayers for the implementation of BEPS recommendations will take significant time, effort and use of resources to be achieved, and may not yet be a priority.

9.4 Competitive Tax Policy Objective

The current government focus is on attracting foreign investment and maintaining significant tax revenues using the current tax framework.

In this context, investment appeals are made by way of tax incentives/reductions upon the approval of investment projects, including benefits on Industrial Income Tax, IAC on dividends, Real Estate Property Tax on the acquisition of immovable property and Stamp Duty on receipts (which in the meantime has been revoked by VAT). BEPS measures and recommended changes are intended to terminate tax avoidance strategies that take advantage of "gaps and mismatches" in tax regulations to avoid paying tax. These objectives may still be achieved, along with a competitive tax system that intends to attract foreign investment and collect significant tax revenues, provided that incentives and competitive tax policies are subject to time limitations, the verification of effective economic and tax benefits for the country, and regular and strict scrutiny.

9.5 Features of the Competitive Tax System

In the short term, the tax incentives granted to attract foreign investment may reduce tax revenues while investors are starting operations in the country. However, the risk of generating low amounts of tax revenue for newly incorporated businesses with foreign investors is duly mitigated by the limited duration of the incentives, which are coincident with the commencement of activities that companies do not start immediately to raise taxable profits.

9.6 Proposals for Dealing with Hybrid Instruments

To date, Angola has not implemented any rules related to hybrid instruments, and there is no expectation that such rules will be implemented in the near future. Angola is still implementing the VAT reform along with the Excise Duty Tax and such other ancillary mechanisms to provide further sophistication to the tax system, notably via the electronic transmission of data and electronic invoicing systems.

Hybrid instruments are not yet used on a familiar and ordinary basis, due especially to foreign exchange control regulations in Angola, and thus the tax system has not yet considered the creation of rules for hybrid instruments, which are treated as capital-related operations and are potentially subject to IAC.

9.7 Territorial Tax Regime

The Angolan tax system is mostly a territorial tax system, although local entities are also taxed on their worldwide income. Furthermore, the limits to interest deductibility relate to the average annual interest rate established by the Angolan Central Bank (BNA). In light of this, foreign investors are typically not interested in the deductibility of interest as a significant criterion to invest in Angola.

9.8 CFC Proposals

As mentioned above, Angola is not an OECD member state and has not implemented any specific changes related to BEPS or CFC proposals. The Angolan tax system is still a territorial tax regime in terms that there is a need to link taxable income to the territory.

The challenges raised by non-resident subsidiaries or affiliates incorporated in low tax rate jurisdictions have been handled mostly from a foreign exchange control standpoint in order to prevent the process of payments outside Angola to non-resident entities that are not effectively providing goods and services to Angolan entities.

As a result, the government has created and enforced the special contribution regime by applying a rate of 10% over all payments of services to be processed outside Angola.

Authorities and commercial banks have also implemented regulations on payments processed to trading entities, which may only be settled after the verification of specific substance requirements related to such non-resident trading entities.

9.9 Anti-avoidance Rules

The existing double taxation treaties include limitation of benefit or anti-avoidance rules in terms that any existing benefits included in the relevant treaty will not apply if there is relevant and concrete evidence that the underlying transactions have been implemented for purposes of obtaining such advantages, notably if the ultimate beneficiaries of the advantages are residents in third party countries.

However, considering that the existing tax treaties are with Portugal and the UAE only and have only recently entered into force, the extension of the limitation of benefits is not expected to be significant until more double taxation treaties are enacted and approved.

9.10 Transfer Pricing Changes

Angola has not yet enacted specific transfer pricing rules other than those mentioned in **4.4 Transfer Pricing Issues**. As a result, the tax authorities' scrutiny is still significantly focused on inspection actions covering all corporate taxes that may be applicable to corporate entities in the previous five years.

The taxation of industrial property rights, including patents and trade marks, falls under the definition of royalties, which are subject to 10% withholding of IAC to be settled by the payer entity (the licensee) if it is a local entity. However, the most challenging topic related to industrial property is not from a taxation standpoint, but rather from a foreign exchange control perspective, as industrial property licensing agreements must obtain prior approval from foreign exchange control authorities, prior to any payment and subsequent settlement of taxes. Considering that the payment of royalties is ranked as a lower-priority payment, industrial property licensing agreements and subsequent taxation are not considered to be relevant topics on transfer pricing, especially if the industrial property holder/owner is a non-resident entity.

9.11 Transparency and Country-by-country Reporting

Other than the double tax treaties currently in force with Portugal and UAE, Angola has not been part of any arrangements for the exchange of country-by-country reports, as the Angolan tax system is not yet prepared for the internal or international exchange of information and reports.

However, due to the strong presence of US companies related to the petroleum sector, Angola has executed an agreement with the USA to reinforce the implementation of the Foreign Account Tax Compliance Act (FATCA), and has enacted Presidential Decree 33/20, 21 February to approve the Regulation of the Financial Information Tax Reporting Regime.

This Presidential Decree sets forth the obligation to report the identification of certain accounts and information to the General Tax Administration and other administrative aspects, as well as the sanctions to be applied for non-compliance with these obligations, applicable to financial institutions with headquarters or effective management in Angola, excluding any branch located outside Angola, as well as branches located in Angola of financial institutions headquartered abroad, and regulating Reporting and Non-Reporting Entities, Scope and Objective, and also the Obligations of Financial Institutions.

9.12 Taxation of Digital Economy Businesses

Angola has not yet adopted any changes to the tax system that directly address digital economy businesses, as it is still a jurisdiction in which the foreign exchange control regulations have a significant impact on doing business in Angola. As a result, the digital economy has not yet been explored in Angola and thus has not been subject to any specific tax regime and/or tax changes.

9.13 Digital Taxation

Although Angola is a member of the OECD/G20 Inclusive Framework on BEPS, it has not yet started to implement specific changes related to BEPS, including in respect of digital taxation. Angola is still very engaged in the implementation of consumption-related taxes, notably VAT, as a result of the Official Development and Monetary Assistance granted by the IMF.

9.14 Taxation of Offshore IP

With reference to **9.10 Transfer Pricing Changes**, the taxation of industrial property rights, including patents and trade marks, falls under the definition of royalties, which are subject to 10% withholding of IAC to be settled by the payer entity (the licensee) if it is a local entity. The tax rate will apply to the agreed amount of royalties (typically a percentage of revenue) that will be supported by the relevant invoice issued by the IP holder/owner. The Angolan tax authorities do not differentiate the applicable taxation if the IP holder/owner is based in a jurisdiction with a more favourable tax system from any other type of entities based worldwide, except for countries that benefit from a double tax treaty in terms of which the maximum applicable tax rate is 8%.

Industrial property taxation through royalties will not be subject to 8% taxation on royalties under the relevant tax treaties if the industrial property right is deployed to a PE of the foreign entity (from Portugal or UAE) based in Angola, notably a branch, but will rather be subject to taxation on income.

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MC Jurist Angola Advogados is a boutique-type corporate and investment law firm based in Luanda. It specialises in providing legal and tax consultancy assistance to corporate clients carrying out business and/or holding investments in the Republic of Angola. MC Jurist was established in 2009 in Angola, with a liaison office in Lisbon, by Nuno de Miranda Catanas and Ana Martins de Carvalho, who have worked together for more than 20 years, notably in Macao, Hong Kong, Singapore and Angola. MC Jurist currently has 20 fee earners in both Angola and Portugal, with significant experience in industry sectors such as petroleum services, private equity, banking and insurance. The firm focuses mainly on oil and gas, corporate and investment, tax and customs, employment and HR assistance.

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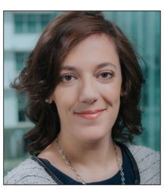

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AUSTRIA

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Corporate businesses generally adopt one of the following two forms of companies:

- the limited liability company (*Gesellschaft mit beschränkter Haftung* – GmbH); or
- the joint stock company (*Aktiengesellschaft* – AG).

Further corporate forms include the co-operative (*Genossenschaft* – Gen) and the *Societas Europaea* (SE), which are taxed as legal entities and are subject to corporate income tax.

Whereas the GmbH is a private limited company with a typically low number of shareholders, the AG is generally a public limited company, the shares of which can be held on securities deposits of banks and also be listed at the stock exchange. However, both types of company can also be formed as a one-man company. In both cases, the liability of the shareholders is generally limited to the amount of the nominal capital allocated to their shares.

Further key differences are as follows:

- under a GmbH, the shareholders are authorised to give instructions to a managing director, the transfer of shares can be restricted by the company statutes and there is a wide range of possibilities for the design of the company statutes; and
- under an AG, the supervisory board and the management board are mandatory, with both operating independently from the shareholders regarding the business decisions. There is a higher degree of organisational strictness and a high degree of fungibility of the shares.

1.2 Transparent Entities

Partnerships (OG or KG) are legal entities but are treated as transparent for income and corporate income tax purposes. There is also a general partnership under civil law, which is not a legal entity. The VAT treatment of partnerships depends on whether or not they engage as entrepreneurs with the public.

The OG is a general partnership (with unlimited liability of the partners), whereas the KG is a limited partnership (where at least one general partner has unlimited liability, while the limited partner's liability is limited to their contribution). A common structure for a partnership is to use a company (GmbH) as the general partner of a KG, with the remaining partners (investors) being limited partners (GmbH & Co KG).

For example, an investment fund business can be made either by an Undertaking for Collective Investment in Transferable Shares (UCITS) regulated under the UCITS V Directive or in the form of an Alternative Investment Fund under the Alternative Investment Fund Managers Act (AIFMG), encompassing most private equity funds and hedge funds. An Alternative Investment Fund is defined as a vehicle that invests regularly on the basis of an investment concept for the benefit of its investors, regardless of its legal form and whether it is a closed or open construction, with the exception of industrial holding companies and single family offices, among others.

In Austria, Alternative Investment Fund Managers are basically subject to the same taxation rules as investment funds regulated as UCITS. The fund itself is treated as transparent for income tax purposes and, as such, is not subject to income tax at the fund level. A tax-free accumulation of proceeds is not possible at the fund level. Upon distribution to investors (or as deemed distributions at year end in the case of accumulating funds), the components of the fund's income are taxed in the hands of the investors and (if applicable) capital yields tax is withheld by the bank on the taxable components thereof. Both Austrian and foreign UCITS and Alternative Investment Fund Managers are obliged to have a fiscal representative, which is obliged to notify the composition of the annual fund income to the Austrian Control Bank. If the fund has not reported its income to the Austrian Control Bank, a lump sum taxation applies, unless the income of the fund can be proved otherwise by the investor(s).

1.3 Determining Residence of Incorporated Businesses

A corporation is treated as being resident under Austrian domestic tax law if it has its statutory seat or place of management in Austria (ie, the place where the most important business decisions for the company are taken and prepared by its managers). If the seat and the place of management of the company are in different countries (ie, a dual-resident company), the company could face unlimited tax liability in both countries.

If a double taxation convention applies, double taxation of dual-resident companies is avoided by the "tie-breaker rule". According to most Austrian double taxation conventions, a dual-resident company would be regarded as being resident in the contracting state where its effective place of management is located. In this regard, Austria has not followed Article 4 of the Multilateral Instrument to Modify Bilateral Tax Treaties (MLI), with its new rules for dual-resident companies.

If a company has its seat or place of management in Austria, it has to pay corporate income tax on all its profits from Austria and abroad. If a company is not based in Austria but has an office or branch there, it only pays company tax on profits from its activities in Austria.

Transparent entities (eg, partnerships, investment funds and certain foreign trusts) are not regarded as taxpayers in Austria. Their income is allocated proportionately to their partners, investors or beneficiaries, being individuals or corporations. Therefore, the taxation of a transparent entity's income depends on the residence of its partners, being individuals or corporations that hold the interest either directly or indirectly via other transparent entities.

1.4 Tax Rates

Corporate income tax amounts to 25% in Austria. There is an annual minimum corporate income tax of EUR1,750 for a limited liability company (with privileged minimum taxes for newly formed companies within their first ten years of existence) and EUR3,500 for a joint stock company.

The individual's income tax rate is progressive, starting with 0% (EUR0–11,000) and rising to 25% (EUR11,001–18,000), 35% (EUR18,001–31,000), 42% (EUR31,000–60,000), 48% (EUR60,001–90,000) and 50% (for annual income exceeding EUR90,000). For annual income exceeding EUR1 million, a tax rate of 55% applies until the end of 2025.

Corporate income tax is paid by corporations, and individuals' income tax is paid by individuals operating a business as sole proprietors. Corporate income tax and individual's income tax is also paid by companies and individuals that hold an interest or share in a partnership or other transparent entity for the profits allocated to them from the partnership or other transparent entity.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Most corporations (especially companies and co-operatives) have to determine their profits based on the statutory accounts under generally accepted accounting principles (Austrian GAAP), adapted by book-to-tax adjustments as required by Austrian corporate income tax law. Major mandatory deviations provided for by tax law for the determination of profits by corporations are as follows:

- losses from the sale or depreciation of participations in other companies have to be spread over seven years;
- dividend income is largely exempt from corporate income tax (see, for example, **6.3 Taxation on Dividends from Foreign Subsidiaries**); and
- remunerations paid to supervisory board members are only deductible at 50%.

Further special deviations may also occur (eg, regarding the acceptance of accruals, car depreciation or the non-deductibility of representational expenses).

Individuals have to determine their profits based on statutory accounts (in the aforementioned way) only if their turnover exceeds certain thresholds (ie, EUR700,000 in two consecutive years). If the turnover does not exceed these thresholds, the individual can determine its profits based on a receipts basis (ie, set up a revenue and expense statement) or optionally on an accrual basis for tax purposes only (except independent services).

Individuals who do not perform an active business always determine their profits on the basis of a revenue and expense statement.

Special rules apply to partnerships, whose statutory accounts serve as the basis for the individual income tax returns of the partners' income determination together with the special tax balance for each partner's partnership interest.

2.2 Special Incentives for Technology Investments

There are no special patent box regimes in Austria, but expenses for in-house research are fully tax deductible. There is also a cash-premium for research and development expenses accrued in Austria by Austrian corporations or by Austrian permanent establishments of foreign corporations, amounting to 14% according to Section 108c of the Austrian Income Tax Act, which is unrestricted for in-house research but restricted to expenses of EUR1 million for contracted research.

Furthermore, to create an incentive for companies to invest during and after the economic crisis following the COVID-19 pandemic, the Austrian legislator decided to introduce a special premium for investments into depreciable fixed assets amounting to 7% (or 14% in the case of certain qualified investments), up to a maximum of EUR50 million. Between 1 September 2020 and 28 February 2021, all companies that have their statutory seat or a permanent establishment in Austria are eligible to apply, but the first step of the investment applied for has to be undertaken between 1 August 2020 and 28 February 2021.

2.3 Other Special Incentives

When one Austrian company acquires another Austrian company, it is generally possible to deduct interest expenses incurred in the acquisition from the Austrian corporate income tax base of the acquiring Austrian company (for exceptions to that general rule, however, see **2.5 Imposed Limits on Deduction of Interest**). By electing to form a (consolidated) tax group between the acquiring company and the target company in Austria, the future operating profits of the target company are taxed at the level of the acquiring company, from which the interest expenses for the debt used for the acquisition of the target can be set off.

The Austrian legislator has implemented a range of supporting measures and incentives for companies affected by the COVID-19 crisis, such as an allowance for overhead costs or compensation for a certain rate of turnover.

2.4 Basic Rules on Loss Relief

In general, business corporations (AG, GmbH) can set off losses without limitation (although this is not the case for corporations that are not operating as a business or individuals).

Tax loss carry-forward is possible, with no time limit, but no carry-back option of tax losses is available; neither option is available for non-business income.

For a corporation, the deduction of the loss carry-forward is limited to 75% of its annual taxable income; the leftover losses remain deductible in later periods, subject to the same 75% limitation.

As the tax loss is carried forward at the level of the corporation, it is possible – unlike in a partnership where the loss is proportionally allocated to the partners – to utilise tax losses at a company level irrespective of shareholder changes, unless the so-called "change-of-ownership rules" apply, according to which tax loss carry-forwards of a company are forfeited if a substantial change in the company's shareholders occurs in connection with a substantial change in its business and management structure (although special rules apply for the forfeiture of tax losses in the case of corporate reorganisations).

2.5 Imposed Limits on Deduction of Interest

There used to be no general interest barrier regulations in Austria. The financing structure of an Austrian company generally had to be at arm's length, to avoid a re-qualification of debt into equity or an adjustment of the concrete interest rate taking place.

However, the EU Anti-Tax Avoidance Directive (ATAD) stipulates a general interest barrier regulation, stating that interest expenses are fully tax-deductible only up to the amount of the interest income, and only up to 30% of the EBITDA. The Austrian Ministry of Finance took the position that the existing regime restricting interest and royalty deduction is as effective as the rules stipulated in the ATAD, but in July 2019 the EU Commission denied such equivalence and opened formal infringement proceedings against Austria. In late November 2020, the Austrian legislator released a draft of an implementing regulation incorporating an interest barrier ruleinto the Austrian Corporate Income Tax Act. This new rule, which entered into force in mid-January 2021 with retroactive effect from 1 January 2021, is very much based on the corresponding Article 4 ATAD and contains nearly all of the reliefs provided for therein, such as the exemption for amounts up to EUR3 million, the so-called Equity-Escape, the standalone exemption, and the extended carry-forward option.

In addition to the interest barrier, intra-group interest and royalties (ie, interest expenses or royalties paid to foreign affiliated companies) are non-deductible if the foreign receiving company is subject to low taxes.

2.6 Basic Rules on Consolidated Tax Grouping

In Austria, a group taxation regime applies upon election, which allows parent companies and their Austrian subsidiaries to consolidate their taxable income at the level of the upper tier parent company (group head) for corporate income tax purposes. The group head must be an Austrian company or a registered branch of an EU/EEA corporate entity that has held more than 50% of the capital and voting rights in the Austrian subsidiary company (group member) since the beginning of the subsidiary's fiscal year. The holding can be either direct or indirect via a partnership or a further group member. If the holding requirement is fulfilled and a request for group taxation was filed with the tax office before the elapse of the calendar year, 100% of the subsidiary's income (profit or loss) is allocated to the taxable income of the group parent company (group head).

There is no need to transfer the actual profits as a condition for the allocation of profits to the group parent company (group head). The minimum duration of the group taxation regime and of the participation in such group taxation regime of each group member is three entire fiscal years, otherwise a recapture rule provides for retroactive taxation on a standalone basis.

The group taxation regime is also available for first-tier foreign subsidiaries in relation to which an Austrian group member fulfils the holding requirement of more than 50% of capital and voting rights. A foreign group member is only accepted if it is a corporation resident in an EU country or in any other country with which Austria has agreed on a comprehensive mutual information exchange (eg, the USA or China). The set-off of the foreign losses from the Austrian tax base is allowed in proportion to the percentage of the share held in the foreign company; it is not required to include foreign profits into Austrian taxation. Certain recapture rules may apply though (eg, if the losses are later exploited abroad).

2.7 Capital Gains Taxation

Capital gains realised by corporations are subject to the ordinary corporate income tax rate of 25%, as part of the overall profits of the corporation.

This is also applicable for capital gains realised from the sale of shares or a participation in a domestic company that (unlike dividend distributions) is subject to corporate income tax. Capital losses realised from the sale of participations are deductible; such deduction has to be spread over seven years.

The sale of participations in non-Austrian corporations is generally tax neutral under the conditions of the international participation exemption (ie, a participation of at least 10% held for at least one year), unless the option for tax effectiveness has been elected in the tax return for the year of the acquisition of the participation (see also **6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates**).

2.8 Other Taxes Payable by an Incorporated Business

General Austrian taxes in connection with transactions include Real Estate Transfer Tax (RETT) for the transfer of legal or economic ownership in land or real estate located in Austria. RETT amounts to 3.5% of the sales price or, in certain cases, 0.5% of the market value of the Austrian real estate. Also, the transfer of 95% or more of the shares in a partnership or company can trigger RETT for Austrian real estate held by the entity (generally at a rate of 0.5%). A further 1.1% is due for the entry of the new owner of the real estate into the Austrian land register.

In addition, stamp duty has to be paid for the setting up of written deeds for certain contracts. This applies if the written deed for the contract is either set up in Austria or set up abroad and there are certain connections to Austria. Contracts subject to stamp duty include business rental agreements (stamp duty of 1% of the annual rent multiplied by the years of duration or of the three-fold annual rent in case of unlimited duration) and assignments of rights (stamp duty of 0.8% of the consideration).

2.9 Incorporated Businesses and Notable Taxes

Generally, corporations are subject to VAT if they are regarded as an entrepreneur and carry out transactions that are taxable for VAT purposes in Austria. An entrepreneur has the right to deduct input VAT for supplies and services received.

Every business has to deduct payroll taxes (wage withholding tax, social security contributions, ancillary labour costs) if it employs people. For freelancers, only social security contributions and employer labour costs have to be remitted (ie, no wage withholding tax).

Depending on the business, various other taxes need to be considered, including environmental taxes, various consumption taxes, motor vehicle tax, insurance tax, local taxes, etc.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses are mostly structured as limited liability companies (GmbH) or as limited partnerships with a limited company as general partner (GmbH & Co KG).

3.2 Individual Rates and Corporate Rates

The special tax rate on dividends (27.5%) together with the corporate income tax rate (25%) shall ensure that the use of a company for conducting business activities approximately amounts to the same tax burden after dividend distribution as if the taxpayer himself had earned the income at the progressive income tax rate (which amounts to 50%, or 55% respectively).

3.3 Accumulating Earnings for Investment Purposes

Apart from the general risk of the attribution of income to shareholders in the case of companies without substance, in certain cases the definition of an Alternative Investment Fund has to be taken into account. This leads to transparent taxation and involves a certain level of regulation.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends from closely held Austrian companies (GmbH or AG) are subject to withholding tax at 27.5%, to be withheld by the distributing company upon the distribution. The withholding tax is final, unless the shareholder opts for loss utilisation or the progressive income tax is below 27.5% and he/she opts for progressive income taxation in the annual income tax return. Expenses related to the dividends are not tax deductible.

Individuals who sell shares held in a closely held company (GmbH or AG) are subject to personal income tax on the capital gain derived from the sale, taxed at the special flat rate provided for investment income (27.5%). The individual has to declare the investment income in his or her annual personal income tax return. Expenses related to the capital gains are not tax deductible.

If shares in a joint stock company (AG) are held by a shareholder within an Austrian bank securities account, the Austrian bank will deduct 27.5% dividend withholding tax on the capital gains. This withholding tax has final character, if the shares are not held by the individual as business assets, so the taxpayer does not need to declare the capital gains from the alienation of the shares in his/her personal annual income tax return, unless certain voluntary conditions apply.

However, the withholding tax on capital gains does not have final character if the taxpayer holds the shares as business assets (from commercial or other independent services). Then the taxpayer has to include the capital gains from the alienation of the shares in his or her annual personal income tax return, where the capital gain needs to be adapted according to the book values of the shares. The special income tax rate of 27.5% provided for investment income applies in the tax assessment, and the withholding tax is credited to the assessed income tax. If the generation of investment income is the main focus of the individual's business activity, then the progressive income tax rate applies on the capital gain from the alienation of a share (Section 27a paragraph 6 Income Tax Act).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The same rules apply as for privately held shares in a joint stock company (AG), including tax on the capital gain to be withheld by the bank, as explained in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Dividend withholding tax amounts to 27.5% (25% if paid to a corporate shareholder), to be withheld by the distributing Austrian company, unless a reduced rate applies under a tax treaty.

Dividends paid to corporations resident in other EU member states falling under the scope of the EU Parent-Subsidiary Directive (company form listed in the annex 2 of the Directive) are exempt from any withholding tax if the EU parent company holds at least 10% of the issued share capital of the Austrian company for an uninterrupted period of at least one year, and if it has sufficient substance in terms of office space and personnel, and conducts operative activity in its state of residence. If the conditions for dividend relief at source are not fulfilled (due to missing substance of the EU parent company or missing certificate of residence), the EU parent company can request a refund procedure with the Austrian tax authority, where it can prove that no case of abuse (directive shopping) is given.

Apart from the general relief for EU companies under the EU Parent-Subsidiary Directive, the Austrian corporate income tax law provides – based on the general Fundamental Freedoms of the EU – for a refund of Austrian dividend withholding tax upon the request of all corporations resident in an EU or EEA country, regardless of the percentage held in the Austrian company and the period of holding (ie, also for portfolio shares in Austrian companies held by the EU or EEA corporation). The refund is only possible in so far as the Austrian dividend withholding tax is not credited in the other member state where the parent company is resident.

Interest income paid from Austrian debtors is subject to a withholding tax of 27.5% (25% in case of corporations as income recipients) under domestic Austrian tax law. However, interest payments to non-residents that are not received via an Austrian permanent establishment of the non-resident are not subject to tax liability and have to be fully relieved in Austria if the recipient is either a non-resident corporation or a non-resident individual resident in a country that is committed to an automatic information exchange with Austria, and if a certificate of residence is provided by the recipient.

Royalties paid to non-resident companies are subject to a withholding tax of 20%, unless a reduced rate applies under a tax treaty or said royalties are exempt from any withholding taxes pursuant to the EU Interest and Royalties Directive.

A special 20% interest rate for non-residents applies to fees for technical or commercial advisory services, even if the provider does not render such services through a permanent establishment in Austria, unless the rate is reduced or the payments are exempt under an applicable tax treaty.

4.2 Primary Tax Treaty Countries

Due to favourable taxation measures granted to EU corporations, many foreign investors invest via EU member states. Austria also has advantageous double taxation conventions with non-EU countries providing for a dividend withholding tax of 0% (eg, with the United Arab Emirates or Bahrain).

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

According to the rather strict case law of the Austrian Supreme Administrative Court, a structure is regarded as abusive if the use of a foreign company does not have a meaningful purpose apart from the channelling of the Austrian dividends or other payments to persons who would otherwise not be entitled to tax relief regarding said payments.

Therefore, mere conduit companies are not accepted by the Austrian tax authorities when it comes to granting a refund of dividend withholding tax or withholding tax for other income categories under a double taxation convention. This is especially the case if the actual beneficial owners of the payments are different persons, but even if this is not the case, there is still a risk that the interposition of a company will not be accepted by the tax authorities if the substantial business reasons and functions of the company cannot be proved. There are various ways to document the economic reasons and functions of a foreign company receiving income from Austria (eg, economic concepts of the group, reinvestment of the income) but if the missing operative character of the non-resident holding company is not obvious, the acceptance will always depend on the overall facts and circumstances.

4.4 Transfer Pricing Issues

All transactions between related parties have to be at arm's length – ie, concluded under the same conditions as between unrelated parties, as defined in Section 6 paragraph 6 of the Austrian Income Tax Act and corresponding to the principle laid down by the OECD in the Transfer Pricing Guidelines. For all companies (and branches of foreign companies) established in Austria, documentation requirements exist for the taxpayers, in order to prove that the transactions with related parties were at arm's length. The documentation should demonstrate in a clear manner that the group has complied with the arm's-length principle. In large transactions, it is important to note that it is recommendable to conduct a transfer pricing study (or benchmark study).

Transfer pricing rules are particularly relevant for large service providers rendering services in Austria or trading activities via Austria, and for transactions in connection with intellectual property rights. Likewise, in the context of intra-group financing, inbound investors should bear in mind the potential restrictions to interest deduction. Currently, there are no statutory thin-cap rules in Austria, so arm's-length inbound financings are accepted in principle (ie, if the Austrian company is not effectively in default or extremely under-capitalised and the financing would have been concluded under the same conditions with an unrelated third party).

Austrian group companies with an annual turnover of more than EUR50 million in two consecutive years (or EUR5 million in commission fees from the principal) have to prepare a master file and/or local file. The content of the master file corresponds to the description contained in Annex I to Chapter V of the OECD Transfer Pricing Guidelines. The core information to be included in the local file is described in Annex II to Chapter V of the OECD Transfer Pricing Guidelines.

Large multinational enterprises with consolidated group turnover of at least EUR750 million must additionally take part in country-by-country reporting. In general, the ultimate parent company of the multinational must annually file the country-by-country report with its tax administration, which then distributes it to all participating jurisdictions where entities of the multinational have been set up.

4.5 Related-Party Limited Risk Distribution Arrangements

In an Austrian distribution company, high importance has to be placed on an arm's-length remuneration to be paid by the foreign principal to the Austrian distributing company, which has to correspond to the risks and functions borne and the assets employed by the distribution company. Furthermore, it has to be noted that Austria follows the two-taxpayers approach in cases of limited risk distributors, as is advocated in the OECD Model Tax Commentary on Article 7 OECD Model Tax Convention and suggested in BEPS Action 7. Accordingly, an agent acting for the foreign principal constitutes a permanent establishment as a dependent agent in Austria. Therefore, if a foreign company sells goods via subsidiaries or other affiliates in Austria that do not assume the responsibility of a fully fledged distributor, close attention needs to be devoted to the arm's-length principle.

The Double Taxation Convention between Austria and Germany provides a special rule whereby the creation of a permanent establishment of the principal (via an Austrian distribution entity as its dependent agent) is generally avoided by the payment of an adequate remuneration to the Austrian distribution entity for its distribution services. It is unclear, however, whether this could avoid the existence of a permanent establishment (PE) of the principal in Austria in all cases of limited risk distributors.

Austria also assumes the creation of a principal's dependent agency PE in cases of commissionaire structures, which are also targeted by the BEPS recommendations. It is advisable to check in the MLI for the adaption of double taxation conventions whether a revised definition of "permanent establishment" is provided for the particular country in that regard. This is not the case with Austria, because the Austrian Ministry is of the opinion that this interpretation was already possible based on the original wording of the OECD Commentary.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

As far as is known, the Austrian Ministry's interpretation of the transfer pricing rules does not deviate significantly from the OECD standards. In particular, the Austrian Ministry of Finance follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. In addition, several decrees and the Austrian Transfer Pricing Guidelines 2010 have been issued by the Austrian Ministry of Finance in accordance with the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

To settle or prevent disputes arising from transfer pricing matters, a taxpayer may apply for the following:

- dispute resolution under a double taxation convention following Article 25 OECD Model Tax Convention;
- the negotiation of a unilateral or bilateral Advance Pricing Arrangement (APA) on a rather generic level; or
- dispute resolution following the EU Arbitration Convention (90/463/EEC).

Since September 2019, taxpayers may also lodge dispute settlement complaints regarding the interpretation and application of intra-EU double taxation conventions in accordance with the implementing provision of Directive 2017/1852/EU. During this procedure, the member states involved are encouraged to find a common solution within two years, which constitutes an enforceable decision for the taxpayer concerned. If no such agreement is reached, arbitration proceedings must be carried out. The final decision by the advisory committee then binds the member states involved, if no agreement can be reached within a further six months.

However, the Austrian tax authorities do not provide public figures regarding the exact number of disputes solved through the above-mentioned measures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

In the case of primary adjustments provided to a related party by the tax authorities of another contracting state, the Austrian tax authority in charge is – in principle – obliged to re-open the Austrian tax of the Austrian related party, in order to make a corresponding (compensating) adjustment. A compensating adjustment (reduction of Austrian taxes after mark-up in the other state) can be made either upon the request of the Austrian related party (subject to the condition that said party can prove the correctness of a transfer pricing correction made in the other contracting state) or ex officio.

If double taxation remains due to diverging interpretations of the double taxation convention by the contracting states, a mutual agreement procedure between Austria and the other contracting state can be initiated (see also **4.7 International Transfer Pricing Disputes**). Basically, the request for such mutual agreement procedure has to be made by the parent company in its residence state or in either of the residence states in transactions between sister companies. Based on the EU Arbitration Convention, the arbitration procedure should be able to be initiated in either of the member states.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Generally, there are no differences between the taxation of corporations resident in Austria and Austrian branches of non-resident corporations. It needs to be determined whether the branch qualifies as a permanent establishment under the applicable double taxation convention with the residence state of the company, and which income needs to be allocated to the permanent establishment in relation to the head office of the company located in the residence state.

The "separate entity rule", which requires similar treatment of branches and resident companies in all respects, as advocated by the Authorised OECD Approach of 2010 (Report on the Attribution of Profits to Permanent Establishments), has not been implemented in any of the Austrian bilateral tax conventions so far, which leads to differences compared to subsidiaries (regarding financing or the letting of intangibles between the head office and the branch).

As the separate entity approach has not yet been implemented in any of the Austrian bilateral tax conventions, interest expenses for debt granted by the foreign head office of the company to its Austrian branch will not be fully deductible at the level of the Austrian branch. Conversely, no (fictitious) interest income will have to be taxed by the Austrian branch for financial means granted by the Austrian branch to its foreign head office (unlike how the French Supreme Court has ruled for the French tax law). Accordingly, the usual methods for the allocation of interest expenses to the Austrian branch can be used (eg, the capital allocation method).

5.3 Capital Gains of Non-residents

Capital gains realised by a non-resident on a sale of shares in an Austrian company are subject to income tax according to domestic Austrian income tax law, if the shareholding amounts to at least 1% (or amounted to at least 1% within the last five years). Basically, the sale of a company at an upper-tier level (unlike in the case of a partnership structure) does not trigger Austrian taxation as long as the direct shares in the Austrian company are not sold.

If a double taxation convention is applicable between the country of the alienating shareholder and Austria, which follows the OECD Model Tax Convention, Austria does not have a taxing right on the capital gain derived by the non-resident from the sale of the shares in the Austrian company.

However, capital gains will be subject to taxation in Austria if the convention deviates from the OECD Model Tax Convention (eg, DTT Austria-France for participations of more 25% or more) or if the company mainly owns domestic real estate and the double taxation convention contains a real estate clause along the lines of Article 13 paragraph 4 of the OECD Model Tax Convention.

5.4 Change of Control Provisions

In a substantial change in the direct shareholder structure (ie, if more than 75% of the shareholders change) against consideration together with substantial changes in the economic and management structure, tax loss carry-forwards are no longer available at the level of the Austrian company. A substantial change in the economic structure is deemed to have occurred if the company's activity significantly decreases in terms of assets, income or other economic operators. A substantial change in the management structure is deemed to have occurred if more than the half of the company's managers are replaced. An exception applies if the share sale serves the restoration of a company. Special rules apply for corporate reorganisations, where the situation of all companies involved needs to be taken into account.

RETT is triggered in a sale of 95% or more of the shares in an Austrian company or partnership holding Austrian real estate, amounting to 0.5% of the market value of the Austrian real estate. It has to be noted that there are grandfathering rules in place due to which the transfer of minority shares might also trigger RETT.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formula apportionment is not accepted as a method of determining the profits of an Austrian affiliated enterprise. The transfer pricing methods accepted by the OECD Transfer Pricing Guidelines can be used to allocate income to Austrian affiliated enterprises. Apart from the comparable controlled price method, this refers especially to the other standard methods like the cost-plus or the resale minus method, as well as the transactional net margin method.

5.6 Deductions for Payments by Local Affiliates

There are no specific rules regarding the deduction of payments made by an Austrian (resident) affiliate to a non-Austrian (non-resident) affiliate for the management of the Austrian (resident) affiliate.

When determining remuneration for the services rendered by a foreign affiliate, the arm's-length principle must be considered, taking into account the functions and risks borne by the foreign affiliate.

Usually the cost-plus method is accepted for routine services – ie, the costs of the services plus a certain mark-up to be charged to the Austrian affiliate. A mark-up of more than 5% can be applied only for high-quality services. A cost allocation without a profit margin is possible and even required for ancillary services – ie, services that do not belong to the business focus of the affiliate rendering the services.

5.7 Constraints on Related-Party Borrowing

Borrowing by an Austrian subsidiary from a non-Austrian parent company or other affiliated company abroad is subject to the arm's-length principle – ie, an arm's-length interest income will need to be allocated and subject to corporate income tax at the level of the Austrian subsidiary.

To determine the interest rate, a comparison with third-party banks is possible. The Austrian Ministry of Finance holds that a direct comparison of the lender with an Austrian bank is not always adequate, as the aims of banks and intra-group financings are different. Whereas the bank's business is to achieve profits from the borrowing of loans to the market, the aim of intra-group financings is to safeguard liquidity and optimise the group internal financing structure. As a consequence, the Austrian Ministry of Finance does not accept that a borrowing group entity charges a rate as high as the rate a bank would have charged to its customers. The effective interest rate applied for intra-group financings depends on various circumstances – eg, the liquidity of the Austrian company (the higher the liquidity, the lower the interest rate), the interest rates that would be offered to the foreign affiliate from Austrian and/or foreign banks, and whether the Austrian company had to refinance the loan.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Austrian corporations are subject to corporate income tax in Austria on their worldwide income. Income that originates from foreign sources may be relieved under a decree of the Ministry of Finance for the unilateral avoidance of international double taxation. The relief takes the form of either a credit of foreign taxes or an exemption in the case of certain active income (eg, derived from a permanent establishment abroad or income from foreign real estate), which is effectively subject to certain taxation abroad (ie, more than 15%). If a double taxation convention applies, the rules thereof take precedence over the unilateral relief measures. However, due to the entering into force of CFC rules on 1 January 2019, the exemption of foreign permanent establishments' profits is no longer applicable in the case of double taxation conventions regarding low taxed foreign permanent establishments (lower than 12.5%).

6.2 Non-deductible Local Expenses

Expenses incurred for business purposes are deductible at the level of the Austrian corporation, unless they are immediately economically related to tax-exempt income. When an Austrian corporation is regarded as having a permanent establishment outside Austria that is exempt under either the unilateral relief provision (foreign taxation above 15%) or a double taxation convention (foreign taxation above 12.5% as of 2020), the expenses and losses attributable to the foreign permanent establishment are not deductible for the purpose of Austrian CIT and need to be added back to the CIT base.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividend income from foreign corporations is exempt from corporate income tax under the international participation exemption in the following circumstances:

- if the foreign subsidiary is an EU company listed in Annex 2 of the EU Parent-Subsidiary Directive or a foreign corporation comparable with an Austrian company from the corporate law perspective;
- if the participation amounts to at least 10% of the nominal capital; and
- if the participation is held for an uninterrupted period of one year.

The international participation exemption is denied if the foreign company is taxed at a low rate abroad (not more than 12.5%) and mainly derives passive income. In this case, the exemption of the dividend is replaced by a credit of the underlying foreign corporate taxes on the Austrian corporate income tax levied on the dividend (switch-over). Due to the introduction of general CFC rules for foreign subsidiaries, the switch-over provision is no longer relevant for participations of 50% or more, as the scope of CFC legislation applies, so that subsequent distributions shall be tax-exempt under the general conditions of the international participation exemption, as described above.

Dividend income from portfolio participations (participation below 10%) in foreign companies is also exempt from corporate income tax if the foreign company is comparable to an Austrian company and is resident in a country with which Austria has agreed on a comprehensive exchange of information, or is an EU company listed in the EU Parent-Subsidiary Directive, and does not fall under the scope of the international participation privilege. The dividend exemption does not apply on qualified portfolio participations (participation of 5% or more) if the foreign company is taxed at a low rate abroad (not more than 12.5%) and mainly derives passive income.

In general, the exemption of foreign dividends does not apply in a hybrid situation – ie, if the dividend payments are deductible from the corporate income tax base abroad.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by an Austrian corporation may be transferred or let to a non-Austrian subsidiary at arm's-length conditions, resulting in taxable income (transfer price or royalty) at regular rates, which is subject to corporate income tax at the level of the Austrian corporation.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Austria's CFC rules entered into force on 1 January 2019 and are based on the EU Anti-BEPS Directive. They provide for an allocation of non-distributed low-taxed passive income of foreign subsidiaries to the Austrian parent company corresponding to the percentage of the directly and indirectly held shares in the foreign subsidiary.

The CFC rules will apply if the Austrian parent company holds – directly or indirectly, alone or together with associated enterprises – more than 50% of the nominal share capital, voting rights or profit participating rights of the foreign subsidiary, and if the foreign subsidiary is low-taxed and earns passive income.

Austria has made use of the option of the ATAD, according to which CFC legislation shall only apply if the foreign subsidiary's passive income accounts for more than one third of its total income. Therefore, CFC legislation is avoided for a subsidiary if at least two thirds of the subsidiary's income is active.

Low taxation is when there is an effective tax rate abroad of 12.5% or below. Passive income is defined according to the catalogue of Article 7 (2) (a) of the EU Anti-BEPS Directive. Furthermore, there is an exception for foreign subsidiaries with substantive economic activity in certain fields.

6.6 Rules Related to the Substance of Non-local Affiliates

There are strict rules regarding the substance of a foreign company for the relief of dividend payments received from Austrian companies under the EU Parent-Subsidiary Directive (Section 94 (2) Income Tax Act). Accordingly, the EU parent company must have office space and personnel, and must conduct an operative activity, or else dividend withholding tax has to be withheld on the dividends. The same principle applies in substance for the eligibility of non-resident corporations for relief under double taxation conventions.

Even before the introduction of formal CFC rules, general anti-abuse provisions (which have meanwhile been adjusted to the ATAD) and the substance-over-form approach were applied by the Austrian tax authorities (and are still applicable next to the application of CFC rules) in relation to foreign subsidiaries of Austrian companies. Accordingly, a look-through approach could be applied, and the foreign subsidiary's income directly allocated to the Austrian shareholder in the case of wholly artificial arrangements or if the management was completely controlled by the Austrian shareholder. The general abuse rules will maintain importance even after the implementation of CFC rules, in cases where the CFC rules do not apply (eg, for individuals as shareholders of foreign companies).

As mentioned above, the CFC rules will not apply for foreign subsidiaries with substantive economic activity.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains from the sale or other disposition of a foreign participation are exempt from corporate income tax if the participation fulfils the criteria of the international participation exemption, which is applicable on a participation in a foreign entity (which is either comparable to an Austrian company or a legal form enumerated in annex 2 of the EU parent-subsidiary directive) if the Austrian corporation holds at least 10% of the issued share capital of the foreign corporation for an uninterrupted period of at least one year. The international participation exemption provides for the neutrality of the participation, which means that capital losses and impairments of the participation also have to be treated as neutral for corporate income tax purposes.

There is also an (irrevocable) option to opt for tax effectiveness of the participation in the CIT return of the year of the acquisition of the participation.

The exemption does not apply and is replaced by an indirect credit of the underlying foreign corporate taxes if the foreign corporate mainly generates low-taxed passive income. However, the switch-over provision is only relevant for participations of less than 50%, which are not covered by the general CFC legislation. The switch-over rules do not apply to the extent that profits were already attributed to the controlling entity based on the CFC rules.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

The general anti-abuse provision was adjusted to the ATAD and considers legal schemes to be inappropriate if, disregarding the tax savings involved, they no longer seem reasonable because the essential purpose or one of the essential purposes is to obtain a tax advantage that is contrary to the objective or purpose of the applicable tax law in its entirety. In addition, the Austrian law follows the substance-over-form approach. These two GAAR rules are often used by the authorities to challenge tax structures, intra-group transactions and reorganisations.

The principal purpose test (PPT), as stipulated in Article 6 of the EU Anti-BEPS Directive, was implemented in Austria in 2019. Accordingly, a transaction is regarded as abusive if one of its principal purposes is the saving of taxes. Apart from looking through foreign base companies, this also enables the non-acceptance of income attribution to companies that do not have any business purpose and are only used for the circumvention of Austrian tax rules. This mainly concerns merely artificial structures for which no reasonable explanation can be given except for the saving of Austrian taxes.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

After a tax decree has become final and binding on the side of the Austrian tax office, tax audits can be performed by the tax authorities until the statute of limitation has been reached, usually after five years (with an extension of one year if there are external official acts by the tax authorities within these five years), with a maximum of ten years. There is no audit cycle prescribed by the law, but audits used to take place every three to five years. The frequency of tax audits depends on the business size, with large businesses being audited on a permanent basis.

Since 2019, large Austrian businesses (with an annual turnover of more than EUR40 million) with a high degree of compliance in the past and an appropriate internal control system have the possibility to opt for horizontal monitoring, according to which a constant control by the tax office will replace the traditional system of tax audits (upon election only).

9. BEPS

9.1 Recommended Changes

Regarding BEPS Action 1, the Austrian parliament passed a Digital Tax Act in September 2019, no longer waiting for co-ordinated actions by the EU member states. Under this new act (applicable from 1 January 2020), income from online advertising services of companies exceeding certain turnover thresholds is subject to a 3% digital tax.

As suggested by BEPS Action 2, Austria has implemented legislation to neutralise hybrid mismatches creating mismatch outcomes. These rules entered into force in Austria on 1 January 2020, in line with the Anti-Tax Avoidance Directive ATAD II (EU 2017/952).

As suggested by BEPS Action 3, Austria has implemented CFC legislation, which entered into force in Austria on 1 January 2019, in line with the Anti-Tax Avoidance Directive ATAD (EU 2016/1164).

Austria has introduced the PPT suggested by BEPS Action 6 in its domestic tax law, which also entered into force on 1 January 2019 and adapted the already existing general anti-abuse provision.

BEPS Action 12 was fully implemented by the Austrian legislator in September 2019, in the course of the transposition of the amendment to Directive 2011/16/EU (DAC6). This new regulation (EU-Meldepflichtgesetz) aims for the reporting of certain cross-border structures and transactions to the tax authorities, initially starting from 1 July 2020. However, due to the fact that electronic submissions of reports were not available until 31 October 2020 for technical reasons, the Austrian Ministry of Finance suspended sanctions for a violation of the reporting obligation until 31 October 2020.

Austria has also fully implemented the OECD recommendations on Action 13 regarding the re-examination of transfer pricing documentation.

As recommended by BEPS Action 15, Austria has signed the Multilateral Instrument to Modify Bilateral Tax Treaties (MLI), in the course of which a number of Austrian double tax conventions were adapted in the framework of the MLI to correspond to BEPS.

9.2 Government Attitudes

It is Austria's intention to preferably fully implement the EU directives enacting the BEPS recommendations, as demonstrated, for example, by the four amendments of EU Directive 2011/16 on Mutual Cooperation in the field of taxation as regards mandatory information exchange or the ATAD.

The Austrian government is seeking to achieve a uniform approach, implementing the OECD recommendations in the BEPS Action Plan and at the same time avoiding double efforts that might arise from different approaches at an EU level. Therefore, regarding some of the remaining BEPS Action points to be implemented, it has to be expected that the Austrian measures will conform with the progress on an EU level.

9.3 Profile of International Tax

International tax law is of high importance for Austria as a business location, as a lot of multinationals and international groups of enterprises use Austria as a centre for their activities. As a consequence, the Austrian Ministry of Finance is aiming to establish good relations with other countries in this respect and to negotiate and further extend the Austrian network of double tax treaties. This led to a quick adaption of the MLI as provided in BEPS Action 15 and the adoption of the arbitration rules as provided for in BEPS Action 14.

9.4 Competitive Tax Policy Objective

Austria has good connections to the OECD and has itself fostered several initiatives at OECD level, so it can be expected that BEPS initiatives will be implemented quickly by Austria in most cases. This is also shown by the fact that Austria was the first country to submit the ratification instrument of the MLI to the depositary.

9.5 Features of the Competitive Tax System

In Austria, a rather high corporate income tax rate of 25% is combined with a rather modest corporate income tax base, accompanied by modern tax features like a swift group taxation regime, the possibilities of interest deduction and incentives for R&D. However, all of these are not preferential tax regimes and are not vulnerable to the BEPS approach.

9.6 Proposals for Dealing with Hybrid Instruments

On the one hand, the existing regime provides for the denial of the exemption of foreign dividends at a company level if the dividends are tax deductible in the state of the paying entity (Section 10 paragraph 4 CITA). On the other hand, the deduction of interest and royalties as a business expense is denied in Austria for payments to affiliated parties that are subject to low taxation below 10% abroad (Section 12 paragraph 1 sub-paragraph 10 CITA).

In addition to these existing provisions, proposals for dealing with hybrid mismatches have been implemented from 1 January

2020, targeting the neutralisation of so-called D/NI (Deduction/No Inclusion) and DD (Double Deduction).

9.7 Territorial Tax Regime

Austria's tax regime provides for the worldwide taxation of residents. However, due to the double tax treaty network, residents' income generated in foreign establishments may be exempt from tax. This is adapted by CFC rules in the case of passive low-taxed income of not more than 12.5% (in this context see also **2.5 Imposed Limits on Deduction of Interest** regarding the interest barrier rule).

9.8 CFC Proposals

The inclusion of foreign permanent establishments located in other states is certainly a treaty override, if an applicable double taxation convention provides for the exemption of the foreign permanent establishment in Austria. Still, it is not assumed that this argument will prevent the application of the CFC rules on foreign permanent establishments in Austria. Changing the CFC rules at an EU level by restricting them to a blacklist of countries may be an alternative, but this was not provided in the ATAD. Regarding the possibilities of the ATAD, Austria opted for the catalogue of passive income (Article 7 (2) a ATAD) and not the option of inadequate arrangements (Article 7 (2) b ATAD).

9.9 Anti-avoidance Rules

Austria did not implement the limitation on benefits rules as provided in Action 6 of the BEPS initiative.

However, Austria did implement the PPT rule, which, according to the explanatory notes of the relevant tax bill, is intended to be interpreted along the lines of the ECJ's case law on the abuse of tax law. In the past, the Austrian Supreme Administrative Court used that same interpretation regarding the existing GAAR, which might indicate that the impact of the PPT rule is not expected to be high.

9.10 Transfer Pricing Changes

The transfer pricing changes proposed by BEPS Actions 8–10 largely correspond to the Austrian view of the OECD Transfer Pricing Guidelines, so not much need for adaptions is seen here. As regards the identification of intangibles, including intellectual property, Austria fully follows the interpretation of the OECD, as it is also laid down in chapter VI of the OECD Transfer Pricing Guidelines 2017.

9.11 Transparency and Country-by-country Reporting

Austria has implemented the special rules for the automatic information exchange on the country-by-country reports for large multinationals (ie, with consolidated group turnover of at least EUR750 million for accounting periods beginning on or after 1 January 2016), as provided for in BEPS Action 13. Due to the required size of the multinational enterprises, the Ministry of Finance expects that this obligation will only concern around 90 business entities in Austria.

The directives for the automatic exchange of information on tax rulings and on money laundering have been implemented in Austria. The EU-wide mandatory disclosure directive (2018/822/EU) amending Directive 2011/16/EU (DAC6), according to which taxpayers and their intermediaries have to report cross-border tax transactions, has been implemented with Austria's own regulation (see also **9.1 Recommended Changes**).

9.12 Taxation of Digital Economy Businesses

In March 2018, the EU Commission published two drafts for directives regarding the enactment of a digital service tax (as a short-term solution) and of digital PEs (as a long-term solution). Austria has so far made no further specifications regarding the provision for digital PEs.

9.13 Digital Taxation

In January 2019, the Austrian Federal Government announced that it would no longer wait for co-ordinated actions regarding digital taxation by EU member states, but would introduce unilateral measures. Consequently, in September 2019, the Austrian parliament passed a Digital Tax Act targeting online advertising services rendered against consideration in Austria. The aforementioned services are subject to a 3% digital tax, but only for companies exceeding certain thresholds for turnover from online advertising.

9.14 Taxation of Offshore IP

Despite the withholding tax provisions regarding income from royalties, there are currently no other provisions dealing with the taxation of offshore intellectual property.

bpv Huegel has been one of the largest and most renowned high-end tax law practice groups in Austria for decades. The firm pays special attention to the dual qualification of practice group members as lawyers and tax advisers. The team regularly advises in tax disputes on tax audits and pre-litigation settlements, as well as on fiscal criminal law matters, voluntary disclosures with penal waiver effect and internal investigations. It represents clients in proceedings before the Federal Fiscal Court, the Administrative and Constitutional Court and the Court of Justice of the European Union. The firm also focuses on rulings and the evaluation of tax risks for tax litigation and tax insurance.

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BELGIUM

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Most businesses adopt a corporate form, not only for tax reasons but also, and often primarily, for the benefit of limited liability. The most commonly used Belgian corporations offering limited liability are the closely held company (bv in Dutch; sp in French) and the limited liability company on shares (nv in Dutch; sa in French). Businesses not incorporated in the form of a limited liability company are either sole proprietorships or contractual arrangements offering no separate legal personality and no limited liability. These are all tax transparent, whereas corporations – even these that do not have limited liability – are taxed as such under the Corporate Income Tax (CIT) rules, which are part of the Income Tax Code of 1992 (ITC92).

1.2 Transparent Entities

Civil partnerships are often utilised to structure family assets (such as shareholdings, art collections and real estate), with a view to parents keeping control while all or part of the value is transferred to the next generation(s), and also in the construction industry to make a consortium to execute a large construction project. Economic Interest Groupings (EIG) or European Economic Interest Groupings (EEIG) are utilised to structure the supporting and/or ancillary activities (for the benefit) of two or more taxpayers. If taxpayers of several EU member states are participating in the Interest Grouping, an EEIG will be chosen; if only Belgian taxpayers are participating, or if non-EU taxpayers are participating, an EIG will be chosen. Otherwise, both types of Interest Groupings are governed by the same rules. If an EIG with non-Belgian members or an EEIG is established in Belgium, it should not create a permanent establishment in Belgium for the non-Belgian participants.

1.3 Determining Residence of Incorporated Businesses

Corporations are tax resident in Belgium if either or both of the following is located in Belgium:

- the place of effective management; or
- the principal place of business of the corporation.

Transparent entities are not subject to corporation tax, so the determination of their tax residence is not relevant. For civil law purposes, Belgian law will apply if the entity is governed by the relevant Belgian laws, provided the Belgian conflict-of-law rules do not make any other jurisdiction competent as governing law.

1.4 Tax Rates

Corporate taxpayers are taxed at the rate of 25%. Small and medium-sized enterprises (SMEs) are taxed at a rate of 20% on the first EUR100,000 of net taxable income (subject to certain conditions). Individuals are subject to a progressive scale of Personal Income Tax on the net income of their business: a first tranche of progressively taxable income is taxed at 0%, the next tranche at 25%, and so on. As soon as the total income that is taxable at the progressive rates exceeds approximately EUR41,060 (per annum), the top rate of 50% kicks in. Personal income tax rates are subject to a municipal surcharge of, typically, 5-10%, increasing the aggregate top rates to approximately 52.5-55%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The accounting profits are the basis for determining the taxable income of a corporation. On the one hand, there is an exhaustive list of non-deductible items, which are added back to the accounting profits (eg, most fines, most local taxes, the CIT itself, the non-deductible part of automobile costs, etc). A number of tax-exempt items are added to the retained earnings measured on the first day of the taxable year, so that the increase of retained earnings diminishes (or the decrease grows) (eg, tax-exempt capital gains on shares that qualify for the participation exemption). Finally, a number of specific tax attributes and tax incentives are deducted, such as dividends that are deductible by virtue of the participation exemption, net profits of permanent establishments that are exempt in Belgium by virtue of bilateral tax treaties, the Notional Interest Deduction, etc. Corporate taxpayers are taxed on an accruals basis.

2.2 Special Incentives for Technology Investments

In terms of CIT, two beneficial regimes exist in parallel:

- the old Patent Income Deduction, which allows a deduction of 80% of gross income from the exploitation of patents developed or improved in Belgium (applicable until 30 June 2021); and
- the new Innovation Income Deduction, which allows a deduction of 85% of qualifying innovation income determined in accordance with the OECD's nexus rules.

On wages for qualifying scientific workers, 80% of the statutory amount of Wage Withholding Tax does not need to be transferred to the tax collector, substantially reducing the "cost to company" for employing such workers.

2.3 Other Special Incentives

Belgium has an attractive tax regime for the financing of audiovisual and certain other creative works, allowing corporate investors in such projects to deduct their investments from their taxable income, up to certain thresholds. Belgium also has an EU-proof tonnage tax regime in place for the shipping industry. For the diamond industry, Belgium applies a so-called carat tax that offers a relatively low – to some extent notional – tax base for diamond traders. Group finance (or treasury) centres enjoy a beneficial regime for computing the 5:1 thin cap interest limitation (by netting interest owed or paid against interest earned or received). The Notional Interest Deduction – allowing Belgian corporate taxpayers to deduct from their taxable income an amount equal to a set percentage of their equity as if it were interest-bearing debt – was overhauled at the end of 2017 and is no longer considered to be an attractive tax incentive for taxpayers with high amounts of equity on their balance sheets.

2.4 Basic Rules on Loss Relief

Belgium allows Net Operating Losses (NOLs) to be carried forward with no time limits (no carry back). However, certain tax deductions, including NOLs carried forward from previous tax years, go into a basket and current-year profits over EUR1 million can be reduced by no more than 70% of the basket, leading to a minimum taxable income of 30% of the basket on income over EUR1 million. With the exception of capital losses on shares, capital losses are deductible from current income, as capital gains (again, with the exception of capital gains on qualifying shares) are taxable as ordinary income (albeit that the taxation of capital gains on fixed assets can be deferred, under strict conditions).

2.5 Imposed Limits on Deduction of Interest

Interest on non-mortgage loans with no fixed term – other than those paid to affiliated companies under a framework agreement for centralised treasury management within a group – is limited to the MFI interest rate published by the National Bank of Belgium (for loans up to EUR1 million with a variable rate and an initial interest rate up to one year provided to non-financial corporations), raised by 2.5%. All other kinds of interest must meet the arm's-length standard in order to be fully deductible. Any excessively high interest is not tax-deductible.

Then there is a 5:1 thin cap rule, whereby interest paid or owed, directly or indirectly, to related parties and/or lenders based in tax havens is deductible only to the extent that the tainted loans do not exceed five times the taxpayer's equity. Finally, the ATAD-compliant interest limitation rule has been transposed into Belgian national law, limiting the deduction of the "exceeding borrowing cost" (which is the positive difference between (i) all interest and other costs being economically equivalent to interest that are considered as a business expense, and (ii) any interest and other financial income being economically equivalent to interest that is included in the profits of the tax year and not exempt from tax in Belgium by virtue of a tax treaty) to either EUR3 million or 30% of the taxpayer's Belgian EBITDA, whichever is higher.

2.6 Basic Rules on Consolidated Tax Grouping

Under the so-called group contribution regime, corporate taxpayers that are 90% or more directly related (parent and subsidiary; sisters of the same common parent company) will be allowed to form a group, and a profitable member of the group will be allowed to transfer a portion of its profits to a loss-making member of the group, which will then remain effectively untaxed due to compensation with losses by the recipient entity. The entity transferring such profits will be required to pay the recipient company an amount in lieu of the CIT that it would have paid in the absence of the group contribution; this payment is not tax-deductible for the payer and not taxable for the recipient. This compensation has to be actually paid and cannot be booked as a debt. More specific details are explained in a circular letter, providing more certainty on matters such as the treatment of the compensation with foreign losses.

2.7 Capital Gains Taxation

In principle, capital gains are taxed as ordinary profits. The first exception is capital gains on qualifying shareholdings (as part of the participation exemption regime), which are 100% tax-exempt if the shareholding represents at least 10% of the share capital of the underlying company or has an (historic) acquisition value of at least EUR2.5 million, and has been maintained for an uninterrupted period of at least one year immediately preceding the disposal. The second exception is that capital gains on tangible fixed assets can be deferred, provided that the assets were on the taxpayer's balance sheet and have been depreciated for at least five consecutive taxable periods, and that the entire proceeds of the disposal – not only the capital gain – are invested into qualifying depreciable assets in Belgium or an EEA member state within three (or five) years following the realisation of the gain. The qualifying capital gain is not (immediately) taxed but is deducted from the tax base of the assets in which the proceeds of the disposal are re-invested. Depreciations will then only be allowed on this reduced tax base, resulting in the taxation of the temporarily exempt capital gain over time, as the newly invested assets are depreciated. This temporary exemption regime is usually referred to as a "rollover".

2.8 Other Taxes Payable by an Incorporated Business

Belgium applies the EU VAT system. A peculiarity is that, at the option of the lessor and the lessee, new buildings can be leased by VAT taxpayers to VAT taxpayers under the VAT regime, which was previously not possible. As a result, the lessor can deduct the input VAT paid on the development and construction of the building. It is expected that this option will be of interest whenever the lessee or tenant is a VAT taxpayer with a full or substantial right to deduct input VAT – ie, most regular commercial and industrial businesses other than financial institutions, insurance companies and investment funds.

Other transactional taxes are mostly "regionalised" and may differ depending on the region where the transaction is situated (Flanders, Brussels Capital Region, or Wallonia). For example, the sale of real estate triggers a real estate transfer tax of 10% in Flanders and 12.5% in Brussels and Wallonia.

The trading (but not the issuance) of shares and bonds and the like is subject to stamp taxes (with a relatively moderate cap per transaction).

Finally, there are – sometimes burdensome – regional and local taxes due on a variety of business activities. For example, many cities and municipalities impose a local tax on hotel rooms, engines, equipment and machinery, etc.

2.9 Incorporated Businesses and Notable Taxes

There are several other taxes that may be due, depending on the business operated by corporations (or unincorporated businesses) and the region where they are operating. For example, businesses selling certain goods packed in plastic or other packaging material (aluminium cans, etc) must pay a "recycling tax". Logistical operators may be subject to a special tax on trucks driving through one of the Belgian regions. In the wake of the financial crisis of 2008, banks are subject to a so-called bank tax. The operation of an "old" nuclear power plant is also subject to a "nuclear tax".

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Because of the high marginal tax rates in the personal income tax system (over 50% on any aggregated income in excess of approximately EUR41,060 per year), inter alia, most businesses opt for incorporation, taking advantage of the lower CIT rates of 25% and 20% for the first tranche of EUR100,000 of taxable profits for SMEs.

3.2 Individual Rates and Corporate Rates

The distribution of profits in the form of dividends triggers a dividend withholding tax of 30% (a lower rate may be available under certain conditions), which is the final tax for a Belgian resident individual shareholder.

3.3 Accumulating Earnings for Investment Purposes

In essence, the most significant rule that would discourage the accumulation of earnings in a corporation (instead of distributing earnings in the form of wages/salaries or dividends) is the fact that capital gains on investment assets are taxable in the hands of corporate taxpayers, whereas capital gains on privately held investment assets (shares and other securities, real estate, etc) are normally tax-exempt in the hands of private individual taxpayers.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends, including liquidation gains, are taxed at 30%. If the distributing company is established in Belgium, this 30% will be levied in the form of a dividend withholding tax, which is the final tax for the individual shareholder. For dividends stemming from non-Belgian shares, either the Belgian financial intermediary will levy the 30% withholding tax, or the taxpayer will be required to declare the dividend income in his or her personal income tax return and pay 30% flat on this income.

Under certain conditions, a reduced rate of withholding or personal income tax may be available.

Capital gains on shares are normally tax-exempt in the hands of private individuals. Exceptions may apply – for example, if the taxpayer, together with his or her close family, owned more than 25% of the share capital in a Belgian company at any time during the five-year period immediately preceding the sale, and the shares are sold to a corporate buyer outside the EEA (the capital gains tax rate would then be 16.5%). Also, so-called speculative gains are taxable (at a flat 33% rate) if the individual shareholder has bought and sold the shares in a speculative way (eg, short holding period, borrowed funds to buy the shares, etc).

In 2019, the Belgian Constitutional Court quashed the so-called securities account tax, and a new securities account tax of 0.15% on securities accounts held by individual taxpayers was introduced in early 2021. The tax is due on securities accounts with an average value in excess of EUR1 million.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The general withholding tax rate is 30%. Lower rates and even exemptions are available – for example, for dividends paid to qualifying parent companies established in countries with which Belgium has a bilateral tax treaty in force or for interest paid to so-called financial holding companies. Subject to certain conditions, a 15% or 20% rate applies to dividends paid by SMEs and related to shares issued in remuneration for a contribution in cash that took place after 1 July 2013. SMEs can also opt to create a so-called liquidation reserve that gives rise to an extra 10% corporate income tax due from the company, with no additional withholding tax due from the shareholder upon the liquidation of the company. Dividends paid out of this liquidation reserve prior to the liquidation of the company give rise to a 20% withholding tax if the distribution occurs within the five years following the creation of the liquidation reserve, and 5% if the distribution occurs after five years. A 15% rate applies to dividends paid by certain real estate investment companies.

4.2 Primary Tax Treaty Countries

Foreign investors in Belgian stock sometimes make use of (interposed) holding companies in Luxembourg or Hong Kong, among other locations, because a zero rate of Belgian withholding tax is available, and dividends leaving Luxembourg and Hong Kong are, by default or subject to further planning, exempt from withholding tax. The Belgian tax authorities will scrutinise these structures and refuse the zero rate in any case of clear treaty shopping. For interest-bearing instruments, the Netherlands and Luxembourg are sometimes used for the same reasons, but also with the same caveat for treaty shopping.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

As mentioned above, the Belgian tax authorities will scrutinise these structures and refuse the zero rate in any case of clear treaty shopping. In several advance tax rulings, the Ruling Commission has listed a number of criteria to test the reality and substance of interposed companies in jurisdictions such as Luxembourg.

4.4 Transfer Pricing Issues

Belgium will pay special attention to all significant internal dealings, such as the purchase and sale of raw materials and semi-finished or finished goods to and from related parties, but also to interest rates on intercompany loans and other financial arrangements and services provided by or to Belgian corporate taxpayers to or by non-Belgian related parties or parties (even unrelated) that are subject to no or low effective taxation.

4.5 Related-Party Limited Risk Distribution Arrangements

In the past, most limited risk distribution arrangements (eg, commissionaire structures) were commonly used and not aggressively scrutinised by the Belgian tax authorities, but this is rapidly changing, especially since Belgium decided in 2017 to opt in to the MLI provision on commissionaire structures (Article 12). Practitioners generally advise taxpayers to apply for an advance tax ruling from the Ruling Commission in order to prevent any dispute with the tax auditors afterwards.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Belgium has adopted a somewhat far-reaching version of the Country-by-Country Reporting standard (BEPS Action 13), inter alia, by imposing CbC reporting for financial years starting on or after 1 January 2016. Other than this, the OECD standards are by and large adopted.

4.7 International Transfer Pricing Disputes

At the time of writing, there is no statistical data on the frequency of transfer pricing dispute resolution through double tax treaties and mutual agreement procedures (MAPs). However, these instruments were recently promoted by the Belgian Federal tax authority as key elements in dispute resolution. It is understood that the MAP process is still viewed as rather the odd-one-out in the field of dispute resolution since most tax officials have not had any experience with it yet. However, in 2020, the Belgian Federal tax authority decided to increase the capacity of its staff specialising in this matter, so there may be a fresh wind on this in the near future.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

There is currently little or no experience in Belgium of compensating adjustments in connection with transfer pricing claims; how this will work out in practice remains to be seen.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

By and large, local Belgian branches are taxed on an equal footing with Belgian subsidiaries, with the only major exception being that Belgium does not levy any "branch profits tax" in lieu of the dividend withholding tax to which Belgian subsidiaries are subject when distributing dividends to their parent companies or non-resident (corporate) shareholders.

5.3 Capital Gains of Non-residents
Belgium does not impose (capital gains or other) tax on the sale of stock in a Belgian company by non-resident corporate shareholders. In exceptional circumstances, non-resident individual shareholders may be subject to Belgian capital gains tax on the sale of stock in Belgian companies, but not as a general rule.

5.4 Change of Control Provisions
Belgium does not have any change of control provisions that would apply to the disposal of an indirect holding in a Belgian corporation higher up the non-resident group or parent company. However, Belgium does have change of control provisions limiting the use of certain tax attributes – especially NOLs – by the Belgian corporation itself upon the occurrence of a change of control, unless such change of control is motivated by bona fide financial or economic reasons.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
Minimum taxable profit formulas are used for non-resident taxpayers operating in Belgium through a branch only if no tax return is filed, if the tax return is filed late, or if the bookkeeping is not in accordance with normal business practices. A comparison will then be made with at least three comparable taxpayers and an absolute minimum of EUR40,000 of taxable profit per year will be applied.

5.6 Deductions for Payments by Local Affiliates
Belgium does not have specific standards for determining the deduction for payments by local companies for management and administrative expenses incurred by non-local affiliates. Any reasonable formula (based on sales, staff, or any other reliable criteria) can be used.

5.7 Constraints on Related-Party Borrowing
Belgium has a 5:1 thin cap rule in place to limit the amount of deductible interest paid or owed by a local company – whether foreign-owned or not – to non-local ultimate beneficiaries. The interest on such loans (as well as on direct or indirect loans from lenders based in tax havens) is only deductible to the extent the tainted loans do not exceed five times the Belgian borrower's equity. In addition, for interest paid or owed directly or indirectly to tax-exempt or low-tax lenders, the burden of proof regarding the reality of the loans and the arm's-length character of the interest rate is reversed; if the Belgian tax authorities reject the deductibility of such interest, it is up to the taxpayer to prove that the loans are real and genuine, and that the interest rate is at arm's length.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Belgian resident corporations are taxed on their worldwide income, unless Belgium's right to impose tax is limited by any provisions of a bilateral tax treaty. The rule whereby foreign-source income that was not exempt in Belgium by virtue of a bilateral tax treaty was reduced to one quarter of the normal Belgian tax rate was repealed several years ago. Under specific circumstances, Belgium allows a foreign tax credit for dividends, interest and royalties that were subject to withholding tax in the source country.

6.2 Non-deductible Local Expenses
There are no specific rules in Belgium to attribute costs or expenses to foreign income that is exempt from corporation tax in Belgium pursuant to the application of a bilateral tax treaty provision. For example, interest on a loan to acquire foreign real estate is not non-deductible by default, even though the income from such real estate will normally be exempt in Belgium by virtue of the applicable tax treaty (if any).

6.3 Taxation on Dividends from Foreign Subsidiaries
In principle, dividends from subsidiaries (foreign or Belgian) are taxed in the hands of a Belgian corporate shareholder but, subject to several conditions, such dividends will be 100% deductible by virtue of the dividends-received deduction.

The main conditions for the dividends-received deduction to apply are that the participation must be at least 10% in the share capital of the subsidiary, or must have an historic acquisition value of at least EUR2.5 million, and that such participation must have been maintained for an uninterrupted period of at least one year (not necessarily prior to the distribution of the dividend). In addition, a complex subject-to-tax test applies to prevent dividends that have not been sufficiently taxed at the level of the subsidiary from being exempt in Belgium.

6.4 Use of Intangibles by Non-local Subsidiaries
Please see **2.2 Special Incentives for Technology Investments** and **9.4 Competitive Tax Policy Objective** regarding the two sets of specific rules to tax income from intangibles developed by local corporations (and that may or may not be used by foreign subsidiaries). Other than that, the normal transfer pricing rules apply, which require the foreign subsidiaries to pay arm's-length royalties or other remuneration for the use of such intangibles (as long as they are owned or licensed by the Belgian corporation). Also, the transfer of a locally developed intangible to a foreign affiliate will be required to be made on arm's-length

terms, and a (taxable) gain may have to be recognised and will be taxed in Belgium accordingly.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

At the end of 2017, Belgium introduced CFC rules that are mostly in line with the EU's ATAD. However, practitioners are of the view that those rules will rarely apply because an arm's-length attribution of income to Belgium will normally follow from the application of the transfer pricing rules.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no specific rules in Belgium to determine the substance of non-local affiliates, except the guidelines derived from a number of advance tax rulings in connection with interposed (mostly finance) companies in Luxembourg or other jurisdictions where interest, dividend or royalty income can, with some planning, be taxed at a low effective rate. These criteria are quite formalistic (book-keeping, office space, knowledgeable local directors, complying with local tax and company laws, etc). This does not mean that the syphoning off of "Belgian" profits to letterbox companies in low-tax jurisdictions will not be challenged on the basis of lack of substance in such jurisdiction, or even on the basis that such companies are effectively managed in Belgium and their profits are, therefore, subject to corporation tax in Belgium.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Under appropriate circumstances, Belgium exempts capital gains on shares in Belgian or non-Belgian affiliates. The conditions for this capital gains exemption are, by and large, the same as those that apply to the dividends-received deduction (see **6.3 Taxation on Dividends from Foreign Subsidiaries**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Belgium has a General Anti-Abuse Rule (GAAR) in place. Transactions that are set up with the sole or predominant aim of benefitting from an advantageous tax rule (eg, a deduction, exemption, deferral, etc) or avoiding the application of a disadvantageous tax rule can be re-characterised by the tax authorities such that the advantageous rule is denied or the disadvantageous rule takes effect. If the tax authorities make such assertion, the taxpayer has the right to demonstrate that he or she had substantial non-tax motives for entering into the transaction the way it was set up.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

In principle, Belgian corporate taxpayers are audited every other year. In most instances, corporate tax and VAT audits will be conducted simultaneously. Especially for larger taxpayers, data mining will be used to seek "suspicious" elements that would warrant a more thorough audit. There is a special audit team that focuses on transfer pricing; this team can identify potential targets on its own (with the help of data mining) or it can be informed by the local tax inspectorate if the latter believes that the taxpayer may have substantial transfer pricing issues. If there is a suspicion of fraud or aggressive tax abuse, the Special Investigation Service may start its own investigation, independent from the local tax inspectorate.

9. BEPS

9.1 Recommended Changes

The following BEPS recommended changes have already been implemented:

- Action 2 (anti-hybrid rule and anti-abuse rules);
- Action 3 (CFC regulation);
- Action 4 (financing cost surplus);
- Action 5 (innovation income deduction + common reporting standard);
- Action 6 (prevention of tax treaty abuse, implemented in Belgium through MLI);
- Action 7 (definition of "permanent establishment");
- Actions 8-10 (transfer pricing);
- Action 12 (mandatory disclosure of aggressive tax planning schemes);
- Action 13 (master file and local file reporting);
- Action 14 (participation in the mutual agreement procedure); and
- Action 15 (MLI).

9.2 Government Attitudes

The Belgian coalition government is generally in favour of BEPS – and the EU version of BEPS, ATAD I and ATAD II – and is seeking to comply with it without much "gold plating". Belgium wants to stay competitive for attracting inward investments from the most significant trading partners, such as the USA, Japan, Canada, Germany, France, etc.

9.3 Profile of International Tax

Since the publication of LuxLeaks, Panama Papers and similar reports, the public interest in international tax has grown substantially, which certainly increases pressure on the present coalition government to close a number of international loopholes (with BEPS-compliant anti-hybrid measures, the introduction of a BEPS-compliant interest limitation rule, etc). Please note that the EU Court of Justice has dismissed the "Excess Profit Rulings" case brought by the EU Commission against Belgium. The "Excess Profit Rulings" are not to be considered as prohibited state aid.

9.4 Competitive Tax Policy Objective

The Belgian legislator has already transposed the BEPS and ATAD measures without much "gold plating", to create a level playing field with other jurisdictions that offer similar non-tax benefits to potential or existing inward investors. A good example is the overhaul of the Patent Income Deduction (now nicknamed: Innovation Income Deduction), which includes the nexus-rule imposed by BEPS but widens the scope compared to the former regime and covers, inter alia, copyright-protected software (under the former regime, only income from patents was eligible for the beneficial regime, which entailed an 80% exemption of qualifying gross income, whereas the new regime exempts 85% of qualifying net income).

Also, the headline CIT rate has been reduced to 25%, in order to be competitive with jurisdictions such as the Netherlands and Luxembourg, which are often competing for the same inward investments as Belgium.

In addition, Belgium has an interesting tax regime in place for employing highly qualified researchers working in the R&D industry in Belgium by allowing the employer to keep 80% of the wage withholding tax that must normally be transferred to the Revenue Service for itself, thereby substantially reducing the gross cost of employing such workers. Only 20% of the normal wage withholding tax has to be effectively transferred to the Revenue Service, while the employees are entitled to credit 100% against their personal income tax liability.

Yet another strong feature of Belgium's international tax system is the participation exemption, which now exempts 100% of qualifying dividends (up from 95%) and capital gains deriving from qualifying participations in other Belgian or non-Belgian companies.

Last but not least, a well-functioning Ruling Commission allows for reliable advance tax rulings on all kinds of anticipated investments and other transactions (including unilateral and multilateral transfer pricing issues), creating advance legal certainty in areas of law where there would otherwise be a relatively large degree of uncertainty and "litigation risk".

9.5 Features of the Competitive Tax System

The most vulnerable feature of the Belgian (international) tax regime that remains after the transposition of BEPS and ATAD I and II is perhaps the so-called Expat Regime, which essentially provides for an attractive income tax regime for highly qualified workers temporarily seconded to Belgium. This regime is currently under revision, with a view to making it less vulnerable for state aid or other threats.

9.6 Proposals for Dealing with Hybrid Instruments

Belgium has already implemented rules to deal with hybrid instruments, defining what is to be understood by the term "hybrid mismatch".

Tax rules targeting hybrid mismatches cover the following, inter alia:

- hybrid mismatch arrangements – profits of an EU-based establishment realised through such an arrangement and that are not considered taxable in the permanent establishment's jurisdiction will be taxable at the level of the Belgian head office;
- hybrid entities – such entity incorporated or established in Belgium will be considered to be a taxable entity in Belgium if one or more associated non-resident entities is established in one or more jurisdictions that consider the Belgian entity to be taxable. The hybrid entity's income will be taxed in Belgium to the extent that it is not already taxed under the laws of Belgium or any other jurisdiction. This rule does not apply to collective investment vehicles; and
- hybrid mismatch payments – such payments are considered a non-deductible expense for the Belgian payer if the receipt thereof does not give rise to a corresponding inclusion at the level of the non-Belgian recipient.

While these new rules are very technical and complex, they would seem to be compliant with BEPS and ATAD, without causing too much overkill. It remains to be seen, though, how these highly technical rules will pan out in practice.

9.7 Territorial Tax Regime

Belgium does not have a territorial tax regime. A Belgian resident company is liable to CIT on its worldwide profits and income, while a non-resident company is taxed in Belgium on its Belgian-source income only.

9.8 CFC Proposals

Although Belgium has a worldwide tax system rather than a territorial one, it introduced comprehensive CFC rules at the end of 2017, which are mostly in line with the EU's ATAD. Under the Belgian CFC rules, non-distributed profits of a foreign company or establishment are added to the taxable income of a Belgian company/head office if and to the extent that such profits arise from artificial constructions that have been put in place for the essential purpose of obtaining a tax advantage. In line with ATAD, a construction is deemed artificial to the extent that the foreign company or foreign establishment does not own the assets, or does not undertake the risks which generate all, or part of, its income if it were not controlled by a company where the significant people functions that are relevant to those assets and risks are carried out and are instrumental in generating the controlled company's income.

Said CFC rules are defective in two significant ways. Firstly, practitioners are of the view that the rules will rarely apply because an arm's-length attribution of income to Belgium will normally follow from the application of the transfer pricing rules. Secondly, the above CFC rules may create situations of effective double taxation of the same income with different companies of the group. Neither the EU ATAD nor the Belgian implementation thereof determines how double taxation is prevented if Belgium and another member state simultaneously apply their respective CFC legislation.

There are multiple arguments that can be made against the introduction of a sweeper CFC rule into Belgian law. For example, it seems at least unfair to tax income of a foreign subsidiary with adequate substance just because it is a resident of a tax haven. In this respect, it must be noted that the Belgian rule excludes income of the CFC to the extent that it is realised through its own significant people functions.

9.9 Anti-avoidance Rules

In practice, it remains to be seen whether the double taxation convention limitation of benefit or anti-avoidance rules will have an impact in Belgium. In April 2018, Belgium's highest tax court (the Court of Cassation) ruled that income earned by a Belgian-resident sportsman from activities performed in the Netherlands remains tax exempt in Belgium (by virtue of Article 17 of the 2001 bilateral treaty between Belgium and the Netherlands), although the same income had not effectively been taxed in the Netherlands, and notwithstanding the "subject to tax" clause in the 2001 treaty. The inclusion of the subject to tax provision in Article 23(1) was seen as an anti-abuse provision, which should prevent double non-taxation.

9.10 Transfer Pricing Changes

The Revenue Service has increased its attention on transactions whereby IP assets are transferred out of the country. In a notorious case, the Special Investigation Team of the Belgian Revenue Service challenged the transfer of a patent application to a non-Belgian related entity as a "sham". The case was decided in favour of the taxpayer by the Tribunal of First Instance, but the Revenue Service has appealed the case. The Court of Appeal ruled recently again in favour of the taxpayer, stating that the transfer of the patent application had a real substance, rather than being a "sham".

9.11 Transparency and Country-by-country Reporting

Most Belgian practitioners are not opposed to transparency or CbC reporting, with the following stipulations:

- administrative formalities and red tape should be kept within reasonable proportions;
- the additional revenue that is expected to be generated by such systems should lead to a reduction of the headline (corporate) income tax rates and/or paying off Belgium's public debt (which currently exceeds 100% of the country's GDP), rather than to the creation of additional government spending; and
- when taxpayers comply with transparency and CbC reporting rules for several years in a row, they should earn a "compliant taxpayer" label and enjoy less cumbersome and time-consuming tax audits in return.

9.12 Taxation of Digital Economy Businesses

No statutory changes have yet been made, but Belgium supports the OECD's initiatives to consider certain "light" forms of presence in the country as a permanent establishment to which profit has to be allocated (and taxed).

9.13 Digital Taxation

The Belgian coalition government is in favour of a multilateral approach toward digital taxation, preferably in co-operation with the OECD or EU. However, in the absence of a multilateral agreement, the government has stated that it will impose a "digital tax" unilaterally as of 2023. Further details have yet to be announced.

9.14 Taxation of Offshore IP

Belgium has not yet introduced any provisions dealing with the taxation of offshore intellectual property.

De Langhe has four specialised tax attorneys in its tax team, all of whom handle Belgian corporate tax matters and tax litigation matters before Belgian courts, as well as the European courts. The firm is also dedicated to international tax matters, ranging from handling Belgian corporate tax work for inbound investors and assisting with non-Belgian tax work for outbound corporate clients, to handling EU and tax treaty work for all types of corporate clients (mostly advisory, but with some litigious work). The tax team also advises (and litigates) in matters that are directly linked to corporate tax work, such as transfer pricing, employee incentive plans and tax planning for company executives. The firm would like to acknowledge the contributions of Robbe Dumont and Lize De Corte.

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BENIN

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In accordance with the OHADA Uniform Act on the Law of Commercial Companies and Economic Interest Groupings, businesses generally adopt a corporate form.

The alternative forms of corporate structures are as follows:

- Entrepreneurial status: Sole Proprietor (*Statut de l'Entreprenant*);
- SARL – Limited Liability Company (*Société A Responsabilité Limitée*)
- SARL U – Single Person Limited Liability Company (*Société A Responsabilité Limitée Unipersonnelle*);
- SA – Joint Stock Company (*Société Anonyme*);
- SA U – Single Person Joint Stock Company (*Société Anonyme Unipersonnelle*);
- GIE – Economic Interest Grouping (*Groupement d'Intérêt Economique*);
- SP – Joint Venture Company (*Société de Projet)*;
- SNC – *Société en Nom Collectif*;
- Association – Cooperative Society (*Société Coopérative*);
- SAS – *Société par Action Simplifiée*; and
- Civil Companies (*Sociétés Civiles*).

The key differences between the above structures relate to the following:

- the number of partners required;
- the minimum amount of share capital;
- the quality of the company's manager;
- the scope of the partners' liability;
- the scope of directors' liability;
- the method of taxation of profits;
- the deductibility of executive compensation;
- the tax regime of the manager;
- the partners' social regime;
- the decision-making body;
- the representative body;
- whether or not an auditor must be appointed; and
- the mode of transmission of the company.

The entities are taxed as separate legal entities.

1.2 Transparent Entities

Transparent entities commonly used are the SNC, the SP, the GIE, theSole Proprietorship Limited Liability Company and the Civil Company.

The principle of individual taxation applies for these entities.

However, these companies can opt for the corporate tax system.

In the main business sectors, such as telecommunications, banking, insurance, transport and logistics, and for investment groups, the entity commonly used is the SA.

1.3 Determining Residence of Incorporated Businesses

The criteria for determining the residence of incorporated businesses (subject to the application of double taxation treaties) are related to the "permanent establishment" – ie, the fixed place of business through which the company carries on all or part of its activities.

This includes any entity operating in Benin, any entity whose taxation is attributed to Benin by an international convention (treaty) for the elimination of double taxation, and foreign companies that have a permanent establishment in Benin.

According to Article 147 bis of the General Tax Code, permanent establishments are constituted by companies that have the following in Benin:

- a management or operating headquarters;
- a branch;
- a warehouse;
- an office;
- a factory;
- a workshop;
- a mine, oil or gas well, quarry or other place where natural resources are extracted; or
- a facility or structure used for the exploration or exploitation of natural resources.

The following are deemed to be permanent establishments:

- a building site;
- an erection or installation project or surveillance activities carried out on it, when this site, project or activities last more than three months; and
- the provision of services, including the services of consultants, by a company acting through employees or other personnel engaged for this purpose, but only if such activities of this nature continue for the same or a related project in the territory of Benin for a period or periods totalling more than 183 days within any 12-month period.

For transparent entities, the term "fiscal domicile" is used for the members who are individuals (natural persons).

1.4 Tax Rates

Corporate Income Tax

The commonly applied rates are 25% for industries and 30% for other companies, except deposit mining companies.

Beside these rates, profits from research and the operation, production and sale of natural hydrocarbons – including transport operations in the Republic of Benin – are subject to tax on the companies at a rate of between 35% and 45%, according to the clauses of the research and exploitation agreements.

The minimum rates are as follows:

- 0.75% of the turnover for industrial activities, without being less than XOF250,000;
- 1% of turnover for other activities, but not less than XOF250,000; and
- XOF0.6 per litre for petrol stations, but not less than XOF250,000.

In any case, the tax cannot be less than XOF250,000.

It is important to specify that discounts are granted to newly established companies for the first three years of operation (25% in the first year, 25% in the second year and 50% in the third year).

Source Deductions

At the customs cordon, 1% of the customs value of imports is deducted for low-risk companies and 3% for others.

Within Benin, the deduction is 1% with the Identifiant Fiscal Unique (IFU –Tax ID), 5% without IFU and 3% for the liberal professions.

Private companies pay the tax on the benefit according to the following progressive rates, either directly or through transparent entities:

- XOF0 to XOF10 million: 30%;
- XOF10 million to XOF20 million: 35%; and
- more than XOF20 million: 40%.

However, the tax may not be lower than 1% of collectible products or XOF0.6 per litre on the volume of petroleum products sold. This amount may in no case be lower than XOF250,000.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are calculated on the basis of the accounting result, which is subject to tax restatement.

In accordance with the provisions of Article 20 of the General Tax Code, the tax is established each year on the profits made the previous year.

Article 167 of the General Tax Code states that taxpayers are required to close their accounts on 31 December each year, except in the event of the disposal or cessation of activities during the year.

New companies created prior to 30 June are required to end their first financial year on 31 December of the same year. Companies created after 30 June may end their first financial year on 31 December of the same year or 31 December of the following year. The applicable tax is levied on profits made during this period.

The taxable profit is the net profit, determined on the basis of the result of all transactions of any kind carried out by taxpayers, including the disposal of any assets, either in progress or at the end of operations.

Substantial Adjustments

Substantial adjustments are made in terms of reinstatements (fines and penalties, excess gifts and donations, excess associated current account interest, excess depreciation on passenger cars, excess technical assistance costs and head office expenses) and deductions (provisions for paid holidays, provisions for losses, etc).

Profits Tax Basis

Profits are taxed on an accrual basis for companies other than the liberal professions (whose profits are taxed on a receipts basis).

The same rule applies for liberal professionals in the form of a company (*société civile professionnelle*).

2.2 Special Incentives for Technology Investments

Generally, the corporate income tax payable by new companies duly created is reduced by:

- 25% for the first year of activities;
- 25% for the second year of activities; and
- 50% for the third year of activities.

The tax reductions do not apply in the event of a recall of rights following a tax audit procedure. Businesses created within the framework of a total or partial takeover of pre-existing activities are also excluded from the benefit of the reductions.

Specifically, the creation of the *Cité Internationale de l'Innovation et du Savoir* (International City of Innovation and Knowledge) gave rise to the idea of tax exemption for training, research and innovation activities. All the companies in this field that set up within the perimeter of this international city will benefit from these advantages as soon as this measure is effectively implemented.

2.3 Other Special Incentives

According to the investment code in force, there are three privileged regimes in Benin:

- Regime "A", intended for small and medium national or foreign companies whose effective investment is between XOF20 million and XOF500 million;
- Regime "B", for large companies justifying an effective investment of between XOF500 million and XOF3 billion; and
- the Fiscal Stabilisation Regime "C", for very large companies whose effective investment must exceed XOF3 billion.

The eligible limiting conditions for each regime are provided for by the investment code.

2.4 Basic Rules on Loss Relief

According to Article 25 of the General Tax Code, a deficit incurred during a financial year is considered as an expense for the following financial year and deducted from the profit made during said financial year.

If this profit is not sufficient for the deduction to be made in full, the excess of the deficit is carried forward successively to the profits of the following financial years until the fifth financial year following the financial year in which the deficit occurred.

2.5 Imposed Limits on Deduction of Interest

Article 149 of the General Tax Code states that the following are deductible from the interest paid to members or that recorded for the benefit of affiliated undertakings, in remuneration of the sums which they leave or make available to the company in addition to their share of the capital within the following limits.

- The total amount of the sums left at the disposal of the company by all these persons may not exceed the amount of its share capital. This limit is not applicable, however, to the members or shareholders of the holdings as mentioned in Article 22 of the General Tax Code – the total amount of this interest may not exceed 30% of the profit before tax, interest, depreciation expenses and provisions.
- The rate of interest paid may not exceed the average rate of advances of the Central Bank of West African States, applied for the current year, increased by three points.
- The repayment of the sums must be made within five years following their availability, and the company must not be liquidated during this period. Otherwise, the interest deducted in respect of such sums shall be added to the result of the sixth year or the year of liquidation.
- Interest paid to such persons is only deductible, whatever the amount, if the share capital of the borrowing company has been fully paid up.

2.6 Basic Rules on Consolidated Tax Grouping

The subsidiaries composing the group must present separate financial statements according to the tax and accounting regulations of the country (in Benin according to the revised SYSCOHADA Act). The group, for its part, must consolidate these accounts according to the Accounting System of Combined and Consolidated Accounts. The General Tax Code does not impose any formal duty to file consolidated financial statements. However, transfer prices must be reported by subsidiaries controlled by a parent company.

When the subsidiary is established in the Republic of Benin, the tax is due on the basis of the profit made in Benin.

When the parent company is located in Benin and if there is a treaty between Benin and the country of establishment of the subsidiary, the tax is due according to the provisions of this treaty.

In the absence of an agreement, double taxation is possible.

2.7 Capital Gains Taxation

Article 23 of the General Tax Code provides that capital gains arising from the disposal of fixed assets in the course of operations are not included in the taxable profit for the financial year in which they are realised if, in the declaration of the results of said financial year, the taxpayer undertakes to reinvest a sum equal to the amount of these capital gains added to the cost price of the items sold in fixed assets in his companies in Benin before the expiry of a period of three years from the end of the financial year.

For the application of these provisions, the values constituting the portfolio are considered as part of the fixed assets when they have entered into the company's assets five years before the date of disposal.

On the other hand, the acquisition of shares or units that give the operator full ownership of at least 30% of the capital of a third company located in the same country is treated as fixed assets in Benin.

If the reuse is made within the period provided for above, the capital gains deducted from the taxable profit are deducted from the cost price of the new fixed assets, either for the calculation of depreciation in the case of depreciable assets, or for the calculation of capital gains realised subsequently. Otherwise, they are included in the taxable profit for the financial year in which the above-mentioned period expires.

If the taxpayer ceases his activities or disposes of his business during the above-mentioned period, the capital gains to be reinvested will be taxed immediately.

2.8 Other Taxes Payable by an Incorporated Business

Other taxes that may be payable by an incorporated business on a transaction include the following:

- the registration fee;
- the Advance Income Tax (AIB), the rate of which varies between 1% and 5%. It is in fact the prepayment of tax on profits; and
- Value Added Tax (VAT) at the rate of 18% of the pre-tax value of the transaction.

It should be noted that, depending on the sector of activity, companies are subject to specific taxes.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are subject to the following other significant taxes:

- the Employer's Salary Payment (VPS); and
- Personal Income Tax (IRPP: *Impôt sur le Revenu des Personnes Physiques)* or corporate tax (IS: *Impôt sur les Sociétés*).

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

This section is not applicable in Benin.

3.2 Individual Rates and Corporate Rates

According to Article 145 of the General Tax Code, individual professionals can choose either the individual taxation system or the companies taxation system.

3.3 Accumulating Earnings for Investment Purposes

The closely held corporation legal system does not exist in Benin.

For the structures commonly used in business, there are no rules preventing any limited liability company or joint stock company from accumulating profits for investment purposes. However, proof of investment must be reported to the tax administration.

3.4 Sales of Shares by Individuals in Closely Held Corporations

The term "closely held corporation" is not applicable in Benin.

However, in accordance with Article 88 of the General Tax Code, the rate is 7% for capital gains generated on the sale of shares received by private individuals.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individual dividends from and gain on the sale of shares are taxable at source in the case of a West African Economic and Monetary Union (WAEMU) member country and exempt in Benin.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding taxes are charged as follows:

- Interest – Personal Income Tax on Income from Receivables, Deposits and Guarantees (IRPP RCDC) category: 15%.
- Dividends/royalties – Personal Income Tax on Income from Movable Capital (IRPP RCM) category.

The withholding tax is levied at source by applying a 15% rate to the tax base. This rate is reduced as follows:

- to 10% for the proceeds of regularly distributed shares;
- to 5% for the proceeds of shares regularly distributed to shareholders not resident in Benin, unless a treaty for the elimination of double taxation between Benin and the country of said shareholders provides for a more favourable tax rate;

- to 5% for income from shares regularly distributed by companies listed on a stock exchange approved by the Regional Council for Public Savings and Financial Markets within the WAEMU; and
- to 7% for capital gains generated on the sale of shares and received by private individuals.

Exemptions

IRPP RCM

Income from bonds received by residents outside the WAEMU as well as the products described in Articles 62 to 73 of the General Tax Code are exempt from personal income tax.

For example, Article 64 of the General Tax Code provides that distributions of reserves made in the form of capital increases are exempt from personal income tax; profits incorporated directly into the capital are also exempt from this tax. However, when these distributions are the result of a reduction of capital not motivated by social losses or of any operation involving the direct or indirect reimbursement of income tax-free for less than ten years, they may only benefit from the exemption provided for above if and to the extent that the resulting increase in capital exceeds the capital reimbursed.

IRPP RCDC

The proceeds of loans not represented by negotiable securities, as well as the proceeds referred to in Article 90 of the General Tax Code, are exempt from income tax when they are collected by and on behalf of bankers or banking institutions, investment or securities management companies, and companies authorised by the Government to carry out land credit operations.

However, this exemption does not apply to the proceeds of transactions carried out by the above-mentioned persons or institutions using their own funds.

Other exemptions are listed in the General Tax Code, in particular with regard to holding companies.

4.2 Primary Tax Treaty Countries

The main tax treaties are with France, Norway and Morocco.

Regulation No 08/2008/CM/UEMOA (WAEMU) adopts rules for the avoidance of double taxation within the WAEMU and rules on assistance in tax matters.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Local tax authorities contest the use of treaty country entities by residents of non-treaty countries.

4.4 Transfer Pricing Issues

An annual transfer pricing declaration must be submitted.

Profits indirectly transferred to the parent company or to other companies in the scope of consolidation by increasing or decreasing the purchase and selling prices must be included in the income statement for tax purposes.

Amounts paid for purposes other than the reimbursement of costs incurred (royalties, fees, use of patents or other fees, etc) are subject to the particular attention of the tax administration.

The effectiveness of the services or transactions must be proven to the tax authorities.

4.5 Related-Party Limited Risk Distribution Arrangements

Local tax authorities challenge the use of limited risk distribution agreements between related parties for the sale of goods or the provision of services at the local level if the agreement is discriminatory.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

There is no significant aspect of local transfer pricing rules and/or their application that differs from OECD standards in Benin.

For example, the treaty signed with Morocco relies essentially on OECD standards.

4.7 International Transfer Pricing Disputes

Article 1102 of the General Tax Code makes it possible to counter transfer pricing.

This Article states that any transaction concluded in the form of a contract or any legal act whatsoever that conceals the realisation or transfer of profits or income carried out directly or through an intermediary is not opposable to the tax authorities, which have the right to restore the true nature of the transaction and to determine the basis for income tax accordingly.

International transfer pricing provisions (changes) have been internalised since 2020.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensatory adjustments are allowed and made by the tax services.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-local companies and local subsidiaries of non-local companies have the same tax regime in Benin.

5.3 Capital Gains of Non-residents

Capital gains of non-residents on the sale of stock in local corporations are subject to income tax for natural persons, at the following rates under Article 136 of the General Tax Code:

- XOF0 to XOF10 million: 30%;
- XOF10,000,001 to XOF20 million: 35%; and
- more than XOF20 million: 40%.

If it is a legal entity, the unique rate is 30%.

5.4 Change of Control Provisions

Article 1018 of the General Tax Code states that all changes that affect the life of the company must be declared to the tax administration within 30 days. The capital gain must also be taxed at this level is the change of control modifies the company's statutory provisions.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The tax system in Benin is declarative. The income of foreign-owned local affiliates selling goods or providing services must be reported through the financial statements.

Failing that, the tax administration can find out through cross-checks and proceed to taxation with penalties and fines.

Corporate income tax is due on profits made by companies operating in Benin as well as those whose taxation is attributed to Benin by an international treaty for the elimination of double taxation.

5.6 Deductions for Payments by Local Affiliates

Article 21 of the General Tax Code expressly states that research costs, royalties, intermediary remuneration and fees are deductible when they meet the general conditions for deductibility.

However, the costs of technical, accounting and financial assistance, study costs, head office costs and other assimilated costs, and commissions to purchase offices, paid by companies operating in Benin to natural or legal persons not established in Benin are only allowed as a deduction from taxable profit on the additional condition that they are not excessive and have the character of an indirect transfer of profit.

In any case, they are only deductible up to a limit of 5% of the taxable profit before deduction of the expenses in question.

5.7 Constraints on Related-Party Borrowing

The constraints on related-party borrowing by foreign-owned local affiliates paid to non-local affiliates are listed in Article 149 of the General Tax Code.

The following are deductible from the outcome.

- Interest paid to members or interest recorded for the benefit of related companies, in remuneration of the sums they leave or make available to the company in addition to their share of the capital within the following limits:
  - (a) the total amount of the sums left at the disposal of the company by all these persons may not exceed the amount of its share capital, although this limit is not applicable to the members or shareholders of the holding companies referred to in Article 22 of the General Tax Code; the total amount of this interest may not exceed 30% of the profit before tax, interest, depreciation and provisions;
  - (b) the rate of the interest paid may not exceed the average rate of advances from the Central Bank of West African States, applied for the current year, increased by three points;
  - (c) the repayment of the sums must be made within five years following their availability and the company must not be liquidated during this period, in which case the interest deducted in respect of such sums shall be applied to the result of the sixth year or the year of liquidation; and
  - (d) interest paid to such persons shall be deductible, whatever the amount, only if the share capital of the borrowing company has been fully paid up.
- Donations, membership fees and other gifts up to a limit of 1‰ of the turnover.
- By way of derogation from the above provision, donations and gifts in the fields of education, health or collective infrastructures granted to the State, its members and sports federations recognised by the Ministry in charge of sports and designated by joint order of the Minister of sports and the Minister of finance, within the limit of XOF25 million, in addition to the deduction granted in the second bullet.
- Proof of receipt of donations and gifts shall be joined to the declaration for tax.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local companies is not exempt from corporate tax. It is taxed at the 30% rate of corporate income tax according to the provisions of Article 156 of the General Tax Code.

If a treaty is signed between Benin and the foreign country, the provisions of the treaty are applicable.

6.2 Non-deductible Local Expenses

The general principle is that foreign income is not exempt.

6.3 Taxation on Dividends from Foreign Subsidiaries

A withholding tax at the rate of 15% applies. This rate is reduced as follows:

- to 10% for the proceeds of regularly distributed shares;
- to 5% for the proceeds of shares regularly distributed to shareholders not resident in Benin, unless a convention for the elimination of double taxation between Benin and the country of said shareholders provides for a more favourable tax rate;
- to 5% for income from shares regularly distributed by companies listed on a stock exchange approved by the Regional Council for Public Savings and Financial Markets within the WAEMU; and
- to 7% for capital gains generated on the sale of shares and received by private individuals.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangible assets developed by local companies and used by non-local subsidiaries in the course of their activities are subject to local corporate tax.

If these intangible assets give rise to the receipt of income (management fees, for instance) by local companies, tax will be due on said income.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

International tax rules are being internalised in Benin.

6.6 Rules Related to the Substance of Non-local Affiliates

Rules related to the substance of non-local affiliates apply, and are called the anti-abuse clauses in the treaties.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

In accordance with Article 23 of the General Tax Code, capital gains arising from the disposal of fixed assets in the course of operations are not included in the taxable profit for the financial year in which they are realised if they are reported in the statement of income for that year, and if the taxpayer undertakes to reinvest in fixed assets in his companies in Benin before the expiry of a period of three years from the end of the financial year a sum equal to the amount of these capital gains added to the cost price of the items sold.

On the other hand, acquisitions of shares or holdings that have the effect of giving the operator full ownership of at least 30% of the capital of a third company based in Benin are considered as fixed assets.

If the reuse is carried out within the period provided for above, the capital gains deducted from the taxable profit are deducted from the cost price of the new fixed assets, either for the calculation of depreciation or for the calculation of the capital gains realised subsequently. Otherwise, they are reported in the taxable profit of the financial year during which the above-mentioned period expired.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

The 2020 Finance Law has strengthened and modernised the legal framework on transfer pricing.

It includes measures to combat evasion of the tax base and the transfer of profits, with the corollary of restoring tax justice and reducing unfair competition from multinationals on local enterprises.

Notably, the rules for the establishment of income tax or company tax apply to companies that are dependent on or control companies located outside Benin, and to legal persons carrying out their activities both in Benin and abroad.

The obligations of declaration and representation of documentation on transfer pricing provided for in Articles 34 and 1085 of the General Tax Code are only incumbent on the persons referred to above whose gross assets or annual turnover before tax is equal or superior to XOF1 billion.

Failure to comply with transfer pricing reporting and documentation obligations is punishable by the fines provided for in the General Tax Code.

8. Audit Cycles

8.1 Regular Routine Audit Cycle
Based on the basic limitation period of three years, the tax administration is supposed to audit companies at least every three years.

9. BEPS

9.1 Recommended Changes
For the moment, the BEPS recommendations that have been implemented relate to changes in transfer pricing.

9.2 Government Attitudes
The government is taking the measures into account progressively.

9.3 Profile of International Tax
The rules of international taxation apply, according to the treaties to which Benin is a party.

9.4 Competitive Tax Policy Objective
The tax policy objective is to comply with international tax standards.

By the end of 2021, Benin will have a new General Tax Code.

9.5 Features of the Competitive Tax System
There are no key features of Benin's competitive tax system that could be more vulnerable than others because the tax reforms undertaken are for the improvement of the business climate and for a developmental tax system.

9.6 Proposals for Dealing with Hybrid Instruments
There are not yet any anti-hybrid tax rules in the General Tax Code.

9.7 Territorial Tax Regime
There is a territorial tax regime in Benin and there are restrictions on the deductibility of interest in Article 149 of the General Tax Code.

9.8 CFC Proposals
This is not applicable in Benin.

9.9 Anti-avoidance Rules
The proposed DTC anti-avoidance rules are not likely to have an impact on inbound or outbound investors.

9.10 Transfer Pricing Changes
In Benin, the transfer pricing changes were adopted in 2020, with application from the 2020 benefit onwards. Therefore, it is too early to assess whether the changes have made any radical difference.

9.11 Transparency and Country-by-country Reporting
The proposals for transparency and country-by-country reporting have already been transposed into legislation, in Article 37 of the General Tax Code.

9.12 Taxation of Digital Economy Businesses
The changes are under discussion at the African Tax Administration Forum.

9.13 Digital Taxation
No proposals have yet been brought forward in relation to digital taxation based on BEPS provisions.

9.14 Taxation of Offshore IP
Revenue earned by offshore companies from intangible property will be subject to income tax.

DHP Avocats is a law firm founded by Hélène Paty Kounake, attorney at law and compliance officer. Its practice covers banking and finance law, public finance and taxation, digital law, corporate law, corporate social responsibility (CSR) and intellectual property law. The team is composed of attorneys at law, counsels and partners, with a compliance and financial specialist, Gail Gibson CFP (RSA). DHP Avocats assists its clients in identifying and complying with the laws and regulations in force, and acts as national and international adviser in the context of investment services.

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

As a general rule, business is conducted in Brazil through the use of corporate forms. Even though some types of obligations can be imposed on an economic group level, such as labour obligations, and even though piercing the corporate veil is possible under specific circumstances (such as cases of fraudulent management or failure to comply with legal obligations), corporate structures more often than not offer some degree of protection to investors and are widely viewed as the better way to structure and operate businesses in Brazil.

Corporate entities in Brazil mostly make use of one of two corporate structures:

- the *sociedade limitada* (limited liability company); or
- the *sociedade por ações* (corporation).

The vast majority of companies in Brazil adopt the form of a limited liability company as it is the structure subject to the least amount of regulation and bureaucracy between the two. Corporations are usually incorporated in cases where the stock owners desire to have more privacy or when the company wishes to go public in the Brazilian stock markets.

Lately, individual entrepreneur companies (EIRELI) have also been increasingly popular; however, apart from some benefits, they are subject to the general rules applicable to limited liability companies.

Each Brazilian corporation is individually taxed; however, at least until 2021, dividends are exempt from taxation.

Investment activity, on the other hand, commonly takes place through the use of Brazilian investment funds, which are jointly owned portfolios of assets, usually not subject to taxes on the portfolio level but rather on distributions.

1.2 Transparent Entities

In Brazil, there are no entities that are transparent from a tax viewpoint. It may be possible to form a consortium in order for two or more companies of different economic groups to undertake together a specific project or business usually limited in time. The consortium is not a legal entity and is transparent from a tax perspective, in the sense that each party to the consortium taxes its stake in the consortium separately. The consortium is, however, a joint venture that can enter into transactions with third parties, as represented by its administrator.

1.3 Determining Residence of Incorporated Businesses

Usually, the residence of incorporated businesses and transparent entities is that of its headquarters (head office) or branch, which should be informed under the corporate constitution documents/acts (eg, the by-laws or the articles of incorporation), as well as upon registration on the taxpayers national registry (*Cadastro Nacional de Pessoas Jurídicas*, or CNPJ). Moreover, in what pertains to investment funds, their residency is tied to the location in which the fund's administrator resides.

1.4 Tax Rates

There are various taxes and contributions applicable to incorporated businesses and individuals alike that can vary according to the activities performed and the markets/businesses developed by each person.

In general, the most relevant tax difference between an individual operating through the use of a company and operating directly relates to the "direct" taxation, which encompasses taxes levied on income and revenues. In this regard, please find below the general tax rates applicable to each case.

For companies:

- income tax (IRPJ and CSLL) levied on net profits and gains (deductions are allowed) – 34% (general companies) or up to 45% (general financial institutions) and 50% (banks); and
- social security contributions (PIS/COFINS) on gross revenue – 3.65% (cumulative), or up to 9.25% (non-cumulative), or 4.65% (financial institutions).

For individuals:

- income tax (IRPF) levied on earnings – up to 27.5%.

In addition to such taxes, there are other production or consumption taxes that may apply to both companies and individuals who are in a trade or business that is typically subject to such taxes, which are:

- excise tax (IPI);
- sales tax (ICMS);
- services tax (ISS); and
- CIDE.

It should be briefly noted that the CSLL taxation on general financial institutions and banks has been temporarily increased from 15% and 20% to 20% and 25% respectively. This increase takes effect as of July 2021 and should last until January 2022. The authors' comments herein are made in consideration of these new and increased tax rates; however, these rates should be reversed back to normalcy by the turn of the year.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporate income tax is levied under one of three tax regimes: actual profit, presumed profit and arbitrated profit.

Actual Profit Regime

The actual profit regime, which is mandatory to some specified taxpayers (such as high-income companies, financial institutions and entities with revenue/investments abroad), adopts for income tax purposes the accounting profits as its tax basis, with some adjustments (inclusions and deductions) provided by law.

The most relevant/substantial adjustments for actual profit income tax purposes are usually:

- operational/necessary expenses;
- premiums and discounts on assets;
- transfer prices;
- accounting allowances (which can be non-deductible or deductible upon realisation);
- an asset's market value, fair value and present value adjustments;
- limited deductibility expenses (such as royalties and free samples);
- corporate bonuses for officers;
- foreign currency exchange variation (gains and losses);
- profits obtained abroad and controlled foreign corporation rules; and
- interest on equity.

The specific additions and exclusions to the actual profit tax basis calculation are generally described under the Brazilian tax authorities' Normative Instruction No 1.700/2017.

Under the actual profit regime, profits are taxed on an accrual basis.

Presumed or Deemed Profit regime

As an alternative to the actual basis regime, the presumed basis regime offers taxpayers a simpler tax calculation system by taxing a statutory percentage of the total gross revenues, varying from 8% to 32% depending on the type of activity and respective revenue.

Companies subject to the presumed profit regime can be taxed on either the accrual or receipts (cash) basis.

Arbitrated Profit Regime

When the accounting books of a company are unreliable, unsubstantiated or lost, the Brazilian tax authorities are allowed to estimate/arbiter the income tax basis for the taxpayer. This is usually a last resort and is mostly deemed excessively burdensome to taxpayers. The most common way to arbitrate profit is to apply an increased percentage over gross revenues but if it is not possible to determine the gross revenue, then other methods apply.

2.2 Special Incentives for Technology Investments

Brazilian legislation allows for the deduction of expenses incurred with R&D and with patent registration from the income tax basis under the actual income regime. Moreover, in addition to such deduction, an additional 60% through to 80% of expenses with R&D, and another 20% of the expenses with patents/registration, can be further reduced from the income tax basis, effectively allowing for a super deduction that can reach 200% of expenses incurred.

Additionally, for the purposes of income tax calculation, Brazilian legislation allows for the accelerated depreciation of assets acquired and employed for the development of technology, as well as accelerated amortisation of expenses incurred in connection with intangible assets related to R&D.

There are also IPI tax reductions (excise tax) on:

- the acquisition of equipment, instruments and tools employed for the development of technology; and
- the production of information technology hardware and automation goods.

There are limitations and requirements for the utilisation of such incentives, which should be analysed on a case-by-case basis.

2.3 Other Special Incentives

There are many tax incentives for the development of businesses in some less developed areas of Brazil, such as in the Amazon Region (SUDAM) and in the Northeast Region of Brazil (SUDENE). Such benefits can include special income tax deductions of expenses incurred in business development and lowered tax rates.

Another notable incentive is the Manaus Free Trade Zone (*Zona Franca de Manaus*), which provides further reduction for both federal and state taxes arising from the development of business and industrial activity relating to the importation, production and sale of goods, to and from the Manaus region.

There are further income tax incentives (as deduction of expenses) regarding company investments in sports projects, cultural projects and on the catering of employees.

Brazil also provides benefits for the financing of export transactions, which includes a withholding income tax exemption on interest paid abroad on credits obtained in connection with export financing (direct and/or indirect). Other financing incentives are also provided regarding infrastructure investments and capital expenditures by companies, especially in what pertains to financing through debentures.

There are limitations and requirements for the enjoyment of these incentives, which should be analysed on a case-by-case basis.

2.4 Basic Rules on Loss Relief

Losses can be carried forward for compensation/offset in future fiscal years. There is no statute of limitations on losses incurred in prior fiscal years; however, the compensation is limited to 30% of the income tax for any year with positive results. If a company changes simultaneously its control and its main corporate activity, it loses the right to offset profits.

2.5 Imposed Limits on Deduction of Interest

Under the actual profit taxation basis, expenses will only be deductible if they are considered to be usual and necessary for the development of the corporate business. Interest can be deductible if it observes these criteria.

There are thin capitalisation rules, however, that prevent the deduction of interest paid to related parties observing some "invested capital vs indebtedness" threshold rules. For local transactions, there is a general arm's-length principle whereby interests paid to partners and their related parties in excess of an arm's-length rate can be considered deemed distributions of profits and therefore not tax deductible.

2.6 Basic Rules on Consolidated Tax Grouping

There are no rules for consolidating profits and expenses.

2.7 Capital Gains Taxation

At the corporate level, capital gains are included in the income tax basis and are subject to a 34% tax rate, which can go up to a 45% rate for general financial institutions and 50% for banks.

2.8 Other Taxes Payable by an Incorporated Business

For companies, in general, the most relevant "indirect" taxes, which are levied upon business transactions, and their corresponding tax rates (not including outliers and exemptions) are as follows:

- excise taxes on the manufacturing of goods (IPI) – from 0% to 30% (selective tax);
- sales taxes on the sale of goods, communication and transportation services (ICMS) – from 7% to 30% (selective tax); general tax rates at around 17% through 19%;
- services taxes on the provision of services (ISS) – from 2% to 5% (selective tax);
- import taxes on the importation of goods (II) – from 0% to 35% (selective tax);
- PIS/COFINS on gross revenue – 3.65% (cumulative), 9.25% (non-cumulative), or 4.65% (financial institutions); and
- CIDE – levies on importation of technical services and royalties at 10% and on the sale of some types of goods, such as fuel.

2.9 Incorporated Businesses and Notable Taxes

Other notable taxes applicable to business in Brazil are the following:

- taxes on financial credit transactions (IOF/Crédito) – from 0.38% to 3.38%, which varies according to the duration of the credit/loan and the debtor; and
- taxes on foreign exchange financial transactions (IOF/Câmbio) – from 0% to 6.38% (but the rate may be increased by presidential decree to up to 25%); general rates at 0.38%.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Businesses in Brazil mostly operate through corporate form, which are more commonly structured as corporations, limited liability companies or individual entrepreneur companies.

3.2 Individual Rates and Corporate Rates

There are no specific rules against individual persons incorporating companies through which to carry out their professions. There is, however, a general anti-avoidance rule that prevents the abuse of legal forms for tax purposes alone. Analysis should be done on a case-by-case basis.

3.3 Accumulating Earnings for Investment Purposes

There are no rules to prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

In 2021, for the purposes of the share/quotaholder, dividends are exempt from taxation in Brazil. Dividends paid, on the other hand, are non-deductible from the corporate income taxation, except for interest on equity (JCP), which is a deduction in the actual basis corporate income tax computation (generally up to 34%) and taxed at source at 15% when paid to the individual shareholder or quotaholder.

Sales of shares and quotas are taxed at the holder's level as capital gains, whereas the tax rate can vary according to the capital gain amount and the person who is selling the assets.

Individuals are subject to progressive capital gain tax rates of 15% to 22.5%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Gains arising from the sale of publicly traded shares will be subject to:

- 20% income tax when concerning day trade transactions; or
- 15% tax concerning other transactions carried out on the regulated market (Bovespa/B3); or
- 15% to 22.5% when the gain is realised outside such markets.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interests and royalties are subject to 15% withholding income tax when the beneficiary is not resident in a low-tax jurisdiction or 25% when the beneficiary is resident in a low-tax jurisdiction. Dividends are tax exempt (at least in 2021). Interests on export financing are tax exempt. Interests paid to beneficiaries not resident in low-tax jurisdictions under certain debentures, real estate certificates and funds whose proceeds are used to invest in capital expenditures debentures are also tax exempt.

4.2 Primary Tax Treaty Countries

Even though Brazil has several tax treaties, the authors do not see any particular tax treaty that provides significant benefits to investors in equity of Brazilian companies. The Brazil and Japan tax treaty reduces the withholding income tax to 12.5%, which extends to branches of Japanese companies located in other countries. Some treaties provide for tax sparing or tax matching on interests received by non-residents. Bearing this in mind, the most common jurisdictions used as holding companies or financial centres to invest in Brazil are Luxembourg, the Netherlands, Spain, Austria, South Korea and Japan.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Discussions around substance on the use of treaty jurisdictions are more related to Brazilian outbound investments or to remittance of services paid to treaty jurisdictions when the parties challenge the levy of withholding income tax based on the allegation that Brazil should not tax a treaty company's main profits. Other than that, it is very difficult for treaties to provide tax benefits in Brazil and therefore for Brazil to challenge treaty application based on substance aspects, even though general anti-tax avoidance rules may apply – for treaty provisions and benefits to be duly applied in any given relationship it is important for a treaty counterparty to be formally incorporated in a treaty country and also to have substance in such country while dealing with Brazil.

4.4 Transfer Pricing Issues

Brazil has statutory transfer pricing methods that differ from the OECD arm's-length principle and in most circumstances, it may be a challenge to make Brazilian statutory limits compatible with global OECD-based transfer pricing models. Most businesses operating in Brazil have to find ways to meet both standards. In Brazil, the most common methods are, for services, cost plus, for the sale of goods, acquisition plus margin or resale less margin methods and there are specific methods that need to be observed for the purchase or sale of commodities. Interest rates are also subject to statutory rates and spreads for transfer pricing purposes. Transfer pricing applies not only to related-party transactions but also to transactions entered into with parties located in low-tax jurisdictions or with parties subject to special and lowered tax regimes.

4.5 Related-Party Limited Risk Distribution Arrangements

Brazil does not adopt OECD standards. The Brazilian company will have to comply with the same statutory margins regardless of its level of risk, capital or added value in the overall business operations.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Brazil has specific statutory margins that have to be observed for transfer pricing regardless of the arm's-length principle. For instance, in the case of imported goods or services, the following methods may be theoretically available:

- compared independent prices;
- cost plus margin of 20% to 40%;
- resale price less margin of 20%; and
- the mandatory pricing method for certain publicly traded commodities.

In the case of exported goods or services, the following methods may be theoretically available:

- independently adopted and compared prices;
- wholesale resale price less 15% margin;
- retail resale price less 30% margin;
- cost plus 15% margin; and
- the mandatory pricing method for certain publicly traded commodities.

The criteria to adopt and prove the compared independent prices is so restrictive that they are very difficult to meet.

There are some safe harbours available and if the company can meet them, it is excepted from having to prove that the prices it adopted meet one of the criteria; however, it continues to have to explain the prices adopted and how they can be considered arm's length.

4.7 International Transfer Pricing Disputes

It is not common at all for Brazil to resolve transfer pricing disputes under double tax treaties and mutual agreement procedures (MAPs) since Brazil does not adopt OECD standards for transfer pricing.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When a Brazilian company is held liable to make transfer pricing adjustments to its tax computations and such adjustments involve a subsidiary or controlled company subject to controlled foreign corporation (CFC) taxation, then the Brazilian company is entitled to make such adjustment on the overall tax effect and not on the transfer pricing adjustment isolated from CFC taxation. The settlement of taxes in Brazil arising from transfer pricing adjustments may trigger tax expenses, interests for past due taxes and penalties expenses. Such expenses may be tax deductible when the taxes are PIS/COFINS and to the extent of the principal and interests amounts. There is a claim to deduct interests for past due corporate income taxes as well. The principal amount of corporate income taxes as well as penalties are not tax deductible. No other adjustments are required or available for transfer pricing purposes.

MAPs are generally not applied in Brazil, since Brazil does not adopt OECD transfer pricing standards.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-local corporations are taxed equally as local subsidiaries of non-local corporations.

5.3 Capital Gains of Non-residents

Non-residents are subject to taxes in Brazil on capital gains arising from the sale of stock in local companies. The tax basis is the difference in Brazilian reais of the sale price less the acquisition cost and the tax rates vary from 15% to 25% depending on the size of the gain and the location of the seller. However, if a non-Brazilian seller sells the stock of another non-Brazilian holding company that, for its turn, owns the stock of the Brazilian company directly, the sale is not subject to tax in Brazil.

It is important to note that the holding company shall have substance other than operating as a shelf vehicle only for the purposes of selling the Brazilian company without taxes, since this type of situation may be caught by anti-tax avoidance rules.

Treaties signed by Brazil usually allow the taxation of capital gains and the application of occasional treaty reliefs, if available, depends on very specific case-by-case analysis.

5.4 Change of Control Provisions

Usually a change of control in a very indirect level much higher up in the corporate chain abroad will not trigger income taxes or duties in Brazil, also because most of the time such change of control will have economic substance and is therefore not subject to anti-tax avoidance rules in Brazil.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Transfer pricing rules generally apply and the profit margin will depend on the methods applied; however, usually a cost plus 15% margin is accepted.

5.6 Deductions for Payments by Local Affiliates

It is very common for Brazilian tax authorities to challenge the deductibility of payments made by Brazilian companies for management and administrative expenses incurred by non-local affiliates and allocated to Brazil. The discussions surround the proof of the expenses and its actual relationship with the Brazilian business since allocations often take place based on managerial estimates and assumptions that are not accepted as reasonable proof in Brazil. Therefore, the Brazilian tax authorities take the view that the expense is not proven to be necessary to the Brazilian operations and therefore is not tax deductible.

Additionally, the payment itself of this type of expense may be subject to severe taxes on imported services, such as income tax, PIS/COFINS, ISS and CIDE, one levying over the others, that may reach up to 50% of the value of the expense itself.

5.7 Constraints on Related-Party Borrowing

Thin capitalisation rules apply to related-party borrowing whereby the amount of the indebtedness is limited to two times the equity that the non-Brazilian lender owns in the Brazilian company or, if this is not the case, two times the total equity of the Brazilian company. This is the limit that applies to lenders not located in low-tax jurisdictions or that are not subject to privileged tax regimes. For lenders in low-tax jurisdictions or subject to privileged tax regimes, the limit is 0.3% of the equity owned in the Brazilian company or, if this is not the case, 0.3% of the total equity of the Brazilian company. Therefore, the total limit for indebtedness may reach up to 2.3% of the total equity of the Brazilian company. Excessive interests are not tax deductible.

Furthermore, interests are subject to transfer pricing statutory rates and spreads and excessive interests are also not tax deductible.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local companies is taxed locally; however, the taxpayer may take credit on taxes paid abroad. Income taxes at the Brazilian corporate level are subject to a general 34% rate for general companies and up to a 45% rate for general financial institutions and a 50% rate for banks.

The income taxation of companies with foreign profits is done yearly and must necessarily be done under the actual income regime.

6.2 Non-deductible Local Expenses

Not only is foreign income taxable, but also transactions carried out with related parties abroad must adhere to transfer pricing rules for the corresponding expenses to be deductible in Brazil. Any such transactions need to observe prices consonant with the activity and, as a rule of thumb, should encompass the cost of services/product and a 15% mark-up. There are rules for the arbitration of due tax when transfer pricing rules are not adhered to.

6.3 Taxation on Dividends from Foreign Subsidiaries

Given that income arising from foreign subsidiaries is subject to taxation at the Brazilian company level annually on an accrual basis, there should be no further income tax levied on profit/dividends distribution.

There are discussions regarding some double tax treaties signed by Brazil that exempt profits distributed by foreign subsidiaries from taxation in Brazil. The discussion is whether this exemption includes all profits abroad, regardless of whether they are distributed as dividends or not, or only the dividend remittances themselves. For other treaties that do allow taxation upon remittance of dividends but prevent taxation of business profits, the discussion is on the opposite side: whether the profits are only not taxed until such time when there is a dividend distribution.

Brazilian tax authorities usually do not allow treaty benefits at all on profits obtained abroad in foreign subsidiaries since they say that the taxes in Brazil apply on the accounting profits of the Brazilian company itself computed as a reflection of the profits obtained abroad and not on the profits of the foreign company itself. There are significant tax disputes around this debatable understanding.

6.4 Use of Intangibles by Non-local Subsidiaries

As a general principle, transactions with related parties abroad should adhere to the transfer pricing rules in place. Hence, the transfer of intangibles should generally be compensated through royalty payments that would be taxed accordingly. Income taxes at the Brazilian corporate level are subject to a 34% rate for general companies, a 45% rate for general financial institutions and a 50% rate for banks. Occasionally, the statutory transfer pricing methods may apply to lower the level of royalty payments or to sell out the intangible to another entity outside Brazil.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Yearly profits accrued by foreign subsidiaries and branches of Brazilian companies abroad are subject to taxation in Brazil. Profits of foreign companies will only be taxed in proportion to the Brazilian company's participation in its capital stock.

This regime applies to both passive or active businesses and regardless of whether they are located in low-tax jurisdictions or not.

The only difference is that active businesses may be taxed on a consolidated basis offsetting profits and losses if they are not located in low-tax jurisdictions, not subject to a privileged tax regime and not subject to low effective tax. Otherwise, foreign investments are taxed on a standalone basis and losses may only be offset with gains of the same entity in future years.

Foreign tax credits may be available depending on the availability of documentary evidence and statute of limitation rules, as well as global and individual taxation limits.

6.6 Rules Related to the Substance of Non-local Affiliates

There is a general anti-avoidance principle in Brazil, which requires that companies have economic substance (ie, have assets and personnel compatible with the activities performed). This principle is extended to non-local affiliates, especially those located in treaty jurisdictions, located in low-tax jurisdictions or listed as subject to privileged tax regimes (under Normative Instruction No 1.037/2010).

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains incurred by Brazilian companies, locally or abroad, are subject to income taxes at a 34% rate for general companies, a 45% rate for general financial institutions and a 50% rate for banks.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

In 2001, a general anti-avoidance rule was introduced in the Brazilian Tax Code that was meant to enable the Brazilian tax authorities to disregard acts and transactions carried out with the purpose of disguising the occurrence of tax-triggering events. Brazilian tax authorities have been enforcing said rules though the use of a "general anti-avoidance policy", which is mostly supported by administrative jurisprudence.

As per the anti-avoidance policy, transactions are evaluated on a substance-over-form basis, whereas legitimate and legal structures/transactions can be disregarded by the tax authorities if the taxpayers are not able to demonstrate the existence of effective economic and legal extra-tax substance to them.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Most taxes in Brazil are self-reported, where the taxpayer is required to file the tax information and pay the ensuing taxes. As a result, tax authorities have a five-year interval to audit the taxpayer's reports and payments.

The tax authorities release annual agendas disclosing key audit targets and annual objectives; however, there is no limitation on which persons or which matters can be audited.

There are some matters subject to closer scrutiny by the tax authorities that are frequently audited throughout the year.

9. BEPS

9.1 Recommended Changes

In relation to Action 5 (Harmful Tax Practices and Exchange of Information) and Action 13 (Country-by-Country Reporting), Brazil signed and is enforcing the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters that allows automatic exchange of information and exchange of information amongst tax authorities upon consultation. In this regard, the Brazilian tax authorities enacted several normative rulings to set the basis to obtain and share information on country-by-country taxation, the ultimate beneficial owner database, the Common Reporting Standard and tax rulings, among others (Normative Rulings IN RFB Nos 1,634, 1,680, 1,681, 1,689). Concerning Action 14 (Dispute Resolution), the Brazilian tax authorities also issued a normative ruling to set the basis for dispute resolution related to treaty applications (IN RFB No 1,689).

Concerning Action 3 (Controlled Foreign Corporation), the Brazilian tax authorities issued a normative ruling to set the basis to analyse the economic and operational substance of legal entities (IN RFB No 1,658).

Other changes to tax legislation on hybrid instruments, such as interests on equity, have not been approved by Congress.

So far, the Brazilian tax authorities have not taken any concrete actions to make any other changes related to the BEPS task force.

9.2 Government Attitudes

The Brazilian tax authorities are participating in an OECD forum to discuss BEPS and are implementing actions related to sharing information amongst countries and tax authorities. The purpose of the Brazilian tax authorities is to protect the Brazilian tax basis and tax revenues, and implement changes to the tax legislation that allow it also to improve the mechanisms and awareness of key topics for auditing international tax matters and international groups.

9.3 Profile of International Tax

International tax does not play such a significant role in Brazil as it could and international tax disputes are more related to withholding taxes and Brazilian investments abroad. Therefore, the authors expect BEPS implementation to remain slow, to the extent that it depends on Congress actions as well as on the Brazilian tax authorities giving up non-OECD-standard legislation. One point that may act as an incentive to implement BEPS is the potential wish of certain authorities in the country for the country to become part of the OECD itself, which is often the subject of speculation.

9.4 Competitive Tax Policy Objective
Unfortunately, competitive tax policy has not been part of the agenda of the Federal Revenue of Brazil so far.

9.5 Features of the Competitive Tax System
In response to BEPS, for some time now the Brazilian tax authorities have been willing to void the interest on equity tax benefit. Interest on equity was created during the 1990s to allow the application of a long-term interest rate on invested equity, the distribution of which would be tax deductible from the corporate profits (at 34% to 50%) but would be treated as income by the beneficiary and thus be subject to withholding taxation (at 15% to 25%). This tax treatment differs from dividends, which are not tax deductible but are also tax exempt to the beneficiary. The objective of the interest on equity was to, in a way, replace the inflationary adjustment that used to exist until that time and that would allow an inflationary allowance on net fixed assets.

Because of BEPS, the authorities wish now to pierce and void the interest on equity deduction while submitting all profit distributions, including the dividends, to taxation at source, probably at 15%, and as a taxable earning to the beneficiary.

9.6 Proposals for Dealing with Hybrid Instruments
One hybrid instrument in general available based on Brazilian local legislation only is the interest on equity and the authors believe it is likely to be disallowed in the near future.

Another hybrid instrument may be preferred shares, which are treated as equity for tax purposes and generate exempt dividends, but from an accounting and economic perspective, may sometimes be treated as debt. In 2014, the tax law confirmed their nature as equity and therefore the authors do not expect changes in this regard.

9.7 Territorial Tax Regime
Brazil has a worldwide tax regime and there is no territorial tax regime available to opt out of the worldwide tax regime. Brazil has thin capitalisation rules as well as transfer pricing rules that apply to interest deductions. Interest is also subject to the general rule, according to which, expenses are only deductible if necessary to the corporate business. The authors expect these principles to continue to apply and they do not expect a lot of changes in this area of the law.

Brazil is a high-tax jurisdiction and the decision to fund the Brazilian operations with debt or equity needs to take place at the very beginning of the operations, since a change from equity to debt in the middle may be subject to discussions around substance over form and deductibility of interests. This continues to be the key point for people investing in Brazil. For people investing from Brazil, the very aggressive taxation of profits abroad continues to be the key point and ways to optimise the use of foreign subsidiaries to be more competitive in the trading of products, outsourcing of services, placement of intellectual property and payment of royalties.

9.8 CFC Proposals
Not applicable to Brazil.

9.9 Anti-avoidance Rules
For some time now, Brazilian authorities have disallowed treaty benefits for investments of Brazilian companies abroad. The authors expect that the rules around substance will help Brazilian companies to win disputes where there is adequate substance in treaty jurisdictions and BEPS guidelines are generally observed. For inbound investments, the authors do not expect such rules to have a significant impact on investors or Brazilian companies.

9.10 Transfer Pricing Changes
Brazil does not follow OECD standards on transfer pricing and the authors do not expect such changes to impact local rules.

9.11 Transparency and Country-by-country Reporting
The authors understand that the OECD has made an effort to improve transparency on tax matters with country-by-country reporting and it is a start. On one hand, it may help companies and tax authorities to have a very broad and general view on the split of profits and operational efforts amongst jurisdictions. The authors understand that this is creating in global groups a greater awareness among senior management of the importance to have substance and look good in addition to do good.

However, the statistics are still very superficial, and the insights may not be conclusive, may not point in the right direction and may work better for some sectors and activities rather than others. Therefore, a significant open issue is the way the tool will be adopted by each country, the impact that it will actually have on tax auditing activities and on past practices still not subject to the statute of limitation, and therefore on the type of tax challenges that it may give rise to.

The authors are very optimistic about the use of this type of tool to improve transparency and to create an incentive for a more sustainable, fair and reasonable economic and tax competitive environment. The countries and tax authorities should, however, use the new tool to improve legal stability and safety rather than the opposite. Instead of giving rise to bilateral tax disputes, the tool should be used to improve international negotiation among countries, internal tax instructions, rulings and laws in local jurisdictions.

9.12 Taxation of Digital Economy Businesses

Recently, there has been no tax legislation on digital economy businesses operating outside Brazil but with customers in Brazil, even though the authors see this type of business growing a lot and representing a significant portion of the digital market.

The authors understand, on the other hand, that Brazil has several protective tax and regulatory rules in place that limit the competitiveness or scope of businesses operating from abroad and that at some point they tend to create local operations or have local partners joining their operations. Some examples are the limitations imposed on the use of credit or debit cards to pay international purchases. These purchases are subject to 6.38% IOF tax and have to be paid in non-Brazilian currency with significantly high foreign currency conversion rates. Most customers acknowledging this may prefer to purchase from sites that offer local payment methods.

Another example is the high import taxes that apply to the importation of goods and services, which may reach 50% to 150% of the value of the purchase.

One alternative would be to pay with bitcoin; however, the purchase of digital currency may also be subject to taxes, on the one hand, and the purchase, sale and use of digital currency in Brazil or to Brazilian parties may also be subject to reporting, in other cases.

9.13 Digital Taxation

The Brazilian tax authorities have not yet taken a formal position on the BEPS proposals for digital taxation.

9.14 Taxation of Offshore IP

Brazil imposes withholding income tax on the payment of royalties for the use of intellectual property in Brazil, which is usually 15% but may increase to 25% for residents in low-tax jurisdictions. In the case of tax treaties, it is necessary to analyse whether the royalty can be subject to withholding income tax depending on whether it is treated as business profits, royalties or other earnings, and the treatment may vary depending on the specific country and treaty.

Depending on the type of intellectual property, it is also subject to registration with the National Institute of Industrial Property and the deduction of the royalty is subject to such registration. The deduction of royalties may also be subject to specific statutory limits as well as transfer pricing limits.

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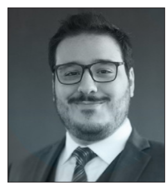

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Trends and Developments

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Impact of COVID-19 on Brazil's 2020 Tax Agenda

2020 imposed unprecedented challenges on virtually every nation on the planet, due to the pandemic caused by COVID-19. The crisis affected citizens around the world in many aspects, the main one obviously related to health. But the consequences on the economy were (and are) also a relevant concern, with unemployment rates rising, GDP growth falling and various sectors of the economy being heavily affected by measures such as social distancing, especially small and medium-sized businesses. The consequence of this scenario was a severe drop in tax revenues, just when governments had to increase public spending to mitigate the effects of the crisis.

The OECD's Centre for Tax Policy and Administration (CTPA), responsible for the mapping out of measures to combat the pandemic, carried out a study suggesting a series of policies tax administrations could adopt to tackle the effects of COVID-19. In general, the measures Brazil adopted are aligned to the CTPA's recommendations (Brazil, however, is not fully aligned, since it did not adopt all the suggested measures). From a tax perspective, the federal government, as well as some states and municipalities, adopted measures that sought to improve the cash-flow situation of companies, such as temporary tax exemptions or reductions, suspension or extension of deadlines in proceedings involving the collection of taxes, simplification of procedures before the authorities and instalment procedures.

There was no increase in taxes (the imposition of new taxes was only suggested in the fourth and last phase of the recovery process defined by the CTPA), despite the presentation of some bills attempting to increase taxes or create new ones, under the argument that additional resources are needed to face the increase in public spending. Among these attempts was Bill No 2,358/2020, presented in May 2020. Allegedly inspired by BEPS Action 1 and by Europe's Digital Services Tax, the bill aimed at the creation of a tax on the digital economy, called CIDE-Digital, that would be due by companies operating in the technology sector, residents or not in Brazil. Although the technology sector was one of the few that prospered in 2020, it already bears a high indirect taxation burden in Brazil, especially in the case of the importation of related services. Thus, there are doubts as to whether the bill on CIDE-Digital will pass, at least as originally proposed. Technology companies operating in Brazil should consider monitoring the progress of this bill in 2021.

Congress Expects to Vote on Tax Reform in 2021

The global crisis scenario of 2020 delayed the progress of important tax developments that were expected to be discussed in Brazil, such as tax reform. Indeed, the Brazilian government had to focus on the responses to the COVID-19 crisis. Notwithstanding, in 2021, the Brazilian Congress expects to resume the discussions on tax reform proposals that began in 2020.

Tax reform in Brazil may be divided into two fronts. The first involves a profound change in the country's indirect taxation and would lead to changes in the Federal Constitution. This front comprises two bills proposing amendments to the Federal Constitution (PEC): PECs 45 and 110.

PECs 45 and 110 aim at the unification of several federal, state and municipal taxes into one single value-added tax (VAT). These proposals aim at reducing the complexity of Brazil's indirect taxation, considered a hurdle to the growth of the country and one of the main reasons Brazil is deemed to have a high tax compliance cost.

In parallel, in July 2020, the federal executive power submitted to Congress a proposal to create a federal VAT through the unification of the Programme of Social Integration (PIS) and the Contribution for the Financing of Social Security (COFINS) in a single tax, so-called CBS. PIS and COFINS are social contributions imposed on gross revenues accrued by taxpayers.

The creation of CBS would represent a reform in Brazil's indirect taxation limited to taxes collected at the federal level, which would not require a constitutional amendment, only changes in ordinary laws. One could claim the creation of CBS is not a real reform, as it would merely represent the combination of two taxes that, in practice, are already treated as one, since they basically have the same rules.

The other front of tax reform under discussion relates to corporate income tax (CIT) and may be subdivided as follows:

- an end to the income tax exemption for dividends distributed by Brazilian companies; and
- an end of the possibility of making deductible payments of interest on net equity.

There are several bills in Congress dealing with these two matters.

The above exemption to dividend distribution has existed in Brazil since 1996. Currently, Brazil has one of the highest nominal rates for CIT (34%). Thus, the repeal of said exemption should, at least theoretically, be followed by a reduction in CIT rates. Otherwise, Brazil would go even more against the current trend, where many jurisdictions moved their CIT rates closer to 20%.

Despite dealing with different topics, the two fronts of Brazilian tax reform must be analysed considering a broader (and challenging) scope, which is to make the country's tax system more efficient and less bureaucratic without increasing the overall tax burden. In fact, despite the need for resources to cope with the increase in public spending, considering the stage Brazil currently finds itself in, an increase in taxes could seriously compromise its economy.

The level of tax reforms approved by Congress will ultimately rely on political alignment. A broader and more structural reform is dependent upon amendments to the Constitution. A more limited reform focused on federal taxes would require a smaller quorum compared to that necessary for a constitutional amendment. The recent changes in the presidency of the Senate and the House of Representatives may favour the proposals presented by the management of the federal executive branch. With these changes, the government may opt to guide Congress's efforts to vote for changes in federal tax legislation. In fact, this may be a trend in 2021, especially if there is no consensus between states (27) and municipalities (5,570) regarding the terms of PECs 45 and 110.

With the approval of tax reform, Brazil would increase the attraction of foreign investments and enhance the process of its economic recovery.

OECD Membership

Another initiative of the Brazilian government that goes in the direction of investment attraction is to become an OECD member country.

Brazil has been strengthening its relationship with the OECD since the 1990s. Now, the OECD considers Brazil a "key partner". Brazil was one of the non-member countries that most contributed to the BEPS Project and already adopts several of the tax policies recommended by the OECD.

In May 2017, Brazil formally expressed its intention of becoming a member country of the Organisation. However, to achieve membership, Brazil must face some legal and procedural challenges. One of the most relevant concerns is the misalignment of the country's transfer pricing (TP) rules as compared with OECD standards. The OECD follows the arm's-length principle, while Brazilian TP methods are mostly based on fixed margins and other presumptions.

By the end of 2019, the OECD and the Federal Revenue of Brazil (RFB) issued a joint report in which both parties demonstrated means towards convergence of the Brazilian TP rules with OECD standards. Additionally, in the middle of 2020, the RFB and OECD launched a public consultation to get collaboration on their ongoing research towards convergence of standards. This consultation presented 17 questions that touched on matters such as identification of situations that could require specific safe harbours, the use of comparable data by Brazilian companies, the possibility of using advance pricing agreements and other simplification measures.

However, TP might not be the only tax issue to be solved in Brazil's accession to the OECD. There may be other issues to address, such as having a proper general anti-avoidance rule (GAAR) in place, an increase in the country's treaty network (this issue may gain more relevance if the dividends exemption is repealed), alignment of the RFB's interpretation of the tax treaties and issues regarding taxation on the digital economy. These matters would be addressed in a report OECD prepares for countries accepted as potential candidates to membership. Brazil is on its path to achieve this stage.

Developments of 2020 That May Affect 2021

Despite the unforeseen events of 2020, there were developments in the taxation area, which may play an important role in the setting of 2021.

The first development to be highlighted is the amendments to Law 11,101 (Law of Judicial and Extrajudicial Recovery and Bankruptcy) by Law 14,112, published at the end of December 2020.

Important parts of Law 14,112 were vetoed by the President of the Republic. Two of them involved tax aspects and were vetoed for the same reason: they would entail a revenue waiver without the equivalent cancellation of another mandatory expense and without an estimate of their budgetary impact. The first veto involved a PIS/COFINS exemption to revenues arising from discounts obtained on negotiated debts (haircut). The other vetoed provision allowed the offsetting of gains from the judicial disposition of assets with tax-loss carry-forwards (TLCs) without the limitation that usually applies to the use of such credits (30% of the taxable period's profit).

Notwithstanding, Law 14,112 introduced significant changes to Law 11,101 tax-wise. They mostly involve the granting of benefits to companies undergoing judicial reorganisation (JR), such as the following.

- Federal tax debts that could be paid within seven years may now be paid within ten years – with a reduction in the amount of the instalment in the first years.
- The possibility of settling to 30% of the debt with both CIT TLCs and credits related to other federal taxes. As an alternative to the term payment of debts, a taxpayer whose judicial recovery plan has already been judicially admitted will be able to submit to the Attorney-General of the National Treasury (PGFN) a settlement proposal relating to debts liable to charge via tax foreclosure.
- The possibility of both enrolment in special term payment programmes and migration of debts included in former programmes to the new special programmes.
- Taxpayers in JR will also be able to include in term payment programmes tax debts related to certain federal taxes that became due after the date on which the JR request was filed.

On the other hand, certain changes brought in by Law 14,112 require caution from taxpayers planning to adhere to the above-mentioned programmes. Tax authorities were granted with the prerogative to request the transformation of the JR into bankruptcy if the conditions for enrolment in the term payment programme are breached or when the debtor's net worth is reduced in a way that results in substantial liquidation of the company to the detriment of creditors not subject to the JR procedures, as is the case of the Public Treasury.

Another important development that took place in late 2020 was the issuance of Public Ruling Cosit 145. Ruling 145, binding at tax authorities level, raised a restrictive position on the CIT exemption over state VAT subsidies granted to legal entities ("ICMS incentives"). Complimentary Law 160 states that state VAT subsidies, in general, are not subject to CIT, but the RFB seems not to share this understanding.

The granting of ICMS incentives is an important tool for the implementation of economic policies as well as for investment attraction by certain less developed Brazilian states. Ruling Cosit 145 conflicts with the position of the Superior Court of Justice (STJ) enforcing CIT exemption on government subsidies (clarification decision on Special Appeal 1,517,492, issued in November 2017, confirmed by several subsequent decisions on the same matter by the STJ), so that the enforcement of Ruling Cosit 145 may open a new front for litigation among taxpayers and the RFB.

Finally, the extinction of the tie-breaking vote in the Administrative Council for Tax Appeals (CARF) should be highlighted. The CARF is the stage for many relevant discussions between federal tax authorities and taxpayers, many of which were decided in favour of tax authorities by the tie-breaker vote. This vote is exclusive of the president of the panel, who is always a representative of tax authorities.

The alteration in the CARF's tie-breaking mechanism occurred in April 2020, under the justification that it could help to reduce the large number of existing tax disputes. Law 13,988 provided that, in the event of a tie in the judgment of an administrative proceeding, the matter under hearing will be resolved in favour of the taxpayer. Tax authorities filed lawsuits aimed at reinstating the tie-breaker vote. Until the present moment, however, the provisions of Law 13,988 are enforceable and may impact the outcome of important disputes in the CARF in 2021.

Discussions Involving a Possible GAAR

Another 2020 development was the beginning of the trial, by the Brazilian Supreme Court (STF), of Direct Action of Unconstitutionality No 2446 (ADI 2446), filed by the National Trade Confederation in 2001. The conclusion of this trial may have a major impact on Brazil's tax system, as well as end a dispute that started 20 years ago, regarding the existence or not of a GAAR in Brazil and its precise scope.

In 2001, the Brazilian Tax Code (CTN) was amended by Complementary Law No 104 to include a paragraph in its Section 116. The paragraph provides that, subject to the procedures to be established in ordinary law (hierarchically inferior to complementary laws), tax authorities may disregard transactions carried out by taxpayers with the sole purpose of concealing the occurrence of the taxable event. Such a change in the CTN was originally deemed as the introduction of a GAAR in Brazil. Since then, a great debate on the scope of the rule has taken place among Brazilian scholars and in tax courts.

The change in CTN, Section 116, sole paragraph, lacks effectiveness until it is regulated. Despite some failed attempts by the executive branch, until today, the federal government has not yet published legislation dealing with the procedures through which tax authorities may disregard taxpayers' transactions. Notwithstanding, tax authorities have been using the rationale of the paragraph of Section 116, despite not citing it, as grounds for the issuance of tax assessments challenging tax planning structures.

The hearing of ADI 2446 started in 2020, with Justice Carmen Lúcia reporting her position on the matter. The reporting vote was seconded by four other justices. Justice Lewandowski suspended the hearing with a request for further review of the case. Five other justices are still expected to cast their vote.

Although Justice Lúcia ruled out the argument of unconstitutionality, she also stated that the paragraph of Section 116 needs regulation (limited effectiveness) and that taxpayers have the right to organise themselves in a tax-efficient manner, provided they do so by legitimate means. Therefore, one should wait for the conclusion of the STF's trial and the publication of the justices' official vote.

The settlement of the above discussion will be key to many disputes and shall be a guidance on the assessment of tax planning limits in the Brazilian tax arena, a reason why the conclusion of the ADI 2446 trial is highly expected to take place soon.

Exclusion of ICMS from PIS/COFINS Tax Basis

Another matter that has kept relevance over the past decade with the potential to be settled in 2021 concerns the exclusion of ICMS from the PIS/COFINS tax basis calculation.

In 2017, the STF decided ICMS may be excluded from the PIS/COFINS tax basis calculation. However, after the STF's decision, the PGFN filed a motion for clarification aiming at:

(i) revisiting the concept of gross revenues adopted by the STF;
(ii) limiting the amount of ICMS taxpayers may exclude from their PIS/COFINS basis to the amount effectively paid to state tax authorities; and
(iii) restricting the effects of the decision issued by the STF to the period started after the n motion is judged.

The position conveyed in item (ii) of PGFN's motion is also adopted by the RFB, while taxpayers defend a different methodology for calculation of the amount of ICMS that may be excluded from the PIS/COFINS calculation.

The decision on the matter may have a great impact on the assessment of amounts companies may recover in relation to payment made in the past.

The matter brings relevant considerations as to the assessment of the values to be recognised in the financial statements of companies, as well as the proper moment to submit such amounts to CIT. Recently, the Brazilian SEC (CVM) issued Official Letter 01/2021, stating that publicly held companies should only consider the recognition of credits related to a PIS/COFINS overpayment if they are able to measure this credit with reasonable reliability. However, due to the current scenario – pending final decision of the STF on the amount of ICMS that may be excluded from the PIS/COFINS tax basis – the CVM acknowledges that most taxpayers may face challenges when it comes to reliably measuring their credits.

So far, there is no date set for the judgment of the PGFN's motion. However, considering the relevance of the matter to Brazilian companies and the federal government, as well as the period elapsed since the filing of the PGFN's motion, the STF may resume the judgment of this matter in 2021.

Goodwill Tax Amortisation

Finally, an expected trend for 2021 is the continuation of assessment and disputes involving transactions that allow the tax amortisation of goodwill. This is still a hot topic, since it always comes up in M&A transactions, with relevant cases still awaiting trial.

The matter has not yet been settled by administrative courts and is beginning to be discussed by judicial courts. The end of the tie-breaker vote may play an important role in the definition of the CARF's position on the matter.

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CANADA

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

There are several options available when doing business in Canada. The choice of structure is generally dictated by a number of factors, based mainly on tax and liability considerations. The most used structures are:

- corporations;
- unlimited liability companies (ULC);
- partnerships;
- joint ventures; and
- sole proprietorship.

Corporations

Businesses are generally carried on by corporations. A corporation is a distinct legal entity, with a patrimony distinct from its shareholders'. Such entity may be incorporated under the Canada Business Corporations Act (CBCA) or under the equivalent law of a province or territory. Corporations' popularity stems from two main factors:

- the shareholders' liability exposure is limited to their investment in the corporation; and
- the corporation is taxed as a separate legal entity at lower rates than individuals.

ULCs

A ULC structure is only available in four provinces of Canada (Alberta, Nova Scotia, British Columbia and Prince Edward Island) and the regime may vary quite a bit between each. The common baseline is that a ULC is a distinct legal entity, but in some situations the shareholders' liability is unlimited. Under Canadian tax laws, ULCs are considered corporations and are taxed as separate legal entities, and they are usually used where there are US shareholders since ULCs may be treated as "disregarded entities" under US tax laws, therefore allowing taxation of the ULC's income in the US shareholders' hands directly for US tax purposes.

Partnerships

A partnership – be it a general partnership, a limited partnership or a limited liability partnership – is a relationship between two or more persons who carry on a business, with such relationship being governed by provincial legislation. In a general partnership, each partner is liable for all of the partnership's debts and liabilities in relation to third parties. In a limited partnership, there are two kinds of partners:

- general partners, who are exposed to unlimited liability; and
- limited partners, whose liability is limited to their capital investment if the limited partners take no part in the management or control of the business.

Multiple provinces have legislation in place allowing only certain professionals, such as lawyers and accountants, to practise through limited liability partnerships, a structure under which the partners are not liable for the actions of those who are not under their direct control or supervision. A partnership is not subject to income tax as a separate entity. It is rather a "flow-through" entity where the net income is calculated at the partnership level and allocated to its partners, who are liable for the taxes on such income.

Joint Ventures

A joint venture shares some similarities with a partnership but, unlike a partnership, where two or more partners conduct business together, a joint venture is created when two or more persons collaborate for a specific project. A joint venture is not taxed as a separate legal entity and the liability of each partner is set out in the joint venture agreement. Such agreement must clearly state that the parties do not wish to form a partnership or else the joint venture could be considered as such and each partner would become liable for all of the partnership's debts and liabilities.

Sole Proprietorship

A sole proprietorship is an unincorporated business owned by a single individual. Such individual's liability is unlimited, and the income generated by the business is added to the individual's other income, if any, and taxed at the personal rates.

1.2 Transparent Entities

Partnerships are commonly used to create investments funds since, as described in **1.1 Corporate Structures and Tax Treatment**, the potential limitation of liability and the absence of taxation at the entity level are valuable advantages to the partners. Since the income and loss are calculated jointly for the parties in a joint venture, such entity is popular in real estate investments as the joint parties may personally determine the depreciation expense that will be utilised when calculating their income, instead of having it calculated at the partnership level.

1.3 Determining Residence of Incorporated Businesses

The residence of an incorporated business is determined in two steps: first, by reviewing the deeming provisions of Canada's Income Tax Act (ITA), and then, if none are applicable, by application of the common law. The ITA deems a corporation to be a Canadian resident throughout a tax year if the corporation was incorporated in Canada. If the corporation was not incorporated in Canada, or if it was incorporated in Canada prior to 26 April 1965, such corporation may be determined to be a resident of Canada by application of common law principles.

The general principle is that a corporation is a resident of the country where its central management is located, and in which control is executed. The ITA also includes a non-deeming provision, pursuant to which a corporation will not be determined to be a resident of Canada under the ITA if it is deemed a resident of another country under a tax treaty with said other country.

A partnership with one or more non-resident partners is not a "Canadian partnership" and is therefore treated as a non-resident partnership. Although partnerships are flow-through entities for Canadian tax purposes, they are considered a taxpayer for certain Canadian tax purposes, so their residency is relevant.

1.4 Tax Rates

The federal tax rates applicable to incorporated businesses vary depending on whether the corporation qualifies as a Canadian-controlled private corporation (CCPC) or not. The federal tax rates of a CCPC are as follows:

- active small business income (up to CAD500,000): 9%;
- active business income (above CAD500,000): 15%; and
- investment income (other than dividends): 38.67%, of which 30.67% is refundable upon payment of taxable dividends by the corporation at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the corporation.

The federal tax rate applicable to a corporation that does not qualify as a CCPC is 15% for all types of income.

As for dividend income, if the dividends are paid by a private Canadian corporation "connected" to the Canadian corporation receiver, the intercorporate dividends received are not taxable, subject to some exceptions. If the dividends are paid by a public Canadian corporation or by a Canadian corporation that is not "connected" to the Canadian corporation receiver, the dividends received are subject to 38.33% tax, which is refundable upon the payment of taxable dividends at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the receiver corporation. A payer corporation is connected to the receiver corporation if the latter (or persons not dealing at arm's length with the latter) controls the payer corporation or if the receiver corporation owns more than 10% of the shares in votes and value.

As of 2021, the federal tax rates applicable to individuals carrying on a business directly are as follows, with it being understood that "taxable income" includes all taxable income earned by such individual other than dividends, whether through a business or not:

- 15% on the first CAD49,020 of taxable income, plus;
- 20.5% on the next CAD49,020 of taxable income (on the portion of taxable income over CAD49,020 up to CAD98,040), plus;
- 26% on the next CAD53,939 of taxable income (on the portion of taxable income over CAD98,040 up to CAD151,978), plus;
- 29% on the next CAD64,533 of taxable income (on the portion of taxable income over CAD151,978 up to CAD216,511), plus;
- 33% of taxable income over CAD216,511.

The net income of a partnership is taxable in the hands of its partner, at the rate applicable to the partner since it is a flow-through entity.

Corporations and individuals are also subject to provincial income tax.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable income of a corporation is composed of business income, investment income (interest, rent, royalties, dividends) and 50% of capital gains, and is the result of its gross income for the year minus the allowable deductions. The deductions a corporation is allowed to claim are expenses incurred for the purpose of earning income. This usually covers salaries, insurance expenses, maintenance and repairs, licences, accounting and legal fees and advertising expenses.

The net income reported on financial statements will often not be the same as the net income calculated for tax purposes, since some income and expenses reported in financial statements may not be used in the calculation of net income for tax purposes. Income is generally reported using the accrual method – only farmers, fishermen or self-employed commission sales agents may use the cash method.

2.2 Special Incentives for Technology Investments

The Scientific Research and Experimental Development Program (SR&ED) encourages all Canadian businesses, regardless of their size or sector, to develop new, improved or technologically advanced products by using three tax incentives:

- an income tax deduction;
- an investment tax credit (ITC); and
- a refund, in specific circumstances.

The maximum ITC and the availability of a refund under the SR&ED depend on whether the corporation is a CCPC or not, and on the amount of qualified expenditures carried out in Canada (such as wages, machinery, equipment, etc). Unused ITC may be carried back three years or forward for 20 years. Provincial incentives are also available.

2.3 Other Special Incentives

A Canadian film or video production tax credit is available for certain labour expenses for certified films or videos (similar credits are also offered by provinces). Also, an accelerated investment incentive was introduced in 2018 that provides for an enhanced first-year depreciation deduction on depreciable properties, and for the immediate write-off of the full cost of machinery and equipment for manufacturing and processing businesses and of the full cost of specified clean energy equipment for clean energy businesses.

2.4 Basic Rules on Loss Relief

A corporation may incur two types of losses:

- capital losses; and
- non-capital losses.

Capital Losses

Capital losses occur upon the disposition of a capital property for an amount less than its cost. Generally, a capital loss may only offset capital gains – it cannot be applied to other income unless it qualifies as an allowable business investment loss. Capital losses may be carried back three years or carried forward indefinitely.

Non-capital Losses

Conversely, a non-capital loss is any loss occurring other than upon the disposition of a capital property. Non-capital losses may offset all sources of income. They can also be carried back three years or carried forward for the subsequent 20 years (or ten years with respect to allowable business investment loss, which will be converted into a capital loss upon the 11th year). An allowable business investment loss for a corporation is a capital loss incurred on the sale to a third party of shares of a small business corporation or upon the bankruptcy, insolvency or winding up of a small business corporation that ceased to operate a business. The allowable business investment loss may offset all sources of income. A limited partner's share of a limited partnership's loss from a business or property may only be deducted by the limited partner if such loss exceeds the limited partner's "at-risk amount" for the year.

2.5 Imposed Limits on Deduction of Interest

Interest expenses are deductible if they are reasonable, and are payable under a legal obligation to pay interest on money borrowed for purposes of earning income from a business or property. Under certain exceptions, interests payable on money borrowed by a corporation to redeem shares, return capital or pay dividends may be deductible. Under the thin capitalisation rules, the deduction for interests paid by a corporation to a non-resident shareholder is limited where the debt-equity ratio exceeds 1.5:1.

2.6 Basic Rules on Consolidated Tax Grouping

Unlike other jurisdictions, Canada does not have a formal system providing for the consolidated taxation of corporate groups. Separate company losses may be used through reorganisations or financing arrangements, but such transactions require thoughtful planning, and some may even require tax rulings.

2.7 Capital Gains Taxation

Only 50% of the capital gain of a corporation is taxable and the resulting amount is taxed at a rate of either 15% if the corporation is not a CCPC or 38.67% if the corporation is a CCPC. Out of the 38.67% tax rate, 30.67% is refundable upon the payment of taxable dividends by the corporation at a rate of CAD1 of tax reimbursed for each CAD2.61 of dividends paid by the corporation. There are no exemptions or reliefs on the taxation of capital gains for corporations.

2.8 Other Taxes Payable by an Incorporated Business

In addition to the federal income tax, corporations may be subject to federal and provincial goods and services tax, municipal taxes, land transfer taxes, withholding taxes, federal and provincial social security contributions and provincial payroll taxes. Corporations are also subject to provincial income tax.

2.9 Incorporated Businesses and Notable Taxes

See **2.8 Other Taxes Payable by an Incorporated Business**.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most businesses are carried on by corporations.

3.2 Individual Rates and Corporate Rates

One of the main advantages of providing services through a corporation is the ability for the individual to defer taxes on their business income as a result of the small business deduction, which provides a preferential tax rate of 9% on the first CAD500,000 of active business income earned by a corporation if it is a CCPC. However, this preferential tax rate does not apply to personal services businesses carried on by a corporation. A personal services business is one that provides services where the individual who performs the services on behalf of the corporation (ie, the incorporated employee) would reasonably be regarded as an employee of the person or partnership to which the services were provided, but for the existence of the corporation. These rules are not restricted to professionals.

The taxable income of a personal services business is taxed at a flat rate equal to the top marginal personal tax rate, thus removing the advantage afforded by the lower corporate tax rates.

3.3 Accumulating Earnings for Investment Purposes

Passive income rules provide for a gradual reduction of the small business active income limit of CAD500,000 available to CCPCs (the Business Limit) on which the preferential tax rate of 9% applies where a corporation, together with its associated corporations, earned investment income between CAD50,000 and CAD150,000 in a year. The reduction is effectively decreasing the annual Business Limit by CAD5 for each CAD1 of investment income earned in excess of CAD50,000.

Pursuant to the rules, when the aggregate investment income of a CCPC earning active income and its associated corporations is CAD150,000 or higher for a year, the CCPC will not have access to the preferential tax rate of 9% applicable to active business income and will therefore be taxed at a rate of 15%.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends from Private Corporations

Three types of dividends can be paid by a corporation resident in Canada in favour of an individual resident in Canada:

- eligible dividends;
- non-eligible dividends; and
- capital dividends.

At the federal level, if an individual receives an eligible dividend, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

At the federal level, if an individual receives a non-eligible dividend, a grossed-up amount equal to 115% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 9.03% of the grossed-up amount, the whole resulting in a non-eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 27.57%.

Eligible and non-eligible dividends are also taxable at the provincial level.

A capital dividend is a dividend paid by a corporation out of its capital dividend account (which is essentially composed of the non-taxable portion of capital gains realised by the corporation) and is not taxable in the hands of the individual.

Gain on the Sale of Shares in Private Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a private corporation.

An eligible individual resident in Canada is entitled to a lifetime capital gains exemption on gains realised on the disposition of qualified small business corporation shares. If the capital gain realised by the individual qualifies under these rules, the capital gain, up to the limit, will be exempt from income tax. The lifetime capital gains exemption limit is indexed annually, and is CAD892,218 for 2021.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends from Publicly Traded Corporations

Dividends received from a Canadian public corporation are eligible dividends. Therefore, at the federal level, a grossed-up amount equal to 138% of the dividend is included in computing the individual's income and the individual is allowed a dividend tax credit equal to 15.02% of the grossed-up amount, the whole resulting in an eligible dividend being taxable in the hands of an individual at a top federal marginal tax rate of 24.81%.

Dividends received from a company residing in another country are not subject to the gross-up nor the dividend credit. The entire dividend amount is taxable in Canada but may be subject to withholding in the other country.

Gain on the Sale of Shares in Publicly Traded Corporations

50% of a capital gain realised by an individual is taxable at the individual's applicable federal and provincial income tax rate, including a capital gain realised on shares of a publicly traded corporation.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Canada imposes a federal 25% withholding tax on certain types of passive income from Canadian sources such as interests, dividends and royalties paid or credited to non-residents.

Subject to limited statutory exemptions, the Canadian payer is required to withhold tax from the gross amount paid or credited to the non-resident payee and to remit it to the tax authorities on its behalf. The withholding tax rate can often be reduced to 15%, 10% or even 0% under Canada's tax treaties. However, before withholding less than 25%, the Canadian payer should normally require a completed Form NR301 (or equivalent) to confirm that the non-resident payee qualifies for treaty relief.

4.2 Primary Tax Treaty Countries

Canada currently has 94 tax treaties in force with foreign countries, which – subject to exceptions – mainly follow the OECD Model Tax Convention.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The OECD Multilateral Instrument entered into force in Canada on 1 December 2019 and introduces a "principal purpose test" into most of Canada's tax treaties, which will deny the benefits of the applicable treaty where one of the principal purposes of the arrangement or transaction is to obtain the benefits of the treaty. For example, if determination is made that one of the principal purposes for using a subsidiary in a particular treaty jurisdiction is to access the benefits of that treaty, then the benefits of that treaty are denied.

The tax authorities' position is that, in certain circumstances, Canada's General Anti-Avoidance Rule could be applied to transactions that are undertaken primarily to secure a tax benefit afforded by a tax treaty.

4.4 Transfer Pricing Issues

Transactions regarding goods, services (ie, management) and intangibles (ie, patent, trade marks) with non-arm's-length non-residents are required to occur under arm's-length terms and conditions. Otherwise, adjustments will be made to ensure that the Canadian payer's price reflects an arm's-length price.

Should the Canadian tax authorities adjust transfer pricing, penalties could apply if the taxpayer has not made reasonable efforts to determine and use arm's-length transfer prices. Prescribed documentation must be maintained since a taxpayer who fails to do so will not be considered to have made "reasonable efforts" to determine and use arm's-length transfer prices.

Multinational business groups with more than EUR750 million in annual consolidated revenues must file a country-by-country report containing various financial and operational information. Country-by-country reporting requirements in Canada were added in congruence with recommendations made as part of the OECD Base Erosion and Profit Shifting (BEPS) project.

4.5 Related-Party Limited Risk Distribution Arrangements

Related-party limited risk distribution arrangements should reflect arm's-length terms and conditions in line with the transfer pricing principles outlined in **4.4 Transfer Pricing Issues**.

In addition, consideration should be given to Article 12 of the OECD Multilateral Instrument regarding the avoidance of permanent establishment status through the use of an agent that is not independent.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Canadian transfer pricing rules are generally in line with the OECD principles.

4.7 International Transfer Pricing Disputes

The Canada Revenue Agency (CRA) encourages taxpayers who are subject to double taxation to consider the Mutual Agreement Procedure (MAP) programme.

In its 2018 MAP Program Report, the CRA mentions that:

- it had 176 negotiable MAP cases as of 1 January 2018, involving taxpayers from 26 different jurisdictions. The USA represents the majority of MAP cases, at 54%;
- during 2018, it accepted 97 new MAP cases and closed as many as 126;
- the average time to complete a negotiable MAP case was 22.8 months; and
- of the 126 MAP cases closed in 2018, 101 (80.2%) resulted in full relief from double taxation upon negotiation and eight (6.3%) resulted in unilateral relief granted. In 12 cases (9.5%), the objection was either not justified, withdrawn by the taxpayer, or resolved via a domestic remedy. The remaining five cases (4%) were closed with other outcomes.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Under domestic law, upward and downward adjustments can be made to transfer pricing disputes. It should be noted that downward adjustments are made only if, in the opinion of the tax authorities, the circumstances indicate the adjustments are appropriate.

In Information Circular IC 87-2R, the CRA mentions that it may decide not to exercise its discretion with regards to downward adjustments where the taxpayer's request has been prompted by the actions of a foreign tax authority. The taxpayer has the right to request relief under the MAP article of the applicable treaty, or such request can be considered abusive.

Canada is recognised as a leader in the efficient resolution of MAP cases, receiving three 2018 MAP awards from the OECD's Forum on Tax Administration in September 2019.

It is generally stated that the CRA is willing to negotiate MAP cases when taxpayers themselves initiate a downward transfer pricing adjustment in Canada within the treaty time limits. The CRA will engage in the MAP process if the other jurisdiction is willing to make a corresponding upward adjustment, provide a position statement and engage in negotiations. This approach is said to be consistent to avoid both double taxation and double non-taxation.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

A non-Canadian entity may operate in Canada through a subsidiary or a branch.

Through a Canadian Subsidiary

Assuming it is a resident of Canada for tax purposes, a Canadian subsidiary will be taxed on its worldwide income from all domestic law sources. In general, a corporation is deemed to be a Canadian resident if it is incorporated or has its central management and control in Canada.

In addition to dividend distributions, also subject to treaty relief, the Canadian subsidiary will have to withhold tax on several types of payments to non-residents, including interest paid to non-arm's-length parties, participating interest, certain management or administration fees and rents, royalties and similar payments.

Through a Canadian Branch

Under the branch scenario, the non-resident corporation will be liable for income tax on its Canadian-source business income at the same rates as Canadian resident corporations.

Moreover, and as a general rule, a 25% branch tax (which may be reduced under certain tax treaties to the rate applicable to dividend distributions) will apply to the after-tax profits of a non-resident corporation that are not invested in qualifying property in Canada.

The branch tax is intended to approximate the withholding tax that would have applied to taxable dividends from a Canadian subsidiary if the non-resident corporation had incorporated a Canadian subsidiary to carry on business in Canada instead of using a branch.

5.3 Capital Gains of Non-residents

Generally, Canada does not tax the capital gains realised by a non-resident on the disposition of shares of a Canadian resident corporation.

An exception to that principle applies if (i) the disposed shares qualify as "taxable Canadian property" (ie, shares of corporations that are not listed on a designated stock exchange); and (ii) at any time in the previous 60-month period, more than 50% of the fair market value of the shares was derived from one or any combination of:

- real or immovable property located in Canada;
- resource property located in Canada;
- timber resource property located in Canada; or
- options or interests in any of the above.

In general, tax on the disposition of taxable Canadian property should not result in double taxation for a non-resident residing in a jurisdiction with which Canada has a tax treaty.

5.4 Change of Control Provisions

Change of control provisions will not trigger immediate tax or duty charges. However, the following occurs when there is a change of control:

- the taxation year of the corporation is deemed to end, and a new taxation year is deemed to begin;
- the corporation cannot deduct non-capital loss carry-forwards unless it carries on the business that gave rise to the loss for a profit or with a reasonable expectation of profit. In such case, the losses are deductible only against the corporation's income from the same or a similar business;
- the corporation's net capital loss carry-forwards expire;
- accrued capital losses cannot be carried forward;

- carry-forward of ITCs is restricted following the change of control.

The disposal of an indirect holding in a Canadian corporation higher up the foreign group could trigger the change of control provisions because "indirect control" has to be considered, as well as "direct control".

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There is no mandatory formula to determine the income of a foreign-owned local affiliate selling goods or providing services in Canada. Transactions with the corporate group's foreign entities should rely on the "arm's-length principle" of the transfer pricing rules.

5.6 Deductions for Payments by Local Affiliates

Generally, a local affiliate's expenses are non-deductible, unless they are made or incurred for the purposes of earning income from a business or property. Hence, local affiliate expenses that are made or incurred for the purposes of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

5.7 Constraints on Related-Party Borrowing

Canada has a set of thin capitalisation rules which may apply where the lender to a Canadian corporation is a non-resident person who, alone or with other related persons, owns more than 25% of the Canadian corporation's shares (by vote or value). The interest expense on the loan would otherwise be deductible to the Canadian corporation. These rules may also apply to trusts and to partnerships of which a Canadian-resident corporation is a member.

The acceptable level of non-arm's-length interest-bearing debt allowed for the Canadian thin capitalisation rules is a debt-to-equity ratio of 1.5:1. Interest deduction will be limited proportionally if a debtor's outstanding debts to a "specified non-resident shareholder" exceed that ratio.

Any non-deductible "excess" interest is treated as a dividend for withholding tax purposes and would trigger withholding tax at a rate of 25% (subject to reductions under an applicable tax treaty).

Debt financing provided by a Canadian corporation to its non-resident shareholders or any other non-resident persons not dealing at arm's length with the non-resident shareholders is generally deemed to be a dividend paid to the non-resident and is subject to Canadian withholding tax at a rate of 25% (subject to reductions under an applicable tax treaty).

Notable exceptions are where the loan is repaid within one year after the end of the lender's taxation year, and the repayment is not part of a series of loans and repayments. In such a scenario, the loan is considered "pertinent loan or indebtedness" (PLOI) under the PLOI regime, which requires the Canadian corporation to include a deemed interest income in its taxable income.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

A Canadian resident corporation is subject to Canadian corporate income tax on worldwide income. Foreign income is taxed in Canada at the same federal corporate tax rate as local income, which does not include provincial taxes.

However, if a corporation has income sourced from another country and is taxed in that other country, it could be entitled to apply for foreign tax credits against its tax payable in Canada to prevent double taxation on the same income. Separate foreign tax credit calculations are prescribed for business and non-business income on a country-by-country basis.

6.2 Non-deductible Local Expenses

Generally, local expenses are non-deductible unless they are made or incurred to earn income from a business or property. Hence, local expenses made or incurred for the purpose of earning foreign business or property income would normally be deductible to reduce the taxpayer's net income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Canadian taxation of a dividend received from a foreign corporation will depend on the foreign corporation's qualification. As a general rule, dividends must be included in computing the recipient's taxable income. If the foreign corporation is not a foreign affiliate (FA) of the dividend recipient, no relief will be available for the foreign corporation's underlying taxes. A FA is a foreign corporation of which:

- a Canadian corporation owns at least 1% of any class of its outstanding shares, directly or indirectly through another entity; and
- the same Canadian corporation owns, alone or together with related persons (individuals or corporations), at least 10% of any class of its outstanding shares, directly or indirectly through another entity.

When a FA pays a dividend to a Canadian corporation, the FA's surplus account must be determined. The four different surplus accounts (exempt surplus, taxable surplus, hybrid surplus, pre-acquisition surplus) accumulate differently.

Exempt Surplus Treatment
An exempt surplus is generally active business income earned by a FA that carries on an active business in a country with which Canada has signed a tax treaty. A dividend from this surplus account is fully deductible to the Canadian parent corporation receiving it. If the FA is in a non-treaty country, the dividend paid to the Canadian parent may also qualify as exempt surplus if the foreign country has entered a tax information exchange agreement with Canada.

Hybrid Surplus Treatment
Hybrid surplus will generally include 100% of any gains from the sale of shares of a FA and/or partnership interest by another FA. Dividends out of hybrid surplus are only included in the Canadian corporation's taxable income at a rate of 50%.

Taxable Surplus
Taxable surplus generally captures "net earnings" from an active business carried on by the FA in a country with which Canada does not have a tax treaty and in respect of its foreign accrual property income (FAPI – see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**). Dividends paid out of this surplus account will be taxable in Canada if the FA's foreign tax rate is lower than Canada's tax rate.

Pre-acquisition Surplus Treatment
Finally, a dividend from a pre-acquisition surplus is a fully deductible capital return that reduces the cost of the shares in the FA.

6.4 Use of Intangibles by Non-local Subsidiaries
Non-Canadian subsidiaries can use intangibles developed by Canadian corporations. However, the Canadian corporation that owns and markets the intellectual property must charge an arm's-length price to the related entity for the use of the intangible under the transfer pricing rules. The income earned from this agreement with the foreign subsidiary, such as royalties from a licensing agreement, is taxable in Canada for the Canadian parent.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
Canadian corporations are taxed on the FAPI of a FA controlled by the Canadian taxpayer (CFA) in the proportion of ownership in the CFA. FAPI is essentially passive income generated in the CFA, notably property income and capital gains. For example, if a Canadian corporation controls 80% of the CFA, it will be taxable in Canada on 80% of the FAPI earned in the CFA at the end of each taxation year.

If the CFA is taxed in the foreign jurisdiction, the Canadian parent is allowed an equivalent deduction known as foreign accrual tax to avoid double taxation. It is also possible to generate a foreign accrual property loss, which can apply against FAPI.

This position is no different for foreign branches of Canadian corporations since the Canadian resident taxpayer is subject to tax on its worldwide income, subject to foreign tax credits to which it may be entitled.

6.6 Rules Related to the Substance of Non-local Affiliates
Canadian domestic legislation does not directly require substance in foreign subsidiaries. However, where a FA does not employ more than five full-time employees in the active conduct of its business, the income of such business will constitute FAPI of the FA.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates
A Canadian resident corporation is taxable in Canada on its worldwide sources of income, including capital gains from the sale of FAs. Only half of the capital gain is included in the taxpayer's net income in Canada (as described in detail under **2.7 Capital Gains Taxation**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions
The ITA contains a General Anti-Avoidance Rule that applies in case of abuse of the ITA's provisions. A transaction will be considered an avoidance transaction when three conditions are met, namely:

- a tax benefit must result from one transaction or a series of transactions;
- a transaction resulting, directly or indirectly, in a tax benefit, unless the transaction can reasonably be undertaken, or arranged primarily for business purposes other than to obtain a tax benefit; and
- there has been abusive tax avoidance in the sense that it cannot reasonably be concluded that the tax benefit would be consistent with the object, spirit or purpose of the provision invoked by the taxpayer.

It is incumbent on the taxpayer to establish that the first two conditions are not met, while the burden for the third condition lies with the tax authority.

Any assessment to be issued under the General Anti-Avoidance Rule will have to be reviewed by a committee established by the CRA.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Canada has no periodic routine audit cycle. The Canadian tax law does not contain any specific rules regarding audit cycles, and tax audits are typically carried out at the tax authorities' discretion. As such, an audit of a timely filed tax return can be conducted at any time by the Canadian tax authorities.

Auditors have significant investigative powers and may require the filing and disclosure of documents and information necessary for the assessment.

The Audit Process

The audit generally begins with a formal demand letter requesting access to specific information, a physical visit to the place of business and/or a meeting with an individual taxpayer. In addition, the auditor may request and be granted access to third-party information, including banking and supplier documents and, to a limited extent, the accountant's file.

The process will usually end with the release of a draft or preliminary assessment, allowing a 21-day delay to submit new information regarding the draft assessment issues. The formal time limit for issuing a reassessment notice is three years following the initial assessment notice for a given year. However, this delay may be extended in cases of negligence and/or fraud. Some corporations will also face different delays depending on the nature of the audit.

9. BEPS

9.1 Recommended Changes

Canada has implemented the BEPS recommended changes as follows.

- Action 1, "Address the tax challenges of the digital economy": Canada proposed that foreign-based vendors selling digital products or services to Canadian consumers be required to register for, collect and remit sales tax on their taxable sales, effective from 1 July 2021, and has proposed to implement a corporate tax on corporations providing digital services, with effect from 1 January 2022. These propositions would apply until a common approach acceptable to Canada and its international partners comes into force.
- Action 2, "Neutralise the effects of hybrid mismatch arrangements": Canada has not implemented the recommendations made by the OECD.
- Action 3, "Strengthen CFC Rules": Canada has adopted Controlled Foreign Corporation (CFC) rules and applies a rather wide definition of CFC and legal and economic control tests to define a CFC.
- Action 4, "Limit base erosion via interest deductions and other financial payments": Canada has not adopted the BEPS Action 4 rules but relies on its domestic interest limitation provisions.
- Action 5, "Counter harmful tax practices more effectively, taking into account transparency and substance": Canada agreed to exchange information regarding cross-border rulings relating to preferential regimes, to transfer pricing legislation, to downward adjustment not directly reflected in the taxpayers' accounts, to permanent establishment determination, and to related-party conduit rulings, under BEPS Action 5.
- Action 6, "Prevent treaty abuse": Canada announced that it would adopt the principal purpose test to address treaty abuse in 2017, according to the OECD's minimum standard. The principal purpose test is an anti-abuse provision that seeks to deny treaty benefits where one of the main objectives of an arrangement or transaction is to obtain treaty benefits.
- Action 7, "Preventing the artificial avoidance of permanent establishment status": Canada will not include the new definition of a permanent establishment in its tax treaties to reflect the recommendations set out in this Action 7.
- Actions 8 to 10, "Transfer pricing": Canada's transfer pricing guidelines are consistent with those established by the OECD.
- Action 12, "Disclosure of aggressive tax planning": Canada has not announced any specific actions.
- Action 13, "Re-examine transfer pricing documentation": Canada implemented country-by-country reporting from 1 January 2016. This reporting applies to multinational corporations whose total annual consolidated group revenue is EUR750 million or more. Such corporations will be required to file a country-by-country report with the CRA within one year of the end of the fiscal year to which the report relates.
- Action 14, "Dispute resolution": Canada has reviewed stage 2 of Action 14 and has made recommendations. Canada opted for the mandatory binding agreement as proposed by BEPS Action 14.
- Action 15, "Develop a multilateral instrument": Canada ratified the Multilateral Instrument (MLI) in 2019. The MLI applies to some of Canada's tax treaties, effective as early as 1 January 2020, for Canada's treaty partners that have also ratified the MLI.

Where Canada has not implemented specific legislative changes concerning the above-mentioned BEPS Actions, it can generally be explained by the fact that it has introduced a series of measures over the past decade to prevent perceived abuses also targeted by the BEPS Actions.

9.2 Government Attitudes

Canada has been actively involved in the BEPS project deployed by the G20 and OECD, and continues to work with the international community to ensure a coherent and consistent response to BEPS. Canada has endorsed all the recommendations developed under the BEPS project. Canada and other G20 members believe that broad and consistent implementation will be critical to the project's effectiveness. While some BEPS Actions have already been implemented, Canada is continuing to analyse recommendations related to other aspects of BEPS.

9.3 Profile of International Tax

International taxation has gained a high public profile in Canada, with the government taking active steps in the fight against aggressive international tax avoidance, protecting the Canadian tax base and enhancing the overall fairness and transparency of Canadian's tax administration.

9.4 Competitive Tax Policy Objective

Canada recognises the significance of business income tax in improving its international competitiveness. It believes that certain BEPS Actions will enhance Canada's international competitiveness.

9.5 Features of the Competitive Tax System

This question is not applicable in Canada.

9.6 Proposals for Dealing with Hybrid Instruments

BEPS Action 2 seeks to neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction. At this time, Canada has not implemented the BEPS Action 2 recommendations. Canada relies on the General Anti-Avoidance Rule to prevent undue tax benefits.

9.7 Territorial Tax Regime

Canada has a worldwide tax regime for resident corporations' income but has some aspects of a territorial tax regime for its FAs.

For example, all dividends derived from active income earned by an affiliate will be fully exempt from tax if the affiliate is both a resident and earns active income in a country with which Canada maintains a tax treaty. However, passive income is treated as FAPI. As the primary base-erosion measure, FAPI rules classify interests, royalties, rents, other passive investment income and unincorporated foreign branches' income as taxable. Regardless of whether or not the profits are repatriated, FAPI income is taxed on a current basis to mitigate the tax advantage of shifting domestic income to low-tax jurisdictions.

9.8 CFC Proposals

This question is not applicable in Canada.

9.9 Anti-avoidance Rules

Recent case law on the application of the General Anti-Avoidance Rule to perceived abuse of a tax treaty concluded that whether the income is subject to taxation in a foreign jurisdiction (double non-taxation situation) and the residence of the ultimate shareholder were irrelevant in determining whether transactions are abusive, and that treaty shopping arrangements are not inherently abusive for Canadian tax purposes.

The introduction of the modified preamble and the principal purpose test in the MLI makes it uncertain that this case law can be relied upon in the future.

9.10 Transfer Pricing Changes

BEPS Actions 8 to 10 addressed several transfer pricing areas related to the arm's-length principle and introduced significantly revised guidance in the form of amendments to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

Canada has played an important role in developing additional guidance on issues identified in the course of the BEPS Project, and believes that the current Canadian practices are consistent with the OECD transfer pricing guidelines.

9.11 Transparency and Country-by-country Reporting

Canadian country-by-country reporting legislation generally conforms to the OECD model legislation, with the notable exceptions that it has not adopted the OECD's master or local file requirements. Under domestic law, contemporaneous transfer pricing documentation is required in place of the local file requirements. As recommended by BEPS Action 13, country-by-country reporting applies to multinational enterprises with an annual consolidated group revenue equal to or exceeding EUR750 million in the previous year, and applies for fiscal years beginning on or after 1 January 2016.

Reports filed are automatically exchanged with other jurisdictions in which the multinational business group operates, provided that the other jurisdiction has implemented country-by-country reporting legislation, that both Canada and the other jurisdiction have a legal framework in place for the automatic exchange of information, and that both have entered into a qualifying competent authority agreement.

9.12 Taxation of Digital Economy Businesses

Under the current rules, foreign-based digital businesses can sell their goods and services to Canadians without charging the sales tax, which puts the burden on Canadian consumers to remit the sales tax. To ensure the fair taxation of cross-border digital products and services, Canada proposed that foreign-based vendors selling digital products or services to Canada's consumers be required to register for, collect and remit sales tax on their taxable sales to Canadian consumers, effective from 1 July 2021. This rule would also apply to non-resident digital platform operators that facilitate the supply of short-term accommodations in Canada.

However, it is worth noting that the provinces of Quebec and Saskatchewan have enacted legislation to have foreign digital corporations collect the sales tax in the province since 1 January 2019.

9.13 Digital Taxation

Canada proposed implementing a tax on corporations providing digital services, effective from 1 January 2022. Said propositions would apply until an acceptable common approach between Canada and its international partners comes into effect. Canada remains committed to a multilateral solution but is concerned about the delay in arriving at a consensus. Details on this new digital services tax are expected to be announced in 2021.

9.14 Taxation of Offshore IP

Offshore intellectual property deployed within Canada may result in taxation under generally applicable Canadian principles. Royalties paid to foreign recipients are among the categories of income subject to withholding tax. The 25% withholding rate may be reduced by treaty.

BCF Business Law has nearly 300 professionals and is the go-to firm for mid-market Quebec businesses and well-established global corporations. BCF's Tax group is composed of a multidisciplinary team of 30 lawyers, notaries and accountants. BCF's tax practitioners are called upon to advise public and private corporations in their most complex transactions, tax and estate planning as well as tax disputes. The firm's key practice areas include M&A, business succession tax planning, the taxation of financial instruments, SR&ED tax credits, and international taxation. A team of notaries also specialises in wealth protection, notably estate settlement, common law and marital relationship planning, and asset protection.

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CHILE

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form in Chile in order to limit liabilities and ensure they can deduct expenses and costs from their tax base.

The most common corporate structures are:

- *sociedad anónima* (corporation);
- *sociedad de responsabilidad limitada* (limited liability partnership); and
- *sociedad por acciones* (stock corporation).

From a tax perspective, all companies are taxed as separate entities and there are no key differences in terms of taxation.

Corporations and limited liability partnerships require at least two shareholders/partners, while stock corporations can be wholly owned entities.

From a management standpoint, corporations are managed by a board of directors, while limited liability partnerships appoint one or more managers that represent the company. In the case of stock corporations, the by-laws can regulate how the company will be managed. In the absence of a particular provision, the rules of corporations apply.

Shares in corporations and stock corporations can be freely transferred, while quotas in limited liability partnerships require the unanimous approval of partners.

Branches of foreign companies can also be incorporated. Although branches have the same legal personality as the parent company, they are separate taxpayers.

1.2 Transparent Entities

From 2020, Chile does not have tax transparent entities per se. An exception is the transparent regime for small companies with sales below USD2 million, where profits are allocated directly to shareholders, who must be Chilean resident individuals.

Branches that, from a legal standpoint, are the same entity as their foreign parent companies are considered as separate taxpayers subject to the same tax regime as Chilean companies.

Foreign companies that are considered transparent for tax purposes under local regulations are treated as separate entities in Chile. Exceptions may apply under certain treaties.

Chilean legislation recognises entities that are not subject to income taxes, provided certain requirements are met, such as private investment, mutual or public funds. These vehicles do not have legal personality; however, they are considered as separate from their quotaholders, not attributing or allocating revenue without effective distributions.

1.3 Determining Residence of Incorporated Businesses

Residence for incorporated businesses in Chile is determined by the country of incorporation.

1.4 Tax Rates

Chile has an integrated system, therefore taxation would be as follows.

Small Businesses (Transparent)

No corporate tax; shareholders – who must be Chilean resident individuals – are subject to individual tax (*Impuesto Global Complementario*), with a progressive rate from 0% to 40%.

Medium-Sized Business Regime (PYME)

Corporate tax at a 25% rate (reduced to 10% for COVID-19 incentives for 2020, 2021 and 2022). Upon dividend distribution, shareholders are taxed as follows, depending on their nature:

- Chilean resident individuals – individual tax (progressive rate from 0% to 40%), with a credit for the 25% corporate tax paid by the company;
- non-Chilean residents (individuals or entities) – 35% withholding tax (WHT), with a credit for the 25% corporate tax paid by the company; and
- companies – dividends between Chilean companies are not taxed.

Large Businesses

Corporate tax at a 27% rate. Upon dividend distributions, shareholders are taxed as follows, depending on their nature.

- Chilean resident individuals – individual tax (progressive rate), with a credit equivalent to 65% of corporate tax paid by the company (the credit can increase in some cases).
- Non-Chilean residents (individuals or entities) domiciled in a non-treaty country – 35% WHT, with a credit equivalent to 65% of corporate tax paid by the company.
- Non-Chilean residents (individuals or entities) domiciled in a treaty country – 35% WHT, with a credit for the corporate tax paid by the company.
- Non-Chilean residents (individuals or entities) domiciled in a country that has a tax treaty with Chile that has been signed before 1 January 2020, ratification is pending (USA and United Arab Emirates) – 35%, with a credit for the

corporate tax paid by the company until 31 December 2026. From 1 January 2027, the non-treaty tax treatment will apply.
- Companies (corporate taxpayer) – dividends between Chilean companies are not taxed.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporate taxpayers are taxed on a worldwide basis. Chilean-source income is recognised on an accrual or receipt basis. Foreign-source income is generally taxed on a receipt basis, with the exemption of permanent establishment (PE) or controlled foreign corporation (CFC) income, which is taxed on an accrual basis.

Taxable income results from adjustments made to the accounting profits. Some of the most relevant adjustments are as follows.

- Expenses can be deducted only if they are deemed necessary to produce income. The concept of "necessity" has been extended by the 2020 Tax Reform.
- Accounting provisions such as vacation and other estimates are not considered as part of the tax results.
- As a rule, intangible assets cannot be amortised.
- The useful life of fixed assets for depreciation purposes is determined based on a list set forth by the Chilean Internal Revenue Service (IRS). Tax law provides for an accelerated (⅓ of useful life) or immediate depreciation, provided some requirements are met.

2.2 Special Incentives for Technology Investments

There are no special regimes for technology investment.

Individual creators of intellectual property are exempt from capital gains tax upon sale to non-related parties.

A 35% credit could be granted against the corporate tax for certain R&D expenses. The credit requires the government's prior approval and has a cap of USD1 million.

2.3 Other Special Incentives

Small businesses that have agriculture, mining or transport activities may be taxed on a presumptive profit, based on the value of the assets associated with the operation.

The acquisition of a fixed asset results in a credit against corporate tax that cannot exceed 4–6% of the asset value, with certain caps. The VAT credit associated with these acquisitions is refundable after a two-month period.

The importation of fixed assets can be exempt from VAT if they are related to investment projects exceeding USD5 million.

Subject to certain requirements, investments in fixed assets can be depreciated, either immediately or in an accelerated manner (see **2.1 Calculation for Taxable Profits**).

Funds are generally exempt from corporate tax.

Sales of shares in publicly traded companies and bonds issued in the Chilean market are not subject to income taxes. Special requirements in terms of acquisition and disposal mechanisms and characteristics of the assets must be met.

All exemptions are currently under review by a special commission mandated by the government.

2.4 Basic Rules on Loss Relief

Losses can be carried forward with no limit on time or amount. Carry-back has been recently eliminated from Chilean legislation.

Corporate tax losses can be offset against dividends from local subsidiaries. As a result of the imputation, the corporate tax paid by the subsidiary on profits subject to distribution could be refunded to the holding company. The benefit corresponds to 90% for dividends paid in 2020, 80% for dividends paid in 2021, 70% for dividends paid in 2022 and 50% for dividends paid in 2023, until complete elimination of the benefit from 2024.

For capital gains relief, see **2.7 Capital Gains Taxation**.

2.5 Imposed Limits on Deduction of Interest

There are no interest deduction limitations, provided that interest relates to the generation of income. However, interest exceeding transfer pricing rules or thin capitalisation rules is subject to a separate taxation regime. See **4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards** and **5.7 Constraints on Related-Party Borrowing**.

2.6 Basic Rules on Consolidated Tax Grouping

There are no consolidated tax grouping rules in Chile.

Chilean parent companies that have net operating losses and receive dividends from their subsidiaries can request a refund of the corporate tax paid by their subsidiaries. This benefit will be available only until 2023.

2.7 Capital Gains Taxation

Capital gains on fixed assets, shares in subsidiaries and other assets generated by corporate taxpayers are considered as general income not subject to particular exemptions or reliefs, therefore the income or loss can be offset against other income subject to the general regime.

Sales of shares in publicly traded companies or companies acquired before 1984 are exempt from taxes, provided some requirements are met.

2.8 Other Taxes Payable by an Incorporated Business

If financing is obtained, stamp tax is levied on the loan transaction, with a cap of 0.8% over the principal amount of the loan.

VAT (19%) could be borne upon the disposal of assets or certain operations. Interests are not subject to VAT.

Mining companies are subject to a particular royalty tax, from 0.5% to 14%.

2.9 Incorporated Businesses and Notable Taxes

Companies must annually pay municipal tax on their tax equity, with a rate that ranges from 0.25% to 0.5% depending on the municipality.

Land tax applies to the owners of real estate. A surtax is imposed on businesses that own real estate assets that exceed a certain value.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

It is a common practice for businesses to be incorporated as stock corporations or limited liability partnerships, since incorporation thereof is fairly straightforward, which makes it possible to deduct expenses and offset credit and debit for VAT purposes.

3.2 Individual Rates and Corporate Rates

As individual tax rates are progressive, the effective tax rate may be higher than the corporate rate, depending on the level of income.

There are no particular provisions prohibiting individual professionals from being incorporated as corporate taxpayers. However, as Chile has an integrated system (see **1.4 Tax Rates**), even if individual professionals are structured as corporate taxpayers, the income will be subject to individual tax at the time dividends are paid. Also, any expenditure not related to the business (ie, school, car or housing) or even the loans granted by the company to its shareholders will be treated as a deemed dividend.

3.3 Accumulating Earnings for Investment Purposes

There are no restrictions on corporations accumulating earnings for investment purposes.

If profits are accumulated through structures intended to grant shareholders access to those profits, such as loans to shareholders or use of assets of the company for a purpose other than the business purpose, deemed dividend provisions could apply.

CFC rules may also apply on profits accumulated in foreign-controlled subsidiaries that generate passive income.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends or income derived from the sale of shares in closely held corporations are subject to the general individual tax regime, with rates ranging from 0% to 40%, depending on the level of income.

Capital gains may be divided in up to ten years or the number of years those shares have been held if less than ten, and added as an income for each year subject to individual tax in order to apply a lower tax bracket.

Sales of shares in corporations acquired before 1984 are exempt from taxes, if other requirements are met.

Dividends allow individuals to use as credit the corporate tax paid against individual tax. For further information, see **1.4 Tax Rates**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends allow individuals to use as a credit the corporate tax paid against individual tax. For further information, see **1.4 Tax Rates**.

Regarding capital gains, Article 107 of the Chilean Income Tax Law provides an exemption, regardless of whether the seller is an individual or corporate taxpayer, when the following requirements are fulfilled.

- Shares have been acquired through one of the following mechanisms:
  - (a) the Chilean Stock Exchange;
  - (b) a public offering especially regulated by the Capital Markets Law;
  - (c) as a consequence of a first issuance of shares, derived from the incorporation of a new company, or a subsequent capital increase;
  - (d) the exchange of share-convertible debt instruments; or
  - (e) as a consequence of the redemption in kind of mutual fund quotas.
- Shares must be sold through one of the following mechanisms:
  - (a) the Chilean Stock Exchange;
  - (b) a public offering; or
  - (c) as a consequence of the acquisition of mutual fund quotas in exchange for shares.
- At the time of the sale, shares must have "market presence". Mark-to-market agreements do not qualify for this purpose.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest is generally subject to a 35% withholding tax. Interest on bonds and debentures is subject to a 4% withholding tax.

The 4% rate also applies on interest from loans granted by foreign banks, financial institutions, insurance companies and qualified investors.

For dividends WHT, see **1.4 Tax Rates**.

Royalty payments are generally subject to a 30% withholding tax. This rate is reduced in the following scenarios:

- copyright – 20%;
- software – 15% (30% if the licensor is a resident of a preferential tax regime); and
- standard software – 0%; in order to qualify as standard software, the rights granted to the licensee should be limited to its use.

4.2 Primary Tax Treaty Countries

It should be noted that the conventions for the avoidance of double taxation subscribed to by Chile do not provide for any tax relief regarding dividend distributions from Chile (the so-called Chile Clause), as long as the corporate tax paid by the Chilean company is a credit against the dividend WHT. For further information on dividend taxation, see **1.4 Tax Rates**.

Considering there is no dividend relief, the main benefit granted to foreign investors relates to capital gains taxation.

Foreign investors acquiring corporate stock are more likely to structure Spanish or Portuguese parent companies, since treaties with those countries provide for a reduced 16% capital gains tax on the sale of controlling interests in Chilean entities.

In turn, foreign investors acquiring corporate debt have a different type of tax relief regarding interest income (10%) and capital gains on the disposal of receivables (exemption). The most common tax treaties are with:

- Australia;
- the United Kingdom;
- Ireland; and
- Switzerland.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

From a technical perspective, the Chilean IRS is entitled to challenge the use of channel companies that lack the substance to use treaty benefits based on the beneficial owner concept.

From a practical perspective, the Chilean IRS rarely challenges cross-border transactions for lack of substance, since the taxing authorities have difficulties in sustaining this kind of claim.

However, the Chilean IRS, in line with BEPS, is adjusting its audit focus, therefore we should expect challenges in the near future, also in line with the OECD parameters.

4.4 Transfer Pricing Issues

The biggest transfer pricing issues for foreign investors are:

- management and other services;
- intangibles;
- non-existence of a regulated and clear treatment for transfer pricing self-adjustments, which results in a 40% penalty tax risk; for further information, see **4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards**;
- non-existence of a bilateral adjustment process for non-treaty countries, while the process for treaty countries cannot be appealed and extends over the refund period; and
- country-by-country, master file, local file and other multinational compliance-related matters.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements regarding the sale of goods are commonly used in Chile; they have been reviewed and accepted by the Chilean IRS, provided they fulfil the functional analysis test in terms of the risk allocation to each entity.

The issue is how to achieve the proper margin of the Chilean distributor, which requires an adjustment of the value of goods acquired from related parties.

Limited risk distribution arrangements for the provision of services or technology are currently subject to review, particularly with respect to tech industry operations in Chile. As no transfers of goods exist and because of the 40% penalty risk, achieving the target margin requires the implementation of alternatives that result in withholding tax and expense deduction considerations.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

In general, Chilean transfer pricing rules and regulations follow most of the OECD standards.

The main difference relates to the effects of transfer pricing adjustments that do not result in an income basis adjustment (by recognising a lower expense or a higher income), but instead the adjustment is subject to a substitutive 40% penalty tax (cash tax), which does not modify the taxable base for corporate tax purposes.

The 40% penalty tax could be increased by 5% to an overall penalty of 45% under some circumstances.

4.7 International Transfer Pricing Disputes

Proper transfer pricing rules have been enacted in Chile for the past decade; however, their implementation is in constant development.

Mutual agreement procedures have been utilised by taxpayers and the Chilean IRS, mostly in relation to the interpretation of the tax treaty provisions (WHT reduction and residence, among others).

Transfer pricing disputes have been mostly limited to administrative or court discussion but not through international arrangements between tax authorities. In this respect, advance pricing agreements have also been limited between the Chilean IRS and Chilean corporate taxpayers.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating Adjustments

Compensating adjustments are only allowed if the counterparty is a treaty country resident. The nature and amount of the adjustment must be previously approved by the Chilean IRS.

Difficulties in Connection with the Process

A taxpayer has a five-year period to apply for the adjustment authorisation, which could be a problem, since tax refunds have a three-year limitation.

The IRS could deny the authorisation if it considers the adjustment to be against Chilean Income Tax Law provisions. A negative decision issued by the IRS cannot be appealed by the taxpayer.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Branches and local subsidiaries of non-local corporations are corporate taxpayers that are subject to taxes on their worldwide income. The taxable income of the branch could also be determined using indirect methods. Branches may not have access to Chilean treaty benefits as they are not Chilean tax residents. Some permanent establishments of treaty-country taxpayers can decide to be taxed on a gross basis.

5.3 Capital Gains of Non-residents

Capital Gains Tax on Direct Transfer

Capital gains on the direct transfer of Chilean stock by non-resident shareholders are subject to a 35% tax. If the shareholder has signed a DL 600 contract that remains in force, capital gains will be subject to a 42% rate.

There are exemptions for shares acquired before 1984, if other conditions are met. Also, capital gains on shares acquired and sold on the Chilean Stock Exchange or under other regulated mechanisms are not subject to income taxes. The exemption also requires a minimum market presence to operate. These exemptions are under review by the government.

Some tax treaties provide for reduced rates on capital gains taxes. The rates could be 20%, 17% or 16%, depending on the nature of the underlying assets (real estate or not), percentage of ownership and holding period.

Capital Gains Tax on Indirect Transfer

Capital gains on the indirect transfer of Chilean stock or other assets by a non-resident shareholder are subject to a 35% tax.

The capital gains tax on indirect transfers applies in two cases:

- more than 10% of ownership is transferred and the value of the Chilean underlying assets is greater than USD150 million or they represent more than 20% of the foreign entity fair value whose shares or quotas are sold; and
- the entity whose shares are sold is a resident of a territory regarded as a preferential regime by the Chilean Income Tax Law and 50% or more of that entity's shares are held by other preferential regime residents, or 5% or more is held by Chilean residents, regardless of the ownership or value of the assets.

The seller has the right to apply the capital gains regime directly in indirect transfers. In that case, if the direct shareholder is a treaty country resident, the provisions of the relevant treaty will apply.

Some tax treaties allow that capital gains on indirect transfers would not apply to sellers that are tax residents of those treaty countries. This interpretation must be analysed on a case-by-case basis as the Chilean tax authorities might not share this view.

5.4 Change of Control Provisions

Any change of control that triggers the direct transfer of shares in a Chilean company is subject to capital gains taxation.

Capital gains resulting from an indirect transfer of a Chilean asset (company) is subject to a 35% tax, provided one of the following requirements is met:

- the fair market value (FMV) of the Chilean entity being indirectly transferred is higher than USD150,000; or
- the FMV of the Chilean entity represents 20% or more of the FMV of the foreign entity being transferred.

In order to apply this tax, at least 10% of the foreign entity should be transferred.

For taxable gains determination and the rate, see **5.3 Capital Gains of Non-residents**.

The indirect transfer regulations allow intragroup reorganisations (any type of alienation, such as a sale) without triggering any tax consequences in Chile, provided that no gains are triggered by the alienation. That is to say, the transfer should be materialised at tax basis. Also, in the case of mergers/accretions or spin-offs that have the same legal effects as in Chile (see above), no taxation should be triggered.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Foreign-owned local subsidiaries must determine their income based on the same rules as a company owned by Chilean shareholders. This means their taxable income is determined based on accounting books, with tax-related adjustments.

In the case of local branches or other types of permanent establishments of foreign companies, the Chilean IRS has the authority to apply indirect methods based on assets or revenues if the accounting books do not present evidence of the annual result.

5.6 Deductions for Payments by Local Affiliates

The deduction of payments to foreign-related parties for management, administrative and other technical or professional services is subject to the same requirements as other expenses, especially in connection with their ability to produce income.

These payments can only be deducted on a cash basis (the general rule is deduction on an accrual basis) and after the withholding tax is filed and paid.

If disbursements are not necessary or able to produce income, a 40% penalty tax borne by the Chilean company applies, regardless of their deduction as expenses.

The deduction of royalty payments to related parties is limited to 4% of the payer's annual revenues. This limitation does not apply in the case of payments to treaty-country residents or when the income is subject to a rate of 30% or higher in the country of the recipient.

5.7 Constraints on Related-Party Borrowing

Article 41 F of the Income Tax Law limits related-party borrowing to a 3 to 1 debt-to-equity ratio (thin capitalisation rule). For purposes of determining the ratio, all debts (related and non-related) must be taken into account.

Interest and other financial expenses exceeding such ratio and paid to foreign-related parties would be subject to a 35% tax borne by the Chilean debtor. The Chilean debtor can use the withholding tax effectively paid as a credit against the penalty tax.

For these purposes, creditors will be related or deemed to be related in the following cases:

- the creditor is organised, domiciled or resident in any of the countries regarded as preferential regimes;
- the creditor and the debtor are part of the same business group;

- either the creditor or debtor owns, directly or indirectly, 10% or more of its counterparty profits or capital, or it has a common partner or shareholder that, directly or indirectly, owns 10% or more of the capital or profits of any one of them;
- funding has been granted with a direct or indirect guarantee of foreign-related parties;
- bonds or debt instruments issued to non-related parties that are afterwards transferred to related parties; and
- mirror structures, where non-related parties act as a link between related parties.

Thin capitalisation provisions are not applicable if guarantees are granted with respect to project finance, provided that the transaction is performed at arm's length.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

General Rule

Net foreign income of local corporations is subject to corporate tax on a cash basis.

Permanent Establishments

In the case of foreign branches or other types of permanent establishment of local corporations, the positive or negative tax result of the permanent establishment is recognised and taxed in Chile on an accrual basis.

CFC Rules

As per the Chilean CFC rules, the passive income generated by foreign-controlled entities must be recognised in Chile every year on an accrual basis, if certain thresholds are met.

6.2 Non-deductible Local Expenses

This is not applicable in this jurisdiction.

6.3 Taxation on Dividends from Foreign Subsidiaries

Net dividends from foreign subsidiaries paid to local corporations are subject to tax on a cash basis. Foreign tax credit is available.

If the foreign entity generates passive income previously recognised under CFC rules, the dividends from that entity will be exempt from income taxes.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations can only be used by non-local subsidiaries under a licence or similar agreements, or as a result of a transfer of ownership subject to corporate tax. The difference between the acquisition value and the fair value of the intangible is subject to income taxes upon transfer.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Subject to specific rules and limitations, passive income generated by controlled foreign entities should be recognised on an accrual basis. In the case of non-local branches, their annual tax results should be recognised in Chile, even if such result is a loss and regardless of the nature (passive or not) of the activities or assets that generate the income.

6.6 Rules Related to the Substance of Non-local Affiliates

Chile does not have specific rules regarding the substance of non-local affiliates. As a consequence, all foreign entities are recognised and taxed equally.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

A gain on the sale of shares in non-local affiliates is subject to income taxes under general rules, on a cash basis and for the net amount of the gain. Foreign tax credits are available only for treaty countries.

If the shares are assigned to a foreign permanent establishment or if those shares qualify as passive income-generating assets, tax consolidation or CFC rules, respectively, will apply.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Since 2015, Chile has had a general anti-avoidance clause (GAAC) that allows the Chilean tax authorities to discard the forms adopted by the taxpayers in order to assess the tax results that would have been applied according to the economic substance of the same acts.

The Chilean GAAR requires that a previous and regulated process is followed in order to declare the existence of a simulated or abusive act in order to operate.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Audit Cycle

Chile has a regular routine audit cycle, which begins with processing the information gathered by the tax authorities from the tax returns and sworn statements filed by taxpayers and third parties.

A formal audit process is initiated by sending a notice intended to request the taxpayer for additional information.

Summons

If the taxpayer does not file the requested information or the tax authorities consider taxes may be due, a summons (citation) will be issued to the taxpayer to formally answer the issues raised by the IRS. The summons overrules the statute of limitations, which is extended to three additional months.

Assessment/Resolution

If the taxpayer does not respond to the summons, or if the response does not solve the differences, an assessment (liquidation) or resolution with a payment order or the denial of a benefit or refund request will be issued. These acts may interrupt the statute of limitations.

Tax Claim

Against the assessment or resolution, the taxpayer could file a tax claim (*Reclama Tributaries*). The tax claim initiates a tax trial.

Settlement Options

The law and regulations allow for intermediate instances to settle tax differences detected in the context of the audit cycle.

9. BEPS

9.1 Recommended Changes

Chile has adopted a number of the BEPS recommended changes. Some of the most important changes are:

- the incorporation of general anti-avoidance rules (GAARs) and CFC rules in the legislation;
- stricter thin capitalisation rules;
- an obligation to file a country-by-country report, master file and local file;
- a new concept of permanent establishment included in the Income Tax Law;
- definitions and regulations of preferential tax regimes;
- the enactment of a tax on digital services in the form of VAT.

Chile has also ratified the Multilateral Instrument and the Convention on Mutual Administrative Assistance in Tax Matters.

9.2 Government Attitudes

As part of the OECD, the Chilean government is aligned with the implementation of BEPS-related measures. The government has a special focus on reducing tax avoidance and increasing transparency and tax responsibility, resulting in higher tax collection.

9.3 Profile of International Tax

Chilean regulations are strongly influenced by international tax-related measures. As a result of this and the participation of Chile in the OECD forum, the country has adopted most of the BEPS recommendations.

9.4 Competitive Tax Policy Objective

Chile has a competitive tax policy. The recently approved tax reform (enacted in February 2020) is a clear demonstration of this objective. The government and the tax authorities consider that, given the international context, the introduction of BEPS-related measures is in line with tax competitiveness.

9.5 Features of the Competitive Tax System

The corporate tax system and the taxation of shareholders under the integrated system – where the corporate tax is a credit against the income tax that affects dividends – has become more complex with time.

The complexity is even greater considering the number of changes and transitory dispositions applicable to different taxpayers, by separating incomes and credits depending on the year they were generated and the fact that some rules that were necessary in the context of an integrated regime have been modified. An example of this is the rule that allows a holding company to offset losses against dividend income has been repealed effective from 2023 onwards.

Chile still maintains formal and outdated taxes, such as inheritance and donations tax, stamp tax, land tax and municipal tax.

The main element that has made the competitive system vulnerable is the legislative process itself. This process has resulted in a set of rules that is not necessarily consistent between them, and also in uncertainty, such as the proposal of technically deficient tax rules and a constant review of the tax system that will probably result in the fifth tax reform in ten years.

9.6 Proposals for Dealing with Hybrid Instruments

No changes have been introduced or proposed in terms of hybrid instruments. Given the upcoming discussions on the evaluation of the Chilean tax system, it is expected that the treatment of hybrid instruments will be one of the topics to be addressed.

9.7 Territorial Tax Regime

Chile does not have a territorial tax regime. In fact, even permanent establishments of foreign entities are taxed on a worldwide basis.

The combination of taxation on worldwide income and the foreign tax credit regulations makes debt financing inefficient.

Not having a proper holding company regime affects foreign investment more than interest deductibility limitations.

9.8 CFC Proposals

According to the Chilean CFC regulations, offshore investments in preferential tax regimes are deemed to be foreign-controlled investments that generate passive income subject to taxation.

Taxpayers have the right to prove their foreign investments are not covered by the CFC rules.

9.9 Anti-avoidance Rules

The DTC limitation of benefit rules will require a complete review of all the structures previously implemented, as some of them may not qualify for treaty benefits.

The DTC limitation of benefit and anti-avoidance rules demand a new approach in terms of tax structuring and risk assessment, where tax sustainability may have a relevant role.

9.10 Transfer Pricing Changes

The taxation of profits from intellectual property is a particular source of difficulty and controversy, mainly due to the lack of specific regulations.

No substantial changes have been proposed in terms of taxation or transfer pricing regulations on intellectual property, other than those related to increased transparency.

9.11 Transparency and Country-by-country Reporting

Chile has already adopted the country-by-country reporting and other transparency-related measures.

The evaluation of these measures depends on the approach of the Chilean tax authorities in terms of audits and on how susceptible the authorities are to the requests made by other tax administrations.

A key point is understanding the right of any multinational enterprise to organise its business under a tax-efficient structure, by complying with the rules adopted by each country in which it operates.

9.12 Taxation of Digital Economy Businesses

In February 2020, a new digital tax, in the form of VAT, was introduced to the Chilean legislation.

9.13 Digital Taxation

As of 2020, Chile incorporated a tax on digital services in the form of VAT.

The VAT on digital services has been a simple and direct way to collect taxes from this type of activity.

The most relevant actors of the industry have also contributed by adopting high compliance standards.

It is also important to highlight that the Chilean tax authorities have adopted a practical and open approach, by having a direct line with the industry intended to solve any issue the implementation of this new tax has raised.

9.14 Taxation of Offshore IP

The country has not introduced specific changes with regard to the taxation of intellectual property deployed within Chile.

Payments abroad for the use of intellectual property are generally subject to a 30% withholding tax, which is reduced to 15% in some cases. The withholding tax reduction does not apply in the case that the owner or licensor of the intellectual property is a resident of a jurisdiction qualified as a preferential regime.

Under the existing tax treaties, intellectual property payments made to the beneficial owner of the income are subject to a 10–15% withholding tax rate. Exemptions are available for payments for the right to use standard software.

Intellectual property payments made to foreign-related parties that are non-treaty country residents can only be deducted up to 4% of the annual revenues of the payer. This limitation may not apply if the income is subject to a 30% or higher rate in the country of the licensor.

Contributed by:** Osiel González and Antonio Guzmán, **Bruzzone & González

Bruzzone & González (B&G) is established in Santiago de Chile. Its team of experienced lawyers and certified public accountants has a strong presence in the market. Its partners have vast expertise in advising large and multinational companies, as well as family offices. Fourteen professionals are dedicated to client service. The firm offers a one-stop shop approach to provide comprehensive and innovative solutions. B&G has gained recognition in the design and implementation of investment structures in Chile and abroad, mergers and acquisitions, tax optimisation, complex negotiations, tax controversy, and wealth management. During 2020, Bruzzone & González entered into a strategic alliance with BaseFirma, a leading consultancy firm that provides transfer pricing advisory and compliance services. This alliance consolidated a premium services portfolio, allowing both firms to deliver a broad spectrum of services not only in the field of tax consulting but also in transfer pricing.

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Trends and Developments

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Tax Reform in Full Force

On 24 February 2020, the latest Chilean tax reform, enacted by Law No 21.210 (the "Tax Reform"), was published in the Official Gazette, concluding an extended process in the Congress, marked by the negotiations performed by the government and the political parties due to the social unrest after October 2019.

The Tax Reform had 1 March 2020 as a date of general entry into force, but it set forth several specific entry-into-force dates on different matters.

The Tax Reform was comprehensive and involved several legislative changes to the Chilean Tax Code, Chilean VAT law and Chilean income tax law, among others. With respect to income tax, the Tax Reform eliminated the duality of income tax regimes and established the Partially Integrated Income Tax system (PIS) as the general income tax regime.

Besides the above, the Tax Reform introduced several changes to corporate taxation that impact Chilean investors as well as foreigners. Considering the broadness and the complexity of some of these changes, the Chilean Internal Revenue Service (the "Chilean IRS") has issued several pronouncements, including circular letters and resolutions, in order to provide guidance to tax officials and taxpayers in navigating the tax and legal changes that are taking place.

Along with the matters that were modified by the Tax Reform, there are other developments in the Chilean tax scene that are worth noting. Firstly, the Chilean IRS has recently issued its 2020 version of the tax schemes catalogue, which includes a series of situations and transactions that are considered to produce tax non-compliance situations. Another relevant development is that the Chilean government entrusted an expert commission to analyse all the special regimes and exemptions that currently exist in Chilean tax law. The referred-to commission recently issued its report containing the analysis and recommendations.

On top of that, the Chilean tax policy discussions have been influenced by the constitutional debate that has surged in Chile since October 2019, and these developments should be closely monitored by investors as it is likely that tax provisions will be included in the new Constitution that is expected to be drafted.

Partially Integrated System as the General Tax Regime

As previously noted, one of the main changes to the Chilean income tax system was the elimination of the Attributed Income Tax system. As a consequence, the Tax Reform established the PIS as the general income tax rule.

The Chilean income tax system is based on an integrated mechanism, according to which, First Category Tax (FCT) paid at the operative company level can be offset against taxes to be paid by final taxpayers (ie, Global Complementary Tax for individuals resident in Chile and Additional Tax for non-residents).

The Attributed Income Tax system aimed to tax, on a yearly basis, income derived at the corporate level irrespective of its effective distribution to final taxpayers by means of attributing such income to them (attributed basis). Under that system, FCT was fully accreditable against final taxes.

On the contrary, under the PIS, final taxes will only be accrued at the moment at which the amounts are effectively distributed to the final taxpayers (cash basis). It is called partially integrated because, as a rule, there is an obligation to reinstate 35% of the Chilean FCT credit. Therefore, only 65% of the Chilean FCT already paid on profits being distributed can be used as credit against final taxes. This results in a total tax to be paid, in the case of foreign residents, of 44.45%, considering both FCT and Additional Tax.

Nevertheless, there are two exceptions where such reinstatement is not required and, thus, the FCT can be fully used as a credit against final taxes. Firstly, for those taxpayers in the small and medium enterprises tax regime. Secondly, in the case of final taxpayers that are resident in a country with which Chile has a double tax treaty (DTT) in force, in which case, the total tax burden remains at 35%.

In this second case, the Tax Reform also provided for a transitory rule that grants full FCT credit until 2026 for taxpayers that are resident in a country with which Chile has a signed (ie, before 1 January 2020), but not yet in force, DTT. Cases that fall under the transitory rule are the DTTs signed by Chile and the USA, as well as Chile and the United Arab Emirates. Thus, dividend distributions made to residents of such countries will bear, broadly speaking, a total tax of 35% up to December 2026.

New Rules on the Provisional Withholding for Remittances Abroad

As a rule, Additional Tax levies the Chilean-source income derived by non-resident taxpayers (and certain foreign-source income) at a general rate of 35%. Additional Tax is applied over the gross amount remitted abroad and works, in most cases, under a withholding mechanism in order to ensure its collection.

Dividend or profit distributions abroad are subject to Additional Tax at a 35% rate. As noted in the previous section, the foreign taxpayer can deduct, either fully or partially, the FCT credit for the First Category Tax paid on those profits at the corporate level.

Before the Tax Reform, the tax characterisation of the amount remitted abroad – pursuant to dividends, remittances, withdrawals and capital returns – was determined, in most cases, at the moment it occurred. This determination was made by applying the tax allocation order to such amount and reviewing to which of the tax records (ie, taxable profits record, exempted profits record, etc) kept by the distributing company the amount being remitted or distributed abroad should be allocated. This is crucial in order to determine effective FCT credit available and Additional Tax to be paid. Indeed, if there were no amounts pending of taxation in such records, the taxpayer could treat such withdrawal as a capital return, being subject to no further taxation.

The Tax Reform changed the legal mechanism described above. Now, the tax characterisation of the remittance and, accordingly, its allocation to the tax records of the company will be determined at the end of the respective fiscal year in which it was made.

The main effect of this change is that any remittance, dividend distribution, withdrawal or even capital reduction abroad will be considered as provisional until the end of the calendar year when it takes place, since only then will its tax characterisation be determined for certain. Hence, no matter what is noted in the tax records of the company that makes the distribution or remittance abroad, a provisional credit should be considered by the entity remitting the funds.

If, as a consequence, it is determined at the end of the calendar year that the provisory credit granted was higher than the actual one, then the Chilean company must pay such difference in its annual Income Tax return, and has the right to request the foreign taxpayer to repay such amount.

On the other hand, if, at the end of the commercial year, it is determined that the provisory credit granted was lower than the actual one, then the foreign shareholder is allowed to request a refund through an administrative procedure before the Chilean IRS, request a refund through its annual income tax return, or increase the accumulated credit ledger of the company.

Considering the latter, all foreign investors should carry out a cash-flow analysis before any dividend distribution, remittance, withdrawal or capital reduction is performed at a Chilean level to mitigate the financial impact derived from it. This recommendation is particularly relevant for those who are resident or domiciled in a country that has no DTT with Chile.

Financing Structures for Investments in Chile

The Tax Reform introduced several legal modifications that impact both current financing structures, which shall be reviewed and adapted accordingly, as well as potential financing structures. The most relevant are commented on below.

Changes to Additional Tax applicable to interest payments to foreign financial institutions

In the case of interest payments abroad, even though the general rule is that Additional Tax applies at 35%, if the interest is paid to a bank or a foreign financial institution (FFI), such income benefits from a reduced 4% Additional Tax rate.

Before the Tax Reform, Chilean income tax law did not provide the requirements to qualify as an FFI, thus the Chilean IRS established them through its administrative interpretations. In addition, the Chilean IRS maintains a voluntary registry of FFIs aimed to grant certainty for an FFI to be qualified as such. This registration should be updated before the Chilean IRS on a yearly basis.

The Tax Reform incorporated a new definition of a FFI and set forth the requirements to be considered thus. In this regard, the minimum capital threshold to be an FFI was augmented to half of that needed to be registered as a foreign bank in Chile, and its main activities alongside its corporate purpose should be the granting of credit or financing.

This increase in the legal requirements to be considered as an FFI created a situation where some entities that prior to the Tax Reform were considered FFIs and were duly registered as such and had provided credits that benefit from this 4% Additional Tax on their interest see a change in the thresholds and therefore may now be subject to a 35% rate. In this sense, a grandfathering rule was set forth for credits that were granted before 1 March 2020, as long as such credits have not been novated, transferred or the amount of the credit or interest rate has not been modified after such date.

Alongside these changes to FFI regulations, a specific anti-avoidance rule was included to prevent the benefit of the reduced 4% rate to those credits that were granted through structured arrangements where the FFI that receives the interest cannot dispose of them and must transfer them to another entity that would not be entitled to benefit from the reduced 4% rate.

FFIs are commonly involved in financing structures of long-term investment projects such as mining or infrastructure. Therefore, it is relevant to review the conditions of the financing of these kinds of projects that were provided prior to the Tax Reform.

Gradual repeal of the provisional payment for absorbed profits

Another aspect that impacts financing structures is the gradual elimination of the provisional payment for absorbed profits mechanism (PPUA). The relevance of the PPUA was that Chilean tax law does not provide for a direct tax consolidation mechanism like many other jurisdictions do. Instead of that, Chilean income tax law allowed for an FCT refund mechanism, whereby profits received from subsidiaries were absorbed by losses at the level of the recipient entity. The Tax Reform does not impact the allocation of own losses nor the use of the corporate income tax credit; however, it does prevent taxpayers from obtaining a refund.

The normal way for foreign investors to structure debt financing used to be through a holding company in Chile, not solely because of the application of the PPUA mechanism, but also because this legal structure grants more corporate-wise flexibility.

The PPUA repeal is envisaged gradually: for 2020, 90%; for 2021, 80%; for 2022, 70%; for 2023, 50%; and, finally, it is expected to be fully repealed by 2024.

One of the core issues of this legal change is that several foreign investments were structured considering PPUA tax refunds within their flow estimations. However, due to the fact that it is being gradually abrogated, it is time for investors to reassess future cash flows of Chilean interests and the financing structures that were created based upon these rules.

Changes to the Tax-Deductible Expense Concept

Another relevant change in corporate taxation in Chile was the modification that involved tax-deductible expenditure. Prior to the Tax Reform, a company's taxable income was determined by deducting those expenses that were necessary to produce such income.

The concept of "necessary" expense was not defined in Chilean income tax law and was therefore construed in a very restricted manner by the Chilean IRS. Before the legislative change, an expense was considered necessary if it was unavoidable and mandatory, and directly connected with the generation of income. This restricted interpretation caused a series of problems in expense deductibility; for example, payments for some labour benefits granted to employees were deemed as rejected expenses as they were not directly connected to any generation of income, or indemnities in regard of contract breaches were also deemed as such.

The Tax Reform stated that a necessary expense is that which has the "ability" to generate income, in the same or future periods, and it is associated with the business purposes of the company. With this, the narrow concept of necessary expense is much broadened and therefore companies will need to reassess such expenses that were not tax deductible in previous years and adjust accordingly.

Besides the general concept of tax-deductible expense, Chilean income tax law also contains specific examples of expenses that, provided certain requirements are met, are considered necessary expenses. These specific rules were also adjusted by the Tax Reform considering changes to the requirements for bad debts, remuneration of partners and owners of a company, and expenses derived from torts, among others.

Latest Developments and What's Coming Next

As mentioned above, there have been some other relevant developments in the Chilean tax scene recently. The issuance of the 2020 tax schemes catalogue by the Chilean IRS and the review of the special regimes and exemptions in Chilean tax law are two of the most relevant highlights.

Since 2016, the Chilean IRS has issued on a yearly basis a series of cases and situations that, in its view, may configure situations of abuse or tax non-compliance. The new catalogue includes ten new cases (five domestic and five international) and keeps 45 of the previous cases gradually added since 2016, totalling 55 cases.

The issuance of this yearly update follows the developments since the addition of a General Anti-Avoidance Rule (GAAR) to the Chilean Tax Code. The GAAR has not featured in a decision by the Chilean tax courts. However, there have been cases analysed under the GAAR by the Chilean IRS. The tax schemes catalogue states that the Chilean IRS has analysed 33 binding and 23 non-binding consultations referring to the application of the GAAR to specific cases.

Another significant development has been the review of the special regimes and exemptions in Chilean tax law. This task was an aim of the Chilean government since it was agreed upon in the legislative process that led to the approval of the Tax Reform in early 2020.

To perform the review, an expert commission – all of its members were economists and not a single tax practitioner was invited – was tasked to perform a full review of the matter. The experts worked on the basis of a report that was prepared for Chile by the International Monetary Fund and the OECD. In broad terms, the expert commission's report goes over the special regimes and exemptions, assessing their fiscal impact and whether or not a review, change or elimination should be performed. It is expected that the outcome of this report, or at least some portion of it, will be addressed in a new tax reform bill to be considered in the near future.

Also, the developments in the political scene in Chile are likely to touch upon tax matters and tax policy. The process of drafting a new Constitution will be something to watch closely alongside the presidential election at the end of 2021.

As may be observed, the past years have been prolific in terms of new legislation and tax developments in Chile. Investors and taxpayers need to keep up to date with the latest modifications, not only to avoid non-compliance situations or falling into abuse scenarios such as the ones in the tax schemes catalogue, but most importantly to be in line with the changes taking place. These challenges, that come at a time when the Chilean IRS is very active in its assessment programmes, may be faced appropriately if they are foreseen and addressed under specialist advice.

PwC has a global network with more than 284,000 employees and a presence in 155 countries. In Chile, PwC has four offices throughout the country, located in Santiago, Viña del Mar, Concepción and Puerto Montt, with more than 1,300 employees. The purpose of the firm is to build trust in society and solve important problems, focused on generating value at the organisational level in order to implement high-quality solutions, to positively impact companies and the development of the country.

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COLOMBIA

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Colombia normally adopt a corporate form, fundamentally to limit the liabilities of partners or shareholders. There are several corporate alternatives, ranging from a general partnership to a stock corporation, but more than 95% of the corporate entities created in Colombia have recently taken the form of a simplified stock company (*Sociedad por Acciones Simplificada*, or SAS). This corporate format is used for big and small businesses.

The fundamental reason why an SAS is so frequently selected is that it has the benefit of complete limitation of liability of shareholders, along with very flexible, simple rules for its operation, with significant cost savings, when compared with partnerships, limited liability companies and corporations.

Foreign investors normally use the form of an SAS to organise their businesses in Colombia, except for in cases where the law or regulation demands a specific type of company (ie, to list in the stock market, it has to be a stock corporation) or when it wants to achieve certain tax planning objectives at the parent company level, demanding a certain corporate form, such as the limited liability company.

Foreign investors may also organise a branch office in Colombia to undertake their business. It is not as usual as the SAS in general terms, but it is the standard form in certain business sectors such as oil and gas, and oil services, due to the exceptional exchange control regime applicable to those sectors.

1.2 Transparent Entities

Transparent entities are very exceptional in Colombia. As a rule, all entities are individual taxpayers. It is only as a matter of anti-deferral rules applicable to passive income from foreign entities that those entities are regarded as transparent in order to tax foreign-sourced passive income without delay.

There are exceptional transparent forms of investment organisations. Private capital funds and collective investment funds are not regarded as taxpayers for income tax purposes and participants in those funds can get additional deferral benefits if certain requirements are met.

1.3 Determining Residence of Incorporated Businesses

With respect to the test to determine the residence of incorporated businesses, without prejudice of particular rules included in double taxation treaties in force, incorporated businesses are considered tax residents in Colombia if:

- they are incorporated in Colombia;
- they have their principal domicile in Colombia; and
- they have their effective seat of management within Colombian territory.

1.4 Tax Rates

Corporate Rates

The current corporate tax rates in Colombia are:

- for 2021 – 31%; and
- for 2022 onwards – 30%.

Financial institutions such as banks are subject to a 3% surcharge for 2021 and 2022.

There are certain exemptions and preferential treatments, among others:

- for small creative and technological enterprises, which can get a complete exemption for seven years;
- hotels and theme parks are taxed at a rate of 9%; and
- industrial users of free trade zones are taxed at a 20% tariff.

Personal Tax Rates

Personal (individuals) tax rates are fixed in a scale ranging from 0% to 39% depending on their annual income:

- up to the equivalent of approximately USD11,000, the rate is 0%;
- 19% up to approximately USD17,000 annual income;
- 28% up to approximately USD42,000 annual income;
- 33% up to approximately USD89,000 annual income;
- 35% up to approximately USD195,000 annual income;
- 37% up to approximately USD320,000 annual income; and
- 39% for annual income exceeding USD320,000.

Simplified Regime

There is a special simplified regime applicable to small taxpayers aimed at simplifying their tax compliance. Small businesses (incorporated or not) with gross annual income of less than approximately USD800,000, meeting certain other requirements, can access the simplified tax regime where income tax along with local industry and commerce tax is paid over gross income. Tariffs are fixed on scales for different economic sectors, ranging from 1.8% to 11.6% over the gross income. The simplicity and the fact that the payments include income tax and industry and commerce tax make this regime very attractive for small businesses with good profit margins.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Income tax is applied to tax profits calculated on an accrual basis. For the most part, taxable income is calculated on the basis of accounting profits, but several adjustments have to be made, according to the income tax rules. Not all accounting income is taxable income and not all accounting cost and expense may be deducted from the tax base.

Among others, the following differences between accounting and income tax rules imply that adjustments have to be made to reach taxable income:

- in transactions where implicit interest has to be calculated according to accounting rules, such implicit interest shall not be accrued for income tax purposes;
- where income has to be calculated according to the equity participation method, it shall not be accrued for income tax purposes;
- income derived for fair-value calculation of assets shall not be accrued for income tax purposes and such difference will only be taxed when the asset is sold or its property transferred;
- accounting provisions and their reversal associated with liabilities shall not be accrued as taxable income;
- account receivable deterioration provisions rules for tax purposes are determined in the Tax Statute and normally differ from accounting rules; the same applies with respect to receivables write-off, where the possibility of taking a tax deduction is subject to much more stringent rules than accounting rules;
- depreciation rules for income tax purposes in certain aspects differ from depreciation rules for accounting purposes, which lead to an adjustment to the accounting records to reach the income tax figures; and
- the cost of certain fixed assets, such as real estate and shares, for income tax purposes and the calculation of capital gains have rules different from accounting rules, which imply an adjustment.

In summary, the accounting tax reconciliation that has to be worked out yearly is an extensive exercise.

2.2 Special Incentives for Technology Investments

There are very significant tax incentives for investments in investigations, technological development and innovations (ITDI) that are fulfilled following the conditions and criteria determined by the National Council of Tax Benefits for Science, Technology and Innovation (CNBT), including:

- investments made in ITDI in projects endorsed by the CNBT and according to its conditions can be deducted in the same tax year in which they were made;
- taxpayers that make an investment in ITDI projects endorsed by the CNBT and according to its conditions will have a tax credit equivalent to 25% of the investment made in the tax year in which the investment was made, and if the investment is made by a micro, small or medium-sized enterprise, the tax credit will be equivalent to 50% of the investment made, but in this case there will be no right to take the deduction described in the prior point; and
- there are special tax incentives for investment in, and the development of, non-conventional energies, and companies making investments in those activities are entitled to a special deduction of 50% of the investment made, in addition to a special depreciation system and certain VAT exemptions.

2.3 Other Special Incentives

There are very generous tax incentives for certain industries, mainly the so-called orange economy industry, hotels and theme parks.

Orange Economy

This sector is comprised of new small companies (with gross annual income of less than the equivalent of approximately USD800,000) that develop creative and technological value-added activities, which include a wide diversity of businesses, among others:

- jewellery;
- editorial and music editions;
- TV and movie production;
- IT consulting and installations;
- architecture;
- engineering;
- photography;
- plastic arts;
- visual arts; and
- theatre.

Meeting small investment and employment requirements, these new companies are entitled to be income tax exempt for seven years.

Hotels and Theme Parks

New hotels and theme parks are subject to a preferential income tax rate of 9% for a term of ten years. If the municipality in which it is located has less than 200,000 inhabitants, the preferential rate will be for 20 years.

Mega Investments

Investments amounting to not less than approximately USD300 million and generating 400 employments can access a 27% income tax tariff for a term of 20 years, by meeting several requirements.

Industrial Users Free Trade Zones

These users (that do not include simple commercial activity users) of free trade zones have a preferential income tax rate of 20%. Noticeably, in Colombia, this preferential rate is not tied to exports.

Acquisition of Productive Fixed Tangible Assets

In addition to these incentives, there is a general one for all industries for the acquisition of fixed productive tangible assets that directly participate in the income-generating economic activity of the taxpayer. The VAT paid in the acquisition of those assets (general rate of 19%) can be credited to the income tax payable in the year of acquisition or the coming years. Normally, such VAT should have been made part of the cost of the asset for future depreciation throughout the useful life of the asset.

2.4 Basic Rules on Loss Relief

With respect to the tax treatment of losses, companies can offset tax losses with ordinary taxable income obtained during the 12 years following the tax year in which the loss occurred. Tax losses may not be offset against capital gains.

In the case of mergers of companies with tax losses, the absorbing company may only use the losses of a merged (absorbed) company up to the proportion of its patrimony in the merged patrimony and subject to the tax years already passed and the limits existing in those years (up to 2011, tax losses had to be used within the following eight years).

In the case of spin-offs, the beneficiary company may only use the tax losses of the spun-off company up to the proportion that the patrimony transferred to the beneficiary company represented in the patrimony of the spun-off company. The spun-off company may use its accumulated losses up to the proportion of the patrimony after the spin-off in the patrimony before it. Both cases are subject to the tax years already passed and the limits existing in those years.

In all cases, the economic activity of the companies involved in the mergers of spin-off transactions has to be the same.

2.5 Imposed Limits on Deduction of Interest

As a rule, interests paid are deductible, provided the applicable income tax withholding is paid. The deductibility of interest has certain limitations.

Thin Cap Limitations

The deductibility of interest paid to local or foreign affiliates is limited, in general terms, to a debt-to-equity ratio of 2. This rule is not applicable to financial entities (banking entities) under the surveillance of the Financial Superintendency, to companies dedicated to receivables discount transactions, to financings of infrastructure projects and to companies in an unproductive stage.

Interest Paid to Parent and Foreign Affiliates

Interest paid to a parent company and foreign affiliates is deductible if the local company is subject to transfer pricing rules, which will normally be the case. If not subject to transfer pricing rules, it is not deductible, except for:

- interest paid by financial entities under the surveillance of the Financial Superintendency;
- interest paid on short-term supplies of raw materials and inventories; and
- interest attributable to a Colombian permanent establishment of a foreign company, provided that tax withholding is made.

Interest on Overdue Tax Payments

Late-payment interest of tax liabilities may not be deducted.

2.6 Basic Rules on Consolidated Tax Grouping

Company grouping for tax purposes is not allowed. The use of intercompany transactions as a means to localise losses within a corporate group is limited by an arm's-length principle and transfer pricing rules.

Among local companies, accumulated tax losses can be transferred from one company to another vía merger and spin-off transactions. However, the use of the losses is limited to the proportion that the patrimony of the "loss" company represents in the merged patrimony and provided that the economic activity of the merged companies is the same.

2.7 Capital Gains Taxation

In Colombia, capital gains are a part of occasional profits, which, in turn, are complementary and a part of income tax. Occasional profits have to be treated and reported separately from ordinary taxable income. The rate for occasional profits is 10%, which is significantly lower than the ordinary corporate tax rate.

Sales of shares in other companies, real estate or other fixed assets held for two years or more will exclude that income from ordinary taxable income to be treated as an occasional profit (capital gains). If the shares, real estate or other fixed assets were not the property of the company for more than two years, the profit will be treated as part of ordinary taxable income.

Corporations are taxed on capital gains whenever they receive an income derived from the sale of fixed assets or the sale of shares in other companies.

The cost of real estate can be adjusted annually according to certain indexes aligned with inflation or to the property tax base for municipal property taxes. The cost of shares can also be adjusted annually according to the mentioned indexes (Articles 70–72, Tax Statute).

Values or assets received as a result of the liquidation of a company in existence for more than two years in which a participation in capital was held will be treated as capital gains. The amounts corresponding to retained profits distributable as dividends will not be treated as capital gains. The capital gain is calculated on the difference between the cost of the asset, shares or participations in the liquidated company and the amount received.

For corporations that qualify as Colombian holding companies, the sale of stock in non-local companies is tax exempt. The sale of stock in Colombian holding companies is also exempt, except for accumulated profits.

Capital gains derived from the sale of stock of corporations listed on the stock exchange in which the seller is a beneficiary of less than 10% of the listed entity are tax exempt.

2.8 Other Taxes Payable by an Incorporated Business

In addition to income tax, there are other taxes payable by incorporated businesses and taxes for certain determined industries, the most relevant of which are:

- the tax on financial transactions – this applies on debits of any type of financial accounts, such as bank accounts, at a fixed tariff of 0.4% over the gross amount of the debit; only 50% of this tax is deductible for income tax purposes; and
- local industry and commerce tax – this is a local tax charged by the municipalities over industrial, commercial and services activities carried out within the municipality; generally, tariffs range from 0.2% to 1% over gross income.

2.9 Incorporated Businesses and Notable Taxes

There are a variety of indirect taxes that apply to businesses, the most important of which is VAT. However, the design of VAT normally shifts the burden to final consumers and in the case of productive fixed assets, it can be credited against income tax.

There are local property taxes on real estate and vehicles, and contributions on payments to public utilities that apply to all businesses.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held businesses operate in a corporate form. Usually the corporate form is an SAS.

3.2 Individual Rates and Corporate Rates

Corporate rates are normally lower than individual rates at relatively low levels of annual income. At a level of annual taxable income of the equivalent of approximately USD42,000, individual rates become higher than corporate rates. If, in addition, it is considered that individual income gives rise to social security contributions, in general terms, individual income has a heavier tax and social security burden than a corporate tax burden.

It is legal for professionals such as architects, engineers or accountants to create a corporate entity to be the service provider of their clients. The corporate tax rate will apply to the taxable income of the company. But when the professional is paid or receives dividends, individual taxes and social security contributions will have to be paid.

Companies can lend money to partners or shareholders, but in that case, the company will have to accrue a presumptive interest as taxable income at an annual rate fixed annually, which currently is 4.54%.

3.3 Accumulating Earnings for Investment Purposes

There are no rules in Colombia preventing earnings accumulation in closely held corporations.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are taxed on dividends distributed by companies:

- resident individuals – 0% up to approximately the equivalent of USD3,000 and 10% above that amount; and
- non-resident individuals – 10%, without prejudice of the special provisions included in double taxation treaties.

The sale of shares in closely held corporations is taxed in the same way as all corporations. If shares qualify as fixed assets held for not less than two years, the sale is taxed as a capital gain over the tax profit at a rate of 10%. If the shares do not qualify as such, the sale will be taxed as ordinary taxable income at the rates applicable to individuals, as stated above.

There is an exemption for the sale of shares in Colombian holding companies.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends received by individuals from publicly traded companies are taxed in the same way as those received from privately held companies. The sale of shares in publicly traded companies is taxed in the same way as for all companies, but if the seller is a beneficiary of less than 10% of the listed corporation, the sale will not attract taxation.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The following income tax withholdings apply to payments to non-residents, without prejudice of special differential tariffs in certain double taxation treaties:

- interest – interest on financial transactions of more than one year are subject to a 15% withholding on the gross payment; if the financing is for an infrastructure project, the tariff is 5% and for interest on other transactions, the tariff is 20%;
- dividends – 10%, provided that the dividends come from profits subject to corporate tax at the distributing company; if not, the full corporate rate will apply; and
- royalties – 20% over the gross payment.

4.2 Primary Tax Treaty Countries

Colombia has double taxation treaties in force with several countries, including Switzerland, Peru, Ecuador, Canada, Chile, South Korea, Spain, India, Mexico, Portugal, Czech Republic and the United Kingdom. Other negotiated treaties are in the process of approval and entry into force with France, the UAE, Japan and Italy.

The treaties used depend fundamentally on the place of business of the investor and origin of the investment. Treaty shopping is not frequently observed in practice.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Any claim of a tax treaty benefit must be based on the evidence of residence. If residence is not properly proven according to the standards of the particular treaty, the tax authority has the power and the duty to reject the benefit and collect the appropriate tax.

Besides the anti-abuse rules contained in the Colombian Tax Statute, recent treaties contain provisions regarding the principal purpose test following the OECD's recommendation.

In addition, Colombia is a signatory to the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, but the Convention has not yet been approved by Congress.

4.4 Transfer Pricing Issues

Normally, the biggest transfer pricing issues for inbound investors are services and royalties on intellectual property, including technology transfer, paid to parent companies and foreign affiliates.

4.5 Related-Party Limited Risk Distribution Arrangements

As a matter of general policy, tax authorities do not challenge related-party limited risk distribution agreements for the sale of goods or provision of services. In fact, many subsidiaries in Colombia of foreign corporate groups use limited-risk models, without expecting challenges by tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Colombia is an active OECD member. In general terms, Colombian transfer pricing rules follow OECD standards and recommendations.

4.7 International Transfer Pricing Disputes

It is not often that transfer pricing disputes are resolved through double taxation treaties and mutual agreement procedures (MAPs).

The Colombian Tax Authority does not have a negative view of MAPs. It is a procedure provided by rules of law and tax treaties that has to be applied.

In line with BEPS Action 14, a new article in the Tax Statute has recently been enacted in order to facilitate MAPs and give better access to them for taxpayers. The mandatory assistance that the Tax Authority must give to taxpayers in this respect has been established, and the agreements reached as a result of MAPs shall have the force of a final judicial sentence.

In the same line of BEPS Action 14, the MAP was further developed by a recent regulation issued by the Tax Authority that established a detailed local procedure to be followed for the assistance to taxpayers in MAPs.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

As a rule, adjustments have to be made whenever a difference with comparables has to be corrected. Moreover, if a claim is settled and if it is as a result of a MAP, it will be regarded as a final judicial sentence that will have to be implemented mandatorily.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Taxation rules for subsidiaries and branches of foreign corporations have a significant difference. While subsidiaries of foreign corporations are taxed on Colombian and non-Colombian-sourced income, branches are only taxed on Colombian-sourced income.

5.3 Capital Gains of Non-residents

The capital gains of non-residents on the sale of stock in local corporations are taxed in Colombia. If the stock has been held for less than two years, the profit on the sale is treated as ordinary taxable income subject to the general corporate rate (currently 31%). If held for more than two years, the profit is treated as capital gains, taxed with a tariff of 10%.

There is an exemption for stock in Colombian holding companies. In addition, if the sold shares are of a corporation listed on the stock exchange and the seller is a beneficiary of less than 10% of such corporation, the sale will be exempt.

Normally, sales of stock of a foreign corporation by another foreign corporation will not be taxed in Colombia, but if the former holds shares, rights or assets in Colombian territory amounting to an indirect sale, the transaction will be taxed. The transaction will be treated as if the underlying assets were sold directly and taxed accordingly.

Certain double taxation treaties to which Colombia is a party contain provisions limiting and reducing applicable capital gains tax under general rules.

5.4 Change of Control Provisions

There are no change of control provisions for tax purposes.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no fixed formulas to determine the taxable income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

Management and administrative expenses paid to foreign parent companies or affiliates by Colombian companies are deductible for income tax purposes, with the condition that a tax withholding is made with a tariff of 20% over the gross payment. For these payments, transfer pricing rules are applicable. If the payment is made to a company in a tax haven, more stringent transfer pricing rules are applied.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing is subject to thin cap rules, as discussed in **2.5 Imposed Limits on Deduction of Interest**. The general limitation on deductibility of interest paid to related parties is based on a debt-to-equity proportion of 2, considering only debt that generates interest. The limitation extends to cases where foreign related parties participate in back-to-back loans where the lender of record is not a related company but the debt is substantially owned by the foreign affiliates.

These thin cap rules are not applicable to debt incurred by local financial entities (banking entities) under the surveillance of the Financial Superintedency or to companies dedicated to receivables discount transactions.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on Colombian-sourced and foreign-sourced income. The foreign-sourced income is taxed as part of the taxable income of the corporation.

Local corporations are allowed to use income tax paid for the foreign-sourced income in the jurisdiction of its source as a tax credit. The tax credit is limited to the tax applied in Colombia to such foreign-sourced income. Additional tax credit rules are available under double taxation treaties.

Under supranational Decision 578 of the Cartagena Agreement, income sourced in Ecuador and Peru of Colombian corporations may only be taxed in those jurisdictions and will be treated in Colombia as exempt income.

6.2 Non-deductible Local Expenses

As a rule, expenses attributable to exempt income are not deductible for income tax purposes.

6.3 Taxation on Dividends from Foreign Subsidiaries

Normally, dividends received by local corporations from foreign affiliates are taxed as ordinary taxable income. Under double taxation treaties, tax benefits may be available (ie, the treaty with Spain).

If the local corporation is a Colombian holding company, such dividend will be exempt. To be regarded as a Colombian holding company, the corporation has to meet very simple requirements in terms of holdings in other companies and employees.

6.4 Use of Intangibles by Non-local Subsidiaries

The use of intangible assets by non-local subsidiaries must be done on an arm's-length basis. Therefore, such use must normally produce an income for the local corporation subject to the transfer pricing rules examination.

In addition, under controlled foreign corporation (CFC) rules, the income of the non-local company derived from the exploitation of intangibles is regarded as passive income that must be included directly as current taxable income of the local corporation.

The contribution of an intangible to a non-local subsidiary is subject to income tax determination as well, on an arm's-length basis.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Local corporations are taxed on the passive income of CFCs. The passive income of the non-local subsidiary is regarded as having been directly obtained by the local corporation.

The income of branch offices of local corporations is taxed in Colombia.

6.6 Rules Related to the Substance of Non-local Affiliates

Non-local affiliates of local companies are regarded as tax residents if it is determined that the effective seat of management is Colombia.

In addition, all payments to tax-haven companies are subject to income tax withholding and to stringent transfer pricing rules.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Local corporations are taxed on the gain on sale of shares in non-local affiliates. The gain on the sale of shares of non-local affiliates is taxed as ordinary taxable income at the general corporate tax rate if held for less than two years. If held for more time, it will be taxed at the capital gains rate of 10%. Provisions in certain double taxation treaties include beneficial treatments.

If the local corporation qualifies as a Colombian holding company, there will be an exemption.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

In line with the BEPS recommendations, the Colombian Tax Statute has a general anti-avoidance provision, granting far-reaching powers to the Tax Authority in order to recharacterise transactions that imply an abuse of tax rules. An abuse of tax rules exists whenever a tax benefit is obtained by means of one or several artificial transactions without reasonable financial or economic purpose.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no established routine audit cycle by tax authorities. Audits are based on certain triggering events (such as a request for reimbursement of balance in favour), information received (such as information from Common Reporting Standard (CRS) countries), risk profiles developed by tax authorities and programmes developed from time to time by tax authorities to tackle points where they anticipate repetitive tax evasion schemes may exist.

9. BEPS

9.1 Recommended Changes

Colombia is a member of the OECD and an active participant in tax matters. It has implemented several BEPS recommendations, including:

- BEPS Action 3 – CFC rules and declaration of assets held abroad;
- BEPS Action 4 – thin cap rules;
- BEPS Action 6 – anti-avoidance rules;
- BEPS Action 7 – permanent establishment regulation;
- BEPS Actions 8–11 – transfer pricing rules, corporate restructuring rules and taxation of certain contributions;
- BEPS Action 13 – country-by-country reports; and
- BEPS Action 14 – MAPs.

9.2 Government Attitudes

The general attitude of the Colombian government towards BEPS is to move in the direction of implementing the recommendations. The main objective is to set the local standards at the level of international best practices in taxation as recommended by the OECD, with the expectation of reaching a much more efficient and modern tax system.

It is expected that these implementations will increase the competitive position of Colombia internationally, with a more efficient tax system that will allow lower corporate rates.

9.3 Profile of International Tax

International tax is constantly increasing its public profile in Colombia.

In the first place, less than 20 years ago, double taxation treaties were very exceptional. Since then, Colombia has negotiated a network of double taxation treaties that have become increasingly important, along with free trade agreements with its most important commercial and investment partners.

Recently, the government decided to become a member of the OECD with active participation in tax matters and, as a consequence of that policy, the CRS was fully implemented and the BEPS recommendations are always a part of the tax policy agenda of the government.

It is to be expected that the BEPS recommendations will continue to be implemented and developed.

9.4 Competitive Tax Policy Objective

A competitive tax policy must be based on reasonably low rates of taxation and well-defined and very limited tax benefits. A competitive tax policy may not be based on loose controls and lack of transparency in tax administration. Most likely, implementation of BEPS and international tax transparency of information will allow the reduction of tax burdens that are often increased as a consequence of tax evasion.

9.5 Features of the Competitive Tax System

Abundant tax beneficial treatments and complexity of certain rules creating obstacles to control make the Colombian tax system vulnerable to manipulation with permanent aggressive tax strategies and straightforward evasion.

9.6 Proposals for Dealing with Hybrid Instruments

BEPS Action 2 has not been implemented in Colombia.

Most likely, the recommendations for local legislation will be implemented in Colombia, particularly with information disclosure requirements of facts that can evidence a hybrid instrument strategy, non-deductibility rules, tax withholdings and limitation on tax credits.

9.7 Territorial Tax Regime

The Colombian income tax regime is, for the most part, territorial.

As a rule, interests are deductible, provided that tax withholding is made within the thin cap rules. These withholdings and thin cap rules certainly affect certain investment and financing structures based on debt, but tax credits at parent company level may grant relief enough to offset the negative impact.

9.8 CFC Proposals

In general terms, CFC rules are necessary and desirable with respect to passive income in an anti-deferral policy. It is not advisable to extend those rules beyond passive income.

Should there be substance in a particular jurisdiction, regardless of the tax rate level, that should not be the basis for applying CFC rules. That would be equivalent to having inefficiency as the standard.

9.9 Anti-avoidance Rules

It is not anticipated that the limitation of benefit in double taxation treaties and anti-avoidance rules will significantly impact serious inbound and outbound investors.

9.10 Transfer Pricing Changes

There are no current proposals that can result in a radical change in the transfer pricing rules in Colombia.

The taxation of intellectual property has always been, and most likely will continue to be, a source of controversy. Changes may create temporary discomfort but not material insurmountable difficulties in practice.

9.11 Transparency and Country-by-country Reporting

In Colombia, county-by-country reports have been mandatory since 2016.

9.12 Taxation of Digital Economy Businesses

Colombia has not implemented a comprehensive regulation on income tax for the digital economy. However, the issue is part of an extensive public discussion in order to create tax rules for the digital economy. It is expected that in 2021, new legal rules will be enacted to capture the income of the digital economy by the Colombian tax system.

The first steps were taken in terms of the VAT applicable to digital services from abroad, which was widely unpaid in the past. A system was put in place to get the digital service providers to register before the Tax Authority. In addition, credit or debit card operators or payment platforms are bound to withhold the applicable VAT when payments are made to the platforms.

9.13 Digital Taxation

There is not yet a clear government position included in a bill presented to Congress with respect to the BEPS proposal for digital taxation. The general opinion is that the issue has to be included in the discussion agenda for a tax reform to create a comprehensive regulation of income tax applicable to the digital economy.

Most likely, that discussion will take place shortly in Congress at the initiative of the government and rules can be expected within 2021.

9.14 Taxation of Offshore IP

Intellectual property deployed in Colombia and compensated by means of royalties is taxed through income tax withholding at a general rate of 20%. Certain treaty countries have lower withholding rates. If the payment is made to a tax haven, for it to be deductible, a transfer pricing rule demanding extensive supportive documentation has to be met, along with the income tax withholding.

If the intellectual property acquired by the local company (not by way of licensing but by way of ownership transfer over the rights) is to be amortised, it has to come from an independent third party.

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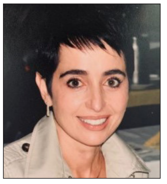

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Trends and Developments

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2021 will certainly bring a broad and intensive discussion on the tax system, within which, corporate tax will be a major issue. There is a consensus that a tax reform is needed this year, fundamentally to correct the deficit created by the economic impact of the COVID-19 pandemic and to correct certain structural deficiencies in the tax system. The government is aware of the compelling need to enhance tax revenue sources in order to be able to meet the fiscal rule to preserve its creditworthiness.

International Experts Commission Recommendations for Tax Reform

A commission of international experts has been convoked to report on recommendations for the forthcoming tax bill to be presented to Congress. Its report was presented in March 2021, with much emphasis on the inefficiency created by the abundance of tax benefits in Colombia. The commission's report includes many recommendations directed to the elimination of many of those benefits, expanding the tax base and achieving efficiency and a better progressive performance of the system.

The commission's most important recommendations to the Colombian government can be summarised as follows.

General recommendation

- Expand the tax base significantly, increase effective progressiveness, and reduce complexity and statutory rates in the medium term.

Personal taxation recommendations

- Drastically reduce exempt income in personal taxation. Treat all payments of employers as personal taxable income, including voluntary contributions to pensions and payments for the education of employees' children.
- Eliminate deductions for personal income and, for deductions that are maintained, set a cap (which has been announced to be 35% of gross income). Eliminate the tax deductions that increase with income (based on a percentage of gross income, which is essentially regressive) and convert tax deductions into a tax discount.
- Reform the rate scheme, reducing deductions and rate ranges. Enhance the tax base to allow a reduction in marginal income tax rates.
- Strengthen compliance with the tax obligations to ensure that the payment of contributions to the health and pension systems is made on all personal income of all types of workers and self-employed persons, and prevent independent workers from deducting their private consumption as a business deduction.
- Transfer the tax burden on capital income from the corporate level to the shareholder level.
- Continue with the automatic exchange of tax information to guarantee a fair taxation of capital income.
- Tax pensions at a fair effective rate. The government has announced the taxation of pensions above COP7 million pesos.

VAT recommendations

Colombia receives only 39% of the potential VAT. The recommendations have the objective of increasing that revenue to 46% of the potential VAT.

- Progressive reduction of excluded and exempt goods and services, according to international practices, and tax as many as possible at the standard VAT rate of 19%.
- Tax all goods and services at the general VAT rate and make direct cash transfers to poor families to reimburse VAT paid. If not practicable, tax the basic family basket at a 0% rate.
- Increase the current reduced rate of 5% to a range between 10% and 12% to minimise the number of companies with a right to refund, thus reducing the opportunities for fraud.
- Allow companies to credit against VAT generated in their sales the VAT paid in the purchase of productive fixed assets and eliminate the credit against income tax.
- Increase taxes on goods and services that harm the health of individuals and the environment.
- Eliminate consumption tax and impose VAT instead.
- Bring the free zones (FZs) to the ordinary VAT regime, particularly the single business FZs (special permanent FZ). If this is not possible, eliminate the latter. Introduce a system that allows the businesses in the FZs to defer the payment of VAT on imports from abroad, and a provision for the refund of imports whereby these are reimbursed after the exportation of qualified items.

Corporate tax recommendations

- Eliminate the industry and commerce tax (ICA), which is a local tax based on gross income. Currently, 50% of it is creditable against income tax. It is expected that the government will not follow this recommendation and keep the credit as it works currently.
- Eliminate the treatment of VAT paid on the purchase of fixed assets as part of their cost, so that the cost of the

investment does not continue to increase. VAT paid would be creditable against VAT generated in current operations.
- Eliminate the tax on financial movements (GMF) or convert it into a tax on cash withdrawals only. This is a heavily criticised tax on all debits on bank and financial accounts.
- Eliminate differences in the tax treatments of economic activities, to make uniform the taxation of businesses in all sectors and avoid the use of tax benefits and special tax rules focused on specific sectors.
- Significantly broaden the tax base and eventually eliminate the income tax recovery (withholding of dividends) of the corporate tax.
- Reduce the general corporate tax rate to a level that is competitive internationally. The government is considering corporate tax rate reductions with marginal tariffs starting at 24% up to 31%, based on the elimination of tax benefits.
- Maintain the FZ regime but with movements towards the merger of this regime with the ordinary corporate tax regime.
- Allow simpler and easier access of small businesses to the Simple Tax Regime (the regimen applicable to small businesses that simplifies taxation with a fixed rate on gross income), and promote this system to particular sectors, such as the agricultural sector. Strengthen the formalisation strategy of the agricultural sector and reduce associated costs.

Other Tax Issues under Discussion

Besides the issues covered by the experts commission report, there are other current issues subject to public discussion.

Taxation on patrimony

The government is considering, and it is likely to introduce, a permanent tax on personal patrimonies above COP5 billion in the tax bill. It is likely that it will be proposed at a rate of 3% and that it will be deductible for income tax purposes.

Taxation on unhealthy food

A consumption tax on sweetened beverages is being considered. Public awareness of unhealthy food is increasing and, with it, an opinion movement to tax heavily beverages sweetened with sugar. In past years, this initiative has been blocked in Congress but for sure it will be part of the discussion again and it is likely that the tax will be created.

Taxation and the environment

A carbon tax has already been created in Colombia, but the general expectation is for it to be reformed to achieve higher impact. The current legislation on carbon tax does not tax coal, which, in general terms, is not regarded as reasonable. The carbon tax intended to disincentive contaminating fuels with this twist becomes an incentive to use the most contaminating fuel, which is coal. However, this tax has had a relatively immaterial impact in terms of environmental progress, which is a point that will be revisited, particularly bearing in mind the international commitments Colombia has made on damaging emissions reduction.

In addition, there are other initiatives being discussed, such as the creation of a local tax on vehicles, and the creation of a tax on single-use plastics and on the use of pesticides.

Taxation of the digital economy

The experts commission report does not make a precise and specific recommendation on digital economy taxation. However, some general comments are included in the report, stating that Colombia should align its VAT system with international developments to expand the base to digital trans-border sales.

It is generally accepted that the Colombian tax system is missing a comprehensive treatment of digital economy activities. The need to capture part of the income generated by digital economy transactions that extract resources from the local economy is generally regarded as an urgent measure to be adopted.

In this context, the report of the commission will raise important elements for discussion. The position that will be taken on Pillar One and Pillar Two matters in the context of BEPS Action 1 analysis remains uncertain.

Considering past experience, the initial steps in the approach to income taxation of digital economy transactions will probably be based on a redefinition of territoriality or an elimination of the territoriality principle for digital economy businesses and transactions, along with widespread income tax withholding requirements and reports (including specific transfer pricing documentation). Under current territoriality principles of income tax rules, developed before the digital economy existed, the taxation of digital economy businesses and transactions is difficult.

An invitation to create a local legal presence derived from the fact that it will be, tax-wise, cheaper will be underlying those rules.

Part of the burden for the collection of the income tax withholding will be placed on the credit card operators and payment platforms in the same way as it was with respect to VAT. For VAT purposes, certain rules were recently enacted whereby payment platforms and credit card operators were designated as withholding agents on the VAT over those transactions.

In the area of the digital economy, it is expected that a chapter on virtual currencies or crypto-assets that are being constantly created and traded will appear. In Colombia, there is a lack of a legal and tax framework for crypto-assets. There is a general concern that the lack of that framework creates an opportunity for tax evasion and money laundering. There are many questions unanswered in this area that will be answered shortly when the discussion of the forthcoming tax reform starts in Congress.

- What is the characterisation of crypto-assets and virtual currencies?
- Shall crypto-assets and virtual currencies be subject to VAT?
- Where are crypto-assets and virtual currencies located in the context of territoriality rules?
- Where do transactions over crypto-assets in general or virtual currencies happen?
- For local tax purposes, where do virtual currencies and crypto-assets fit?
- What are the necessary disclosure requirements with respect to crypto-asset transactions?

Tax treaty with the USA

Apart from all the issues that will be discussed and decided in the context of a tax reform, another big issue in the corporate tax agenda in Colombia is a double taxation treaty with the United States. This treaty is certainly missing in the double taxation treaty network Colombia has, considering that the USA is the most important source of private investment into Colombia. Hopefully, the negotiation will be finalised in 2021.

Besides the clear benefits of a tax treaty with the USA, the issue of tax information exchange with the United States is very important. Colombia is an active participant in the Common Reporting Standard, the benefits of which are undoubtable. But the exchange of information with the USA based on the Foreign Account Tax Compliance Act is not as effective. In this context, the provisions on tax information exchange in this treaty are widely expected from all sides of the discussion.

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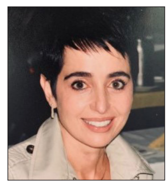

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COSTA RICA

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form in Costa Rica. Commercial corporations pursue profits as their main goal, while it is uncommon to use civil corporations to conduct business in Costa Rica.

Corporations are taxed as separate legal entities from the individuals that incorporated them.

Taxpayers usually structure their business through corporations (*Sociedad Anónima*) or limited liability companies (*Sociedad de Responsabilidad Limitada*).

1.2 Transparent Entities

Costa Rica does not have pass-through tax rules included in its current legislation, except for investment funds that act as withholding agents of their investors.

1.3 Determining Residence of Incorporated Businesses

As stated in **1.2 Transparent Entities**, Costa Rica does not have pass-through tax legislation.

On 4 December 2018, Costa Rica enacted a tax reform bill, the Law on the Strengthening of Public Finances. The reform brought new rules on permanent establishments following the OECD model definition. This reform entered into force on 1 July 2019. In general, non-domiciled parties engaging in local activities for over 183 days may be deemed as having a permanent establishment.

Costa Rica has executed three double taxation treaties (Germany, Spain and Mexico) and tax residence rules may vary from one treaty to another.

1.4 Tax Rates

Legal entities (local or non-local) developing businesses within Costa Rica generate Costa Rican-source income. Costa Rican-source income accrued by legal entities is subject to the following corporate income tax rates.

- In general – 30%.
- Legal entities whose gross income does not exceed CRC109,337,000 during the fiscal year:
  - (a) 5% for annual net income (taxable income) up to CRC5,157,000;
  - (b) 10% for annual net income between CRC5,157,000 and CRC7,737,000;
  - (c) 10% for annual net income between CRC7,737,000 and CRC10,315,000; and
  - (d) 20% on the amount of annual net income exceeding CRC10,315,000.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

According to Article 1 of the Income Tax Law, income tax is levied on Costa Rican-source income derived from for-profit activities. Costa Rican tax systems follow a territoriality principle.

Therefore, income tax is applicable to Costa Rican-source income, regardless of the nationality, domicile or residence of the recipient.

Costa Rican-source income is any amount arising from services rendered, goods located or capital used in the territory of Costa Rica.

Income tax is assessed on an accrual basis.

Taxable profits are calculated by subtracting deductible expenses from the gross income.

According to Article 10 of the Income Tax Law, expenses are deductible provided that:

- they are necessary, useful and pertinent to the for-profit activity generating actual or potential taxable income;
- any tax due was withheld (if applicable); and
- they are supported with documents and registered in accounting records.

2.2 Special Incentives for Technology Investments

In Costa Rica there are no special incentives for technology investments, but many tech-oriented businesses are developed under a Free Trade Zone Regime (explained in **2.3 Other Special Incentives**).

2.3 Other Special Incentives

Companies operating under the Free Trade Zone Regime that are located in the Great Extended Metropolitan Area (GEMA) benefit from an income tax exemption of 100% for the first eight years and 50% for the next four years. Companies located outside the GEMA benefit from an income tax exemption of 100% for the first 12 years and 50% for the next six years.

The Ministry of National Planning and Economic Policy specifies which areas are considered part of the GEMA.

With no expiry lifespan, companies under the regimen (located inside or outside the GEMA) are also exempt from value added tax and remittances abroad tax. These companies are granted an exemption from any taxes or customs duties on the importation of items such as raw materials, products, parts, packing material, containers, machinery, equipment, spare parts and other goods necessary for their operation.

In order to comply with Costa Rica's commitments as a member of the World Trade Organization, Law 8794 amended the Free Trade Zone Regime Law. A new category of companies that can apply for the Free Trade Zone Regime was included. This option is for companies producing goods, regardless of whether those are destined for exportation. Companies in this category are subject to income tax at reduced rates (0%, 5%, 6% or 15%) for a specified number of years depending on whether they are located inside or outside the GEMA or depending on the amount of the investment.

2.4 Basic Rules on Loss Relief

Prior to the tax reform, carry-forward of losses was only allowed for industrial and agricultural companies. Losses incurred by commercial enterprises were not able to be carried forward.

As of 1 July 2019, any type of company may carry forward net operating losses for three years. Agricultural companies may carry forward net operating losses for five years. Losses generated in prior fiscal years cannot be deducted.

Net operating losses may not be carried back.

Net operating losses cannot be offset against capital gains and vice versa.

2.5 Imposed Limits on Deduction of Interest

Costa Rica has no thin capitalisation rules, with the exception of a restraining rule in the case of credits granted by non-financial institutions, as explained in **5.7 Constraints on Related-Party Borrowing**.

2.6 Basic Rules on Consolidated Tax Grouping

Costa Rica does not allow tax consolidation.

A taxpayer's losses should remain separate regardless of whether they are part of a group of companies.

2.7 Capital Gains Taxation

Capital gains generated by corporations or legal entities engaged in for-profit activities are subject to the standard corporate income tax rate (30%) if the gain derives from the sale or transfer of assets and/or rights used in said activities. If not, the gain will be subject to a 15% tax.

Corporations or legal entities not engaged in for-profit activities are subject to capital income and capital gains rules. According to said rules, a capital gain will be subject to a 15% tax; however, if the assets and/or rights belonged to the taxpayer before 1 July 2019, the taxpayer may opt to pay the capital gains tax, calculated as 2.25% of the sale price (no deductions allowed).

2.8 Other Taxes Payable by an Incorporated Business

Value added tax is accrued on the sale of goods, the rendering of services, the rent of property or the importation of goods or services. There are different rates and some goods and services are exempted, but the general rule is that a 13% VAT applies on the purchase of goods and services.

A special tax applies to imports or the manufacturing of alcoholic and carbonated beverages and all kinds of cigars; also, a selective consumption tax applies regarding the importation of luxury goods.

2.9 Incorporated Businesses and Notable Taxes

The Real Estate Tax Law is administered by the local governments, also called municipalities. The tax is collected on a quarterly basis and calculated on the registered value or appraised value of the real estate (including land and all permanent buildings and structures located within the territory of the municipality).

The tax rate is 0.25% of the base or appraised value of the property.

The appraised value is established by the municipal tax administration.

The value can also be revised at any time by the tax administration or automatically adjusted when an updated value surfaces from documents subject to registration before the Public Registry.

Real estate taxes are deductible for income tax purposes.

Employers' social security contributions are imposed on all remuneration paid to employees, including benefits in kind. There is no maximum amount.

The employer rate of social security is 26.33%. The employee rate is 10.34%.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

In the case of individuals operating businesses or rendering professional services directly, the rates are as follows:

- annual net revenue up to CRC3,742,000 is not subject to taxation;
- 10% on the annual net revenue between CRC3,742,000 and CRC5,589,000;
- 15% on the annual net revenue between CRC5,589,000 and CRC9,322,000;
- 20% on the annual net revenue between CRC9,322,000 and CRC18,683,000; and
- 25% on the annual net revenue above CRC18,683,000.

There is no rule that forbids or limits individuals from rendering professional services through corporations or legal entities.

3.3 Accumulating Earnings for Investment Purposes

No rules prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals receiving dividends from a corporation or another legal entity are subject to a 15% withholding. The payer must act as withholding agent.

Individuals not engaged in for-profit activities are subject to capital income and capital gains rules. According to said rules, a capital gain will be subject to a 15% tax; however, if the assets and/or rights belonged to the taxpayer before 1 July 2019, the taxpayer may opt to pay the capital gains tax calculated as 2.25% of the sale price (no deductions allowed).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Because of the tax reform, distribution of dividends from publicly traded corporations to individuals is taxed at 15%. Gains derived from the sale of shares in publicly traded entities is taxed according to the capital gains rules. There are specific regulations regarding shares acquired prior to the reform entering into force.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In general, interest payments from Costa Rica to abroad are subject to a 15% withholding tax.

For interest payments, commissions and other financial expenses paid or credited by local financial entities subject to regulation by SUGEF (the Superintendence of Financial Institutions) to foreign financial entities (also subject to overseeing and inspection in similar terms by the equivalent authority in their jurisdiction) will be subject to a 5.5% withholding tax.

Dividends paid to an individual (local or non-local) or to a legal entity (local or non-local) are subject to a 15% withholding tax. Said withholding does not apply if the dividends are distributed to a local legal entity, as long as the recipient is engaged in a for-profit activity. Remittances abroad related to the use of patents, formulas, trade marks, privileges, franchises and royalties are subject to a 25% withholding tax.

4.2 Primary Tax Treaty Countries

Many international companies set up their holding entity in Panama (due its territorial tax system). Spain is also an option due to the existence of a double taxation treaty and the Spanish treatment for income deriving from investments outside that country.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The authors have no knowledge of cases in which the Tax Administration has questioned the application of double taxation treaties in this sense.

4.4 Transfer Pricing Issues

The main problem that Costa Rica has faced regarding transfer pricing application is the lack of uniformity during tax audits.

The majority of administrative and judicial cases related to transfer pricing concern the correct application of the method for calculating prices and open market comparable data that must be taken into account.

The resolution of these cases is still pending; once they are resolved, they will bring light into the discussion.

4.5 Related-Party Limited Risk Distribution Arrangements

As a general principle, local tax authorities do not challenge the use of related-party limited risk distribution arrangements for the sale of goods or provision of services locally. In general, prices agreed between related parties should follow the arm's-length principle.

The authors have no knowledge of judicial or administrative proceedings in which the authorities have questioned this type of agreement between companies.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

In Costa Rica the rules applicable to transfer pricing do not have considerable differences from the OECD regulations on the matter. The discussions that have arisen are related to the correct application of the methodology or the utilisation of comparable data.

4.7 International Transfer Pricing Disputes

There is no experience in Costa Rica in this matter.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

It is possible to compensate adjustments related to a transfer pricing claim, but the taxpayer should file a tax return in order to identify the specific amounts involved.

In Costa Rica there is no legal basis in order to propose a mutual agreement procedure (MAP) to the Tax Administration.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Taxation for local branches of non-local corporations and local subsidiaries of non-local corporations is the same. There is no difference in the treatment from the perspective of corporate income tax.

5.3 Capital Gains of Non-residents

In general, capital gains are subject to taxation in Costa Rica. A non-resident party transferring stock in local corporations to a local taxpayer is subject to a 2.5% withholding tax that applies on the sale price. In principle, the non-resident party may self-assess the capital gains tax and use the withholding tax as a tax credit towards the capital gains tax.

As previously stated, taxpayers – including non-resident parties – may choose between two options in order to determine the capital gains tax: 2.25% on the sale price or 15% of the gain (as the difference between the cost or book value and the sale price).

Currently, Costa Rica has only three double taxation treaties in place. None of them has specific regulations on capital gains. Whether or not the sale of stock falls within the meaning of "business profits" is debatable; the authors are not aware of administrative or judicial precedents on this matter.

5.4 Change of Control Provisions

Changing control of local legal entities owning Costa Rican real estate triggers real estate transfer tax (change of control implies the transfer of at least 51% of the voting stock).

The concept of transfer includes direct transfer of real estate (typically, Costa Rican real estate is transferred by granting a public deed before a notary public) and indirect transfer by changing control of the legal entity.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

This is not applicable in this jurisdiction.

5.6 Deductions for Payments by Local Affiliates

Local affiliates are able to deduct payment for management and administrative services rendered by non-local affiliates. Similar to other expenses, these must be connected with the for-profit activity and the amount paid should follow the arm's-length principle.

5.7 Constraints on Related-Party Borrowing

There are no specific rules constraining financing operations between related parties (local or domiciled abroad); however, the Income Tax Law includes an interest limitation rule, under which, interest expenses that exceed 20% of the taxpayer's earnings before interest, taxes, depreciation and amortisation (EBITDA) will not be deductible for corporate income tax purposes.

In general, interest payments derived from debts with financial institutions (local or non-local) are excluded from this limitation. As a consequence, interest payments in favour of related companies (regardless of their tax residence) may fall under this limitation.

This provision is effective in the second tax year following the date of enactment of the tax reform. The deduction is limited to 30% for the first two tax years and will then be adjusted downward by two percentage points each year until it reaches 20%.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Costa Rica follows the territoriality principle, meaning that only Costa Rican-source income is subject to taxation.

6.2 Non-deductible Local Expenses
As a consequence of the territoriality principle, local expenses attributed to foreign income should not be deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries
Dividends received from non-local subsidiaries should not be subject to taxation.

6.4 Use of Intangibles by Non-local Subsidiaries
The transfer of intangibles developed in Costa Rica should be done according to fair market value. It is the same in the case of licensing of intangibles developed in Costa Rica; the consideration should follow the arm's-length principle.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
Costa Rica has no controlled foreign corporation-type rules in its current tax legislation.

6.6 Rules Related to the Substance of Non-local Affiliates
There is no applicable information in this jurisdiction.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates
Following the territoriality principle, gains deriving from the sale of shares in a foreign affiliate are not subject to taxation in Costa Rica.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions
In December 2018, Costa Rica enacted a tax reform bill, the Law on the Strengthening of Public Finances. Through this reform, a general anti-avoidance rule was included in the tax legislation. These rules seek to avoid aggressive tax strategies lacking economic and business purpose.

8. Audit Cycles

8.1 Regular Routine Audit Cycle
There are no regular audit cycles in Costa Rica.

However, the tax authority tends to audit more often large taxpayers annually. The Comptroller General of the Republic has advised and recommended the Tax Administration to audit large taxpayers on a regular basis in order to avoid the statute of limitation of tax periods.

For regular taxpayers, every tax period, the Tax Administration issues criteria in order to select activities or sectors that are relevant for said Administration.

9. BEPS

9.1 Recommended Changes
As part of the tax reform, the taxation on financial returns was increased from 8% to 15%.

As discussed above, a rule on interest payments deduction is now part of the tax legislation in Costa Rica. The final version differs from the one proposed by the Tax Administration due to negotiation in Congress.

Prior to the tax reform, capital gains were not subject to taxation in Costa Rica. Now they are, regardless of whether they are habitual or not.

9.2 Government Attitudes
Costa Rica is in the process of being admitted as a member of the OECD. Implementing most of the BEPS recommendations is part of the government's policy.

9.3 Profile of International Tax
The Tax Administration has stressed a concern with tax havens and how they may affect local taxes in Costa Rica. In general, discussion about international tax surrounds that topic.

9.4 Competitive Tax Policy Objective
Costa Rica does not have a comprehensive competitive tax policy. The tax legislation lacks tax incentives aside from those related to the Free Trade Zone Regime.

9.5 Features of the Competitive Tax System
During the discussion of the last tax reform, the Free Trade Zone Regime was a focus for political parties that were looking to modify such regime in order to eliminate or diminish its tax incentives. None of its features were modified.

9.6 Proposals for Dealing with Hybrid Instruments
As part of the tax reform, a specific rule on hybrid instruments was approved. Despite the fact that the rule is obscure, the

intention is to reject expenses as being deductible if the related income is not subject to taxation.

9.7 Territorial Tax Regime
The Costa Rican tax system is based on a territorial tax regime. Modifications to said regimen were not part of the discussions during the analysis of the tax reform. Not being able to deduct expenses related to investments located outside Costa Rica is a consequence of the regime due to the fact that the non-Costa Rican returns shall not be subject to taxation.

9.8 CFC Proposals
The authors do not foresee a change in the territorial tax system. A discussion of controlled foreign corporation (CFC) rules was not part of the most recent tax reform. From the authors' standpoint, the CFC rules and its variations should be part of a more comprehensive tax system shift.

9.9 Anti-avoidance Rules
Costa Rica has no rules similar to the Direct Taxes Code. As a consequence of the tax reform, an anti-avoidance rule was introduced to the country's tax legislation, as discussed in **7.1 Overarching Anti-avoidance Provisions**.

9.10 Transfer Pricing Changes
Transfer pricing rules have been part of the tax system since 2003 (through Administrative Directive 20-2003). From that point, transfer pricing has evolved until it was included in Costa Rican income tax law as part of the most recent tax reform.

In particular, intellectual property does not bring additional difficulties to the regime.

9.11 Transparency and Country-by-country Reporting
Country-by-country reporting is part of the compliance obligations of certain taxpayers (in general, multinational companies having a predetermined amount of global earnings). However, the forms have not been published yet and, as a consequence, it has been delayed.

9.12 Taxation of Digital Economy Businesses
Under the framework of the most recent tax reform, the value added tax encompasses the taxation of digital businesses.

Now, cross-border digital services will be subject to VAT at a rate of 13%. The Costa Rican Tax Administration based its regulations on the OECD International Guidelines (2017), by proposing registration and compliance mechanisms to expedite tax collection in respect of transactions between non-domiciled parties and local consumers. Besides such mechanism, the Tax Administration also published a list of cross-border providers that will be subject to VAT.

Finally, if a digital service provider does not register as a VAT payer, law establishes the credit or debit card processors as responsible for the collection of tax in respect of online purchases.

9.13 Digital Taxation
See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP
Costa Rica has no specific regulations on this matter.

Deloitte Tax Costa Rica is made up of more than 100 professionals, including lawyers and accountants. There are two male and two female partners, 10 managers, and 34 senior and 51 junior-level officials and attendees. Approximately 50% of the staff is male and 50% female. The offices are located in a large business office in the north west of the capital city. Among the most important clients are AstraZeneca, The Bank of Nova Scotia, MAERSK, UNILEVER, Bridgestone, Hultec, Banco Popular and Dos Pinos. Services include traditional tax compliance, transfer pricing, tax advice, business process solutions, consulting for family businesses, global trade advisory and specialised litigation in different areas. Deloitte Tax Costa Rica also works in tax planning, preventative tax audit, preventative customs duties, and advice and support to the Free Trade Zone Regime; all these roles are performed in co-ordination with the legal services.

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DOMINICAN REPUBLIC

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In the Dominican Republic, businesses generally adopt a corporate form. The types of legal entities that can be incorporated in the Dominican Republic, according to Law No 479-08 of Companies and Individual Enterprises, are the following:

- companies in collective name;
- limited partnerships (simple or by shares);
- limited liability companies;
- corporations; and
- simplified corporations.

The law also recognises accidental companies, which do not have legal personality. Additionally, most foreign legal entities are recognised and operate in the Dominican Republic through the incorporation of a Dominican branch.

Once incorporated under Dominican law and/or established in the country through a Dominican branch, legal entities will be considered as a separate entity for accounting and tax purposes. The tax system in the Dominican Republic is mainly territorial, with some exceptions. All income from a Dominican source is taxed (those obtained from the realisation of commercial, industrial, agricultural, mining and similar activities in the country, and those derived from capital, property or rights located, placed or used economically in the Dominican Republic). In addition, foreign financial income (such as dividends, interests, bonds and other similar income) is subject to income tax payment in the Dominican Republic.

1.2 Transparent Entities

Not applicable in this jurisdiction.

1.3 Determining Residence of Incorporated Businesses

A company may be considered domiciled in the Dominican Republic when it is incorporated under the laws of the Dominican Republic and when it has the headquarters of its business or its effective centre of management in the country.

In order to be considered as an incorporated business in the Dominican Republic, legal entities must register before the Mercantile Registry in the corresponding Chamber of Commerce, and before the National Taxpayer Registry of the Dominican Tax Administration (*Dirección General de Impuestos Internos*, or DGII). During the registry process in the DGII, the entity will have to provide its incorporation documents in which the corresponding jurisdiction is clearly stated.

In regard to individuals, the main link with the Dominican tax system is "residence", which results from the application of a quantitative rule of permanence in the country (the "182-day rule"). However, for tax purposes, the effective domicile of the taxpayer could be determined from certain assumptions of the obliged taxpayer in the Dominican Republic, such as place of effective management, and/or of the taxable event (qualitative elements).

1.4 Tax Rates

Incorporated businesses pay a 27% income tax rate applicable over the net taxable income. Individual income is taxed using a progressive scale that ranges from 15% to 25% of such income. Dividends are subject to a final withholding tax of 10% at the source of payment.

Capital gains, which derive from the sale of assets (real estate property or shares), are included in the corporate income tax rate, and the tax base is the difference of the price and the acquisition cost (adjusted for inflation).

Corporations are subject to tax over assets, at a 1% rate, assessed on the total amount of the taxpayer's taxable assets. The amount settled for this tax will be considered as a credit against the income tax declared on said fiscal year. If the amount paid for income tax is equal to or greater than the payable asset tax, the latter shall be considered extinguished.

The trade of goods and services is subject to a value added tax (VAT), with a standard rate of 18%. Some special goods (dairy products, chocolate, coffee, sugar, among others of high consumption) have been taxed at a reduced rate of 16%.

The excise tax rate is a consumption tax considered for luxury goods (alcohol, tobacco, vehicles, among others) as well as some services (such as telecommunications and insurances), and will vary depending on the acquired goods and services (assessed at rates of 10%–20%). In addition, a rate of 0.0015% is withheld by financial intermediation entities assessed on the value of each cheque or wire transfer.

Transactions involving the acquisition of real estate property will be subject to a transfer tax of 3% assessed on the transaction price.

Dominican legal entities are subject to a 1% tax over their authorised capital payable at the time of incorporation, and the difference from it, of any capital increase made afterwards.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits of an incorporated business in the Dominican Republic will be determined based on the financial result of the entity as well as on certain positive or negative tax adjustments that should be considered in accordance with current tax regulations.

Some positive tax adjustments are non-deductible tax items, excess depreciation, adjustments for control of previous years, excess provision for uncollectible accounts, excess donations to public welfare entities, loss of non-compensable capital for the year, exchange difference, positive adjustments for refunds, transfer pricing adjustments, non-deductible interest expenses, expenses not admitted, inventory adjustments, expenses without vouchers with tax value, deferred income tax, forecasts not admitted and non-sustained liability, among others.

In the case of negative adjustments, the following can be mentioned: deficiency in depreciation, inventory adjustments and exchange difference.

In addition to these adjustments, taxpayers have the formal duty to include in their income tax return any exemptions by law of incentives, dividends earned on investments in other companies, and proportion of tax losses of previous years that are compensated.

Profits earned by legal entities will be taxed using an accrued basis method, while individual taxpayers will be subject to income tax based on the taxable income perceived on the tax year, respectively.

2.2 Special Incentives for Technology Investments

There are no special incentives for investments in technology or special treatment of R&D expenses in the Dominican Republic. The tax legislation basically establishes that, subject to the consent of the DGII, taxpayers may treat expenses incurred or the payments made in R&D during the fiscal year as current expenses and not add them to the capital account. Such treatment must be consistently applied during the fiscal year and subsequent years, unless the DGII authorises a different method for all or a portion of said expenses, and this treatment shall not apply to land or depreciable assets, or to any expense incurred or paid for the purpose of determining the existence, location, extent or quality of any natural deposit.

2.3 Other Special Incentives

In the Dominican Republic, there are special incentives aimed at the development of industries or relevant economic sectors by granting tax exemptions related to income tax and import taxes, among others, to promote capital mobility. Some of the industries or relevant economic sectors are:

- the border area of the country with Haiti;
- free trade zone regimes;
- tourism businesses development;
- special trusts under Dominican law;
- the film industry;
- non-renewable energy companies;
- manufacturing companies under special regimes;
- textile and footwear manufacturing companies;
- religious, sports and educational institutions; and
- books and libraries.

In regard to financing for businesses in the Dominican Republic, there are currently no tax incentives available. However, for tourism businesses under the special tax regime available in the Dominican Republic, the interests generated from external financing shall not be subject to income tax withholding. In addition, companies under the special tax regime applicable for non-renewable energy activities will have a reduced rate of 5% (in comparison to the standard 10%) withholding tax for the payment of interest for external financing.

2.4 Basic Rules on Loss Relief

According to Dominican tax regulations, operational losses suffered by legal entities in their financial years will be deductible from profits obtained in the immediate years subsequent to the losses. This compensation cannot be extended beyond five years, and is subject to a limitation of 20% per tax year for the first three years. In the fourth year, that 20% will be deductible only up to a maximum of 80% of the taxable net income corresponding to that exercise, and in the fifth year, this maximum will be 70% of the net taxable income. The losses that are not deducted during corresponding timeframes cannot be carried forward.

Capital losses would not be subject to percentage or annual limitations; however, they can only be compensated against capital gains.

2.5 Imposed Limits on Deduction of Interest

In general, expenses (as interests) generated by entities in the Dominican Republic during their ordinary course of business shall be deductible for income tax purposes. However, there are some limitations established on the deduction of interests as expenses by entities in the Dominican Republic. Said limitations apply to sub-capitalisation rules, interest payments to individuals and interest payments made to foreign legal entities

These rules aim to control leverage compared to invested capital, as well as to discourage the granting of non-formal financing and financing structures in favour of creditors established abroad, basically, in low or zero-tax jurisdictions.

2.6 Basic Rules on Consolidated Tax Grouping

Permanent establishments (branches or subsidiaries) of incorporated businesses in the country must elaborate their accounting records separately from their parent companies, their subsidiaries and other branches abroad in order to determine the tax result of income from Dominican sources. Tax losses are not transferable between companies of the same group.

The DGII has the faculty to declare what constitutes an economic group for tax purposes. Taxpayers who make up the same economic group could request the DGII via a special process to be considered as such, and consequently could receive exceptional treatment for accounting records of operations that occur between the components of said group, and submit their joint or individual tax returns according to the guidelines established by the DGII for the taxes in question.

2.7 Capital Gains Taxation

Capital gains subject to income tax shall be determined by deducting from the price or value of disposal of the asset the acquisition or production cost adjusted for inflation (cost basis). In the case of shares, the sum or subtraction of accumulated gains or losses of the issuing entity must be considered. There is no specific tax applicable to capital gains. Corporations established in the country must include capital gains in their gross income for the determination of their net taxable income subject to income tax.

2.8 Other Taxes Payable by an Incorporated Business

Transactions that involve other assets could be subject to other taxes such as VAT, excise tax or transfer of real estate property tax, depending on the nature of the transaction.

2.9 Incorporated Businesses and Notable Taxes

In addition to income tax applicable over the net taxable income, businesses established and operating in the country will have to comply with other taxes related to:

- trade of goods and/or services such as VAT;
- tax over assets; and
- excise tax related to the capital mobility of capital and services.

An incorporated business in the Dominican Republic must comply with formal duties of reporting as a withholding agent, especially as an employer in the country (including social security contributions on behalf of employees), and as a provider of goods or services.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses could incorporate and execute their businesses from a corporate or non-corporate form. However, the structuring of businesses via corporate form offers the advantage for the shareholders to separate their personal assets from the commercial operation, as well as being able to define the corporate governance rules that will govern the administration of the business. In the Dominican Republic, most closely held businesses operate in a corporate form.

3.2 Individual Rates and Corporate Rates

In the Dominican Republic, the corporate tax rate is higher than the individual tax rate. Additionally, both the method and the base of the determination of the net taxable income are different for each case. The Tax Administration has been making efforts for the implementation of special regimes focused on small and medium-sized businesses, as well as liberal professionals, with the main goal of simplifying their taxation procedures.

3.3 Accumulating Earnings for Investment Purposes

There are no rules that prevent closely held corporations from accumulating profits for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends derived from Dominican sources are subject to a 10% rate of withholding tax, considered as a unique and definitive payment for income tax purposes.

Dividends derived from foreign sources will be taxable in the Dominican Republic. However, they must be included as part of the gross income for the determination of their net taxable income subject to income tax at the maximum rate of 25% for individuals, and 27% for corporations.

Capital gains received from the sale of shares will be subject to income tax and shall be included as part of the taxable income considered for the determination of the taxable net income that would be subject to income tax payment.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations
The tax treatment of dividends from Dominican sources or for taxable capital gains on the sale of shares will be the same in the case of closely held or publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Payment of interests from Dominican sources made to individuals and legal entities resident or non-resident in the Dominican Republic must withhold 10% of the amount paid as a sole and final payment for income tax purposes.

Interests paid to an individual – resident or domiciled in the country – are subject to a final withholding tax of 10% by financial entities. The law establishes the possibility that individuals can apply for a reimbursement of said withholding, considering certain conditions are met.

Dividends and/or any other way of profit distribution from Dominican sources to individuals, legal entities or resident or non-resident entities are subject to a final withholding tax of 10%. Dividends distributed by way of shares are exempted from the application of income tax.

Payments other than interest and dividends (such as royalties or services) made abroad from Dominican sources are subject to a 27% final withholding tax over the gross amount.

4.2 Primary Tax Treaty Countries
The Dominican Republic only has two double taxation treaties. One is with Canada (1977) and another with Spain (officially approved on 31 March 2014).

4.3 Use of Treaty Country Entities by Non-treaty Country Residents
The DGII has the faculty to challenge the use of treaty country entities by non-treaty country residents with a special emphasis on ensuring the non-implementation of precedents of abusive tax practices.

4.4 Transfer Pricing Issues
One issue could be the need to comply with all the obligations and formal duties of reporting in accordance with the established scope, in addition to dealing with market terms and conditions in their commercial or financial operations carried out with other related parties, for tax purposes.

4.5 Related-Party Limited Risk Distribution Arrangements
Local tax authorities may challenge the use of related-party limited risk distribution agreements for the sale of goods or provision of services locally if they do not establish reasonable market terms and conditions, and/or if they create economic circumstances in detriment of determining the effective taxable income or deductible expenses of the participants.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards
The current transfer pricing rules in the Dominican Republic are based on the OECD guidelines. Nevertheless, they have to be modified in order to fully comply with all OECD standards.

An annual information report must be submitted no later than 60 days after the income tax due date. Current methods established to assess arm's-length standards are:

- comparable uncontrolled price (CUP);
- resale price (RPM);
- cost plus;
- transactional net margin (TNMM); and
- profit split.

4.7 International Transfer Pricing Disputes
It is the authors' understanding that the tax authorities do not often resolve international transfer pricing disputes by the use of double tax treaties in the Dominican Republic.

With regard to the applicability of mutual agreement procedures (MAPs) by the tax authorities, the provisions of the double tax treaties establish that the taxpayer, at the outset, has the possibility to request the MAP assistance within a dispute (whether under an administrative or a judicial procedure). However, in practice, it is the authors' understanding that MAPs are rarely implemented by the Dominican Republic Tax Administration since it has not been very proactive in applying double tax treaties (this is rather recent in application in this country).

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
Compensatory adjustments will be allowed or made when a transfer pricing claim is settled. The Dominican Republic does not have rules with respect to PTC.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-local corporations will be taxed similarly to local subsidiaries of non-local corporations.

5.3 Capital Gains of Non-residents

Capital gains obtained by non-residents or non-domiciled entities from the sale of stock in local corporations and the sale of shares of a non-local holding company that indirectly owns assets in the Dominican Republic will be taxable in the country. The DGII has the faculty to audit combined transactions in order to ensure compliance with local tax duties.

Double taxation treaties do not necessarily eliminate the obligation of taxation in the country, but try to govern with respect to contracting countries (Canada and Spain in the case of the Dominican Republic), in which country the income tax would be paid. Under the current treaties, investment transactions that directly or indirectly have a relevant local real estate patrimony would be taxed in the Dominican Republic. The DGII must validate every transaction in which the treaties are challenged.

5.4 Change of Control Provisions

Changes of control that result from/in changes, directly or indirectly, of the ownership structure of an asset held in the Dominican Republic could implicate tax duties in the country. The DGII has the faculty to review any combined transactions and determine if the situations and events occurred in accordance with the facts by applying the substances over form rule.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The withholding of taxes at the source of the payment, the obligation to claim expenses deductions, formal duties established on sales and expense reports matters, as well as transfer pricing rules, are some of the formulas used by the tax regulation to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

To allow the deduction for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate, without prejudice to the basic rule related to expenses to be deducted, any payments abroad from Dominican sources other than interest and dividends (as services) will be subject to a 27% final withholding tax over the gross amount. Therefore, the services effectively provided must be billed by the non-local affiliate and said income tax withholding paid to claim the deductibility of the expense.

Since operations occurred between related parties, they must also comply with transfer pricing rules. A special administrative process established by this jurisdiction's tax regulation could be executed before the DGII with respect to the distribution of corporate expenses, subject to the authorisation of the Tax Administration.

5.7 Constraints on Related-Party Borrowing

There are no restrictions imposed on loans between related parties such as a local affiliate and a non-local affiliate. The Dominican tax system has sought to control the leverage of established local affiliates through the limitations imposed on the deduction of interest, given that interest paid from a Dominican source in favour of legal entities established in low or non-tax jurisdictions would not have the quality of being deductible for the local affiliate.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The Dominican tax system is essentially territorial given that all income from a Dominican source is taxed and, in addition, it establishes that income from foreign sources that exclusively derive from financial gains will be taxable in the country. This income must be included as part of the gross income for the determination of the net taxable income subject to income tax.

6.2 Non-deductible Local Expenses

If expenses are incurred in order to obtain, maintain or keep taxed income, the deduction will be made in the respective proportion in which such expenses were incurred in the year. These deductible expenses must be effectively incurred and related to the activity or business. In general, expenses not considered deductible are:

- personal expenses;
- withdrawals or salaries to shareholders and related parties (without an effective provision of services with an according amount);
- preventative losses from illicit operations;
- income tax and its accessories charges;
- taxes on inheritance and donations;
- taxes incurred to build, maintain and preserve capital goods (except when they are computed as part of the cost to be alienated from the good);
- expenses without feasible vouchers;
- remuneration of persons or organisations operating from abroad; and

- remuneration or salaries paid to board members, councils and other management or administrative bodies that operate abroad.

Profits for the tax year that are used to increase capital or to reserves of companies are not expressly admitted as deductions.

6.3 Taxation on Dividends from Foreign Subsidiaries
Dividends derived from foreign sources will be taxable in the Dominican Republic. However, they must be included as part of the gross income for the determination of their net taxable income subject to income tax at the established rate of 27% for corporations.

6.4 Use of Intangibles by Non-local Subsidiaries
Payments made abroad (individuals, legal entities or entities that are not resident or domiciled in the country) other than interest and dividends (such as royalties or services) from Dominican sources are subject to a 27% final withholding tax over the gross amount. The transaction will not be subject to VAT.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
The Dominican Republic does not have controlled foreign corporation (CFC)-type rules, regardless of the jurisdiction of the company. From a tax standpoint, non-local branches or subsidiaries established in the country, and local corporations, will have equal fiscal treatment in the country, except for (i) the capitalisation tax (1%) that applies to Dominican entities and (ii) real estate transfers tax (3%) that is applicable to the contribution in kind of real estate property if the recipient is a foreign entity established in the country (as local branch or subsidiary).

6.6 Rules Related to the Substance of Non-local Affiliates
The DGII has the faculty to audit combined transactions in order to ensure compliance with tax duties in the country.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates
Gains derived from a local corporation that holds shares in a non-local affiliate entity are subject to taxation in the Dominican Republic as taxed income from foreign sources (those from investments and financial gains). Subsequently, capital gains obtained by non-residents or non-domiciled affiliates from the sale of stocks in a local corporation, and/or with respect to shares of a non-local holding company that indirectly owns assets in the country, will be taxable in the Dominican Republic.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions
There are two thin capitalisation rules in the Dominican Republic incorporated for anti-avoidance and transfer pricing regulation purposes, which are applied on the deduction of interests derived from loans obtained by taxpayers.

Under the first rule, the proportion of interest that can be deducted by a domiciled or resident debtor for loans provided by resident or foreign individuals or entities shall be calculated by dividing the withholding rate applied to interest payments made to said lenders (ie, 10%) by the current corporate income tax (ie, 27% for FY 2020). However, if said interest is considered taxable income for a non-resident or non-domiciled lender in their jurisdiction, and if the foreign lender's tax rate for such income is equal to or greater than the 27% tax rate applicable in the Dominican Republic, the local debtor may deduct 100% of said interest for income tax purposes. However, if the foreign lender's income tax rate for the interest income is lower than 27%, the local debtor shall only be allowed to deduct a proportion of the interest equal to the foreign lender's income tax rate divided by the 27% tax rate in the Dominican Republic.

Additionally, thin capitalisation rules exist whereby interest on loans granted by resident individuals or non-resident or non-domiciled individuals, corporations or entities is not deductible if the local debtor's debt-to-equity ratio exceeds 3:1. The aforementioned interests may be deducted no later than three years following the date the interest was accrued.

8. Audit Cycles

8.1 Regular Routine Audit Cycle
A regular routine audit cycle is not established in the Dominican Tax Code; instead, a non-periodic audit takes place after the reports of income tax, asset tax and VAT are filed and any inconsistency in a tax return might trigger the suspicion of tax evasion or avoidance. This non-periodic audit can be carried out in the premises where the taxpayer keeps proper books and records; this auditing can extend from three months to twelve months. Also, a non-periodic audit can consist of the verification of a determined fiscal year, and be carried out in the local Tax Administration of the taxpayer.

9. BEPS

9.1 Recommended Changes

Thus far, the only measure implemented in the Dominican Republic in compliance with the recommendations of the BEPS Action Plan is Action 4, the limitation on interest deductions.

9.2 Government Attitudes

The government of the Dominican Republic is seeking to implement the BEPS actions that allow the reduction of erosion of the tax base. In March 2018, the Dominican Republic started a process to adhere to the BEPS inclusive framework and became a member as of October 2018. Action plans of minimum required standards are currently undergoing the peer review process.

9.3 Profile of International Tax

The Ministry of Treasury and the DGII implemented the international tax strategic plan in 2013, and from that moment it has represented one of the pillars of the tax policy of the country. This plan is based on:

- adherence to the Global Forum on Transparency and Exchange of Information for Tax Purposes;
- signing the Federal Account Tax Compliance Act (FATCA) – Model 1A IGA (reciprocal exchange of information);
- signing the Convention on Mutual Administrative Assistance in Tax Matters; and
- the implementation of BEPS Action Plan.

In consequence, BEPS is an element that will define international taxation policy in the Dominican Republic, and currently tax authorities are structuring an international taxation unit to specifically address and administer these matters.

9.4 Competitive Tax Policy Objective

The balance of the government's competitive tax policy objective against the pressures that BEPS will bring may be sought in the negotiation of double taxation conventions (DTCs) and the modification of the tax rates and the tax base applied to non-residents (ie, tax withholding to payments abroad). These matters are subject to discussion in the upcoming "fiscal pact", established in Law No 01-12 of the 2030 National Development Strategy.

9.5 Features of the Competitive Tax System

From an international taxation perspective, the key features that must be considered are:

- taxation of permanent establishments;
- taxation of intangibles;
- taxation from services rendered via the internet (ie, streaming);
- CFC rules; and
- adequacy of transfer pricing regulation.

9.6 Proposals for Dealing with Hybrid Instruments

The Dominican Republic has not implemented the hybrid instruments standards to date.

9.7 Territorial Tax Regime

The Dominican Republic has a territorial tax regime and, as previously stated, interest deductibility provisions in effect, and this firm does not think these will affect people investing in and from this jurisdiction.

9.8 CFC Proposals

The Dominican Republic does not have CFC rules in place. Nonetheless, this firm does not agree with having a sweeper CFC rule put into effect; it agrees on implementing it when there is no substance located in an offshore subsidiary.

9.9 Anti-avoidance Rules

Since the Dominican Republic only has two DTCs in place, the proposed DTC limitation of benefit or anti-avoidance rules have not had any impact.

9.10 Transfer Pricing Changes

This firm does not consider the transfer pricing changes that have been proposed as a radical change in this jurisdiction, considering that the current rules contain most of the OECD guidelines, and just have to be modified/updated to recent standards. Regarding the taxation of profits from intellectual property in transfer pricing, a recurrent adjustment is made to the payment of royalties for the concept of intellectual property or industrial property.

9.11 Transparency and Country-by-country Reporting

This firm is currently in favour of the proposals for transparency and country-by-country reporting, which is a minimum standard of BEPS; however, law modifications are required in order to complete the process.

9.12 Taxation of Digital Economy Businesses

No implementations have been made in relation to the taxation of transactions effected or profits generated by digital economy businesses operating largely from outside this jurisdiction; discussions on this matter are on the agenda for the upcoming year.

9.13 Digital Taxation

Thus far, the country has not taken an official position in relation to the BEPS proposals for digital taxation.

9.14 Taxation of Offshore IP

No additional provisions have been introduced by the Dominican Republic with regard to dealing with taxation of offshore intellectual property that is deployed within the country. The Dominican Tax Code establishes the tax withholding for payments made abroad, which are taxed at the source of said income.

OMG integrates research and professional services, gathering strategists from diverse areas with the purpose of creating social impact, generating knowledge and adding innovative value in the societies in which it operates. The firm has two offices within the territory of the Dominican Republic, which are located in Santo Domingo and Punta Cana, and one office located in Panama. OMG's tax team is regarded as a highly talented and innovative group of experts on income tax and VAT; it is also recognised for a practical bottom-line approach that looks for the most efficient organisational structures and measures the efficacy of the solutions proposed against the tangible net savings resulting from such solutions to clients. OMG assists in governmental taxation processes, accounting and taxation audits, tax planning and fiscal structure revisions.

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ECUADOR

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses commonly adopt a corporate form. The most common structures are corporations and limited liability companies (partnerships). In 2020, the Ecuadorian legislation was amended to include a new type of entity referred to as a "simplified stock corporation".

- *Compañía anónima* (corporation) – the transfer of issued stock is not subject to limitations. For incorporation, at least two stockholders are required and there is a minimum share capital of USD800.
- *Compañía de responsabilidad limitada* (limited liability company/partnership) – the transfer of issued shares requires unanimous approval by the partners (shareholders). For incorporation, at least two partners are required and there is a minimum share capital of USD400.
- *Sociedad por acciones simplificada* (simplified stock corporation) – issued stock may be freely transferred. However, it cannot be traded on the Ecuadorian stock market. For incorporation, only one stockholder is required. There is no minimum capital requirement. Shareholder agreements can be implemented.

Corporate structures are taxed as independent entities. Stockholder and partner liability is limited to the amount of their equity in the company.

Consortiums and joint ventures are corporate entities that are not as widely used in Ecuador. They are used primarily when undertaking public work contracts, as well as specific productive projects with a limited duration. For tax purposes, consortiums and joint ventures are regarded as independent entities and taxed accordingly. Nevertheless, their members' liability is not limited to their equity.

1.2 Transparent Entities

In general, under Ecuadorian law, corporate forms are not considered transparent entities. In fact, local legislation provides limited liability for all stockholders and partners.

All corporate entities are considered to be independent taxpayers. Dividends paid by corporate entities are tax exempt unless the beneficiary is an Ecuadorian individual. However, the individual beneficiaries of the dividends may be subject to paying additional income tax if they fall within a tax bracket that is higher than the income tax applicable to corporations. Dividends paid to foreign investors are subject to a 10% income tax withholding rate. Exemptions apply under double taxation treaties.

Stakeholders in sectors such as banks, insurance, the stock exchange and securities are obliged to use corporations to carry out their businesses.

The Ecuadorian stock exchange law provides for trusts, investment funds, commercial funds and hedge funds. Under Ecuadorian law, these legal entities are considered to be independent for both commercial and tax purposes. In some cases, trusts and funds are obliged to act as tax withholding agents.

Stakeholders in the construction sector (both for private and public projects) normally perform their activities using trusts, consortiums and joint ventures.

1.3 Determining Residence of Incorporated Businesses

As a general principle, whenever an entity is domiciled and/or incorporated within Ecuadorian territory, it is regarded as a tax resident in the country.

Under Ecuadorian law, tax residency is determined as follows.

- Main criteria:
  - (a) the entity's domicile; and
  - (b) the entity's incorporation under Ecuadorian law, as well as its main place of business being within Ecuadorian territory.
- Secondary criteria (if the aforementioned is not determinable):
  - (a) location where the entity's economic activities are performed; and
  - (b) location where the taxable event occurred.

Ecuador has entered into double taxation treaties with the following countries: Argentina (limited to air transportation), the Andean Community (Bolivia, Peru and Colombia), Belarus, Belgium, Brazil, Canada, Chile, China, Germany, France, Italy, Japan, Mexico, Qatar, Romania, Singapore, South Korea, Spain, Russia, Switzerland and Uruguay. Ecuadorian double taxation treaties generally follow the OECD model, except for the Andean Community Treaty, which follows certain premises suggested by the United Nations' Model Double Taxation Convention.

Under most of the aforementioned double taxation treaties, Ecuadorian-source income is taxed locally. However, particular income – such as royalties, interests and technical service fees – are subject to tax withholding at lower rates (10% and 15% compared to the general 25% rate).

1.4 Tax Rates

Entities are subject to a 25% income tax levied on their net taxable profit. However, a 28% income tax rate applies whenever:

- one or more stockholders are residents of a tax haven, and the beneficial owner is a tax resident in Ecuador; and
- the entity does not report its chain of ownership up to beneficial owner to the tax authority.

Ecuadorian law provides for 15% employee profit sharing, meaning that the entity is obliged to distribute 15% of its profits among its employees. This expense is tax deductible when determining the taxable base.

Income tax is paid in a single instalment during the first quarter of the fiscal year following the fiscal year that the profit corresponds to.

As of 2020, micro businesses are subject to a 2% income tax levied on their revenues.

With regard to transparent entities, see **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**.

Individuals are taxed at progressive rates. The payable income tax bands and rates for 2021 are as follows:

- up to USD11,212 – exempt;
- over USD11,212 and up to USD14,285 – 5% on the balance in excess of USD11,212;
- over USD14,285 and up to USD17,854 – USD154, plus 10% on the balance in excess of USD14,285;
- over USD17,854 and up to USD21,442 – USD511, plus 12% on the balance in excess of USD17,854;
- over USD21,442 and up to USD42,874 – USD941, plus 15% on the balance in excess of USD21,442;
- over USD42,874 and up to USD64,297 – USD4,156, plus 20% on the balance in excess of USD42,874;
- over USD64,297 and up to USD85,729 – USD8,440, plus 25% on the balance in excess of USD64,297;
- over USD85,729 and up to USD114,288 – USD13,798, plus 30% on the balance in excess of USD85,729; and
- over USD114,288 – USD22,366, plus 35% on the balance in excess of USD114,288.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Ecuadorian commercial entities are obliged to keep their accounting records according to International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS). However, accounting profit is subject to adjustment for tax purposes.

The main adjustments (accounting profit versus taxable profit) are as follows.

- Accounting expenses not deductible for tax purposes:
  - (a) depreciation and amortisation that exceed those provided for by tax law (real estate, ships and planes – 5%; machinery and equipment – 10%; vehicles and transportation equipment – 20%; hardware and software – 33%; intangible assets – 20%);
  - (b) provisions and reserves not related to incurred expenses;
  - (c) interests exceeding the maximum rates authorised by the Ecuadorian Monetary Authority;
  - (d) royalties and technical service fees paid to related parties exceeding 20% of the entity's taxable income;
  - (e) interest paid on foreign loans not registered with the Ecuadorian Central Bank; and
  - (f) overall, any other expense not directly related to taxable income.
- Expenses not supported by valid invoices.
- Tax-exempt income, among others:
  - (a) dividends received from Ecuadorian entities;
  - (b) foreign-source income that has been taxed abroad;
  - (c) occasional capital gains arising from real estate;
  - (d) financial returns generated by investments at terms greater than 365 days;
  - (e) financial returns on investment in public bonds; and
  - (f) foreign-source income according to double taxation treaties.

The aforementioned adjustments are made in the applicable tax return based on accounting records.

2.2 Special Incentives for Technology Investments

The Ecuadorian Income Tax Law provides for a five-year tax exemption on income arising from new investments in productive projects performed. Particular reference is made to technology projects, including biotechnology and software, as well as biological and software development, and related services. Also, the exemption applies to projects related to hardware production and development, digital infrastructure, computer security, products and digital content, and online services. This special tax treatment is subject to fulfilling specific requirements.

2.3 Other Special Incentives

The Ecuadorian tax law provides for a five-year income tax exemption on profits generated by new projects in the following sectors:

- agricultural sector; fresh, frozen and industrialised food;
- forestry, agroforestry and related products;
- metal-mechanics;
- petrochemical and oleochemical;
- pharmaceutics;
- tourism, film and audio-visual productions, and international events;
- renewable energies;
- logistic services for international trade;
- export of services;
- hospitals; and
- educational services.

This special tax treatment is subject to the investment being made in jurisdictions outside Quito and Guayaquil, as well as fulfilling specific requirements.

New productive investments in sectors regarded as basic industries benefit from a ten-year income tax exemption. The aforementioned benefit may be extended for an additional two to five years, whenever the investments are made in cities located on Ecuadorian borders. For the purposes of this special tax treatment, basic industries include the following:

- casting and refining of copper and/or aluminium;
- steel foundry for flat steel production;
- hydrocarbon refinement;
- the petrochemical industry;
- the cellulose industry; and
- naval vessel construction and repair.

Entities in the manufacturing sector, receptive tourism industry or qualified as habitual exporters may apply for a 10% reduction of the corporate income tax rate if the entity acquired fixed assets for the purpose of increasing its productivity and certain conditions are met.

New micro enterprises may benefit from a three-year income tax exemption, subject to meeting specific requirements.

Entities that manage or otherwise operate an Economic Special Development Zone will benefit from a ten-year income tax exemption.

2.4 Basic Rules on Loss Relief

Losses of up to 25% of the taxable income recorded in a fiscal year can be amortised (carried forward) for up to five years. Ecuadorian law does not provide for loss carry-back, nor for offsetting income losses against capital gains or vice versa. Losses incurred in transactions with related parties are not tax deductible.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible whenever the related loan is needed for the debtor to undertake its commercial activity. For tax purposes, interest is deductible provided the rate does not exceed the maximum rate set by the Ecuadorian Monetary Authority.

This also applies to foreign loans, which, in all cases, are subject to registration with the Ecuadorian Central Bank. For registration purposes, the capital of the loan must be deposited in an Ecuadorian bank. Interest paid exceeding the maximum rate applicable to these kinds of transactions is subject to income tax withholding.

2.6 Basic Rules on Consolidated Tax Grouping

The consolidation of financial statements for tax purposes is not permitted under Ecuadorian law. As such, groups of companies are not allowed to record separate losses.

However, for reporting purposes before the Superintendence of Companies, IFRS rules on consolidating financial statements apply.

2.7 Capital Gains Taxation

In general, Ecuadorian law does not provide for particular tax treatment on capital gains, which are taxed as general income.

Despite the aforementioned, there are exceptions, which are listed below:

- occasional capital gains obtained in the sale of real estate are tax exempt; and
- capital gains on the sale of shares and other equity rights are taxed at a maximum rate of 10%. This treatment also applies to the indirect sale of the equity of an Ecuadorian entity. An indirect sale occurs when the stocks owned by the equity of any stockholder within the chain of ownership of an Ecuadorian entity are disposed of, including shares held outside Ecuadorian territory.

The taxable base applicable to the disposal of shares is determined as the difference between the sale price and:

- the face value of the shares;
- the original cost of the shares; or

- the proportional value of equity.

Whenever the seller is a foreign entity, the Ecuadorian company whose shares are being transferred is obliged to act as a withholding agent for the applicable income tax levied on the profit generated by the transaction.

The sale of shares listed on an Ecuadorian stock exchange is subject to a special tax treatment.

The applicable progressive rates for capital gains on the sale of shares and other equity rights are as follows:

- up to USD20,000 – exempt;
- from USD20,001 up to USD40,000 – 2%;
- from USD40,001 up to USD80,000 – 4%;
- from USD80,001 up to USD160,000 – 6%;
- from USD160,001 up to USD320,000 – 8%; and
- from USD320,001 – 10%.

2.8 Other Taxes Payable by an Incorporated Business

The following taxes are commonly applicable.

- Value added tax – VAT of 12% is levied on the sale or provision of goods and services. The tax is collected by the business that sells the goods or provides the services. VAT is paid on a monthly basis. Businesses are allowed to deduct (tax credit) the VAT paid when acquiring goods and services required to undertake their economic activity.

- ICE (excise tax) – excise tax is levied on specific imported or domestic goods (generally regarded as luxury or harmful goods). For example, alcoholic beverages, cigarettes and vehicles are subject to the aforementioned tax. The ICE tax is collected by the seller of the goods and paid on a monthly basis.

- ISD (capital remittance tax) – capital remittance tax of 5% is levied on funds sent abroad by any Ecuadorian entity. It also applies to the payment of imports, in which case, a tax credit is granted whenever the imported merchandise is a raw material used to produce local goods. Exporters who have not deposited funds into an Ecuadorian account must also pay the capital remittance tax whenever such funds are used to pay for transactions recorded in the entity's accounting records.

The payment of dividends and interests, whenever certain requirements are met, may be exempt from ISD.

2.9 Incorporated Businesses and Notable Taxes

Tax on Overseas Financial Assets

This tax applies at a rate of 0.1% to 0.35% and is levied on the monthly average of the funds held abroad. This tax applies to the funds held abroad by the following entities:

- banks and other entities that perform financing activities;
- entities that manage funds and trusts;
- securities companies;
- insurance and reinsurance companies; and
- portfolio managers.

Special Contribution

- From USD1,000,000 up to USD5,000,000 – 0.10%;
- from USD5,000,000.01 up to USD10,000,000 – 0.15%; and
- from USD10,000,00.01 and above – 0.20%.

As of 2020, businesses must pay a special contribution levied on the 2018 taxable base, provided that the business reported sales equal to or greater than USD1,000,000 in such fiscal period. The contribution must be paid on the 2020, 2021 and 2022 fiscal years.

In any case, the contribution does not exceed 25% of the income tax paid in 2018. The special contribution is not applicable to businesses that reported losses on the aforementioned fiscal year.

Tax on Profit Generated on the Sale of Real Estate

Profit generated on the sale of real estate is subject to this tax, which is at a rate of 10% and payable to the municipality in which the asset is located.

A deduction of 5% of the net profit for each year of ownership is permitted when determining the taxable base. Whenever the elapsed time is 20 years, the transfer is tax exempt.

Municipal Patent Tax

Businesses, whether individual or corporate structures, are also subject to a municipal tax called "*Patente Municipal*", which is payable on an annual basis. The rate of the tax is determined by the municipality based on the entity's equity, and in no case whatsoever will the tax be lower than USD10 or higher than USD25,000.

1.5 per Thousand Taxed on Assets

Businesses are obliged to make an annual tax payment to the municipality of their domicile equivalent to 1.5 per thousand of their total assets.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate using a corporate form. Commonly, the preferred corporate form is a corporation or a limited liability company. New businesses are expected to be incorporated as a simplified stock corporation, due to significant cost reductions on incorporating this type of entity.

3.2 Individual Rates and Corporate Rates

Despite the fact that corporate rates are lower than individual rates, there are no rules to prevent individual professionals from earning income at corporate rates because dividends paid by companies to individuals are taxed at individual rates. Income tax paid by the entity distributing the dividends is recorded as tax credit by the individual, who then deducts such credit from their final tax.

3.3 Accumulating Earnings for Investment Purposes

There are no legal provisions that prevent closely held corporations from accumulating earnings for investment purposes. However, Ecuadorian law considers loans granted by business to their stockholders or partners as taxable dividends.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends paid by Ecuadorian corporations to individuals are subject to a 10% income tax withholding. In any case, dividends received by individuals become part of their taxable income, and, as such, are subject to individual tax rates. Both the corporate tax paid by the distributing companies and the aforementioned withholding tax are tax credit, which is then deducted from the final individual tax levied on the individual's income.

Regarding capital gains on the transfer of shares, please refer to **2.7 Capital Gains Taxation**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends paid by publicly traded corporations are subject to the same treatment applicable to dividends in general.

As for capital gains on the sale of shares in publicly traded corporations, the following treatment applies:

- the related capital gains of up to USD22,424 is income tax exempt; and
- despite the aforementioned, a 10% income tax withholding on the gains applies on transactions performed within a local stock exchange.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of double taxation treaties, the following tax withholding rates apply.

- Dividends paid to non-resident corporations and individuals are subject to a 25% withholding tax rate levied on 40% of the dividend (effective rate: 10%).
- Interest paid to foreign financial institutions related to foreign loans duly registered with the Ecuadorian Central Bank and not exceeding the maximum rate are not subject to an income tax withholding. In the absence of registration and/or the amount exceeds the maximum rate, a 25% income tax withholding applies.
- Royalties and technical service fees paid to a foreign entity are subject to a 25% income tax withholding.

4.2 Primary Tax Treaty Countries

Despite the fact that Ecuador has entered into double taxation treaties with 21 countries, the primary tax treaty countries foreign investors use to make investments in local corporate stock or debt are Spain, Uruguay, Germany, Brazil, Mexico and Canada.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Ecuador does not challenge the use of treaty country entities by non-treaty country residents.

However, local law provides for some particular rules on applying double taxation treaties. In fact, the exemption of tax withholdings on payments made to residents of countries holding a double taxation treaty applies only up to USD560,600 within a fiscal year. Payments exceeding such amount are subject to a 25% income tax withholding. However, the beneficiary can apply to the Ecuadorian tax authority for reimbursement of the amount withheld, which is granted after an analysis is made of the effective applicability of the double taxation treaty.

4.4 Transfer Pricing Issues

Despite the fact that Ecuador is not a member of the OECD, the country applies transfer pricing parameters contained in the guidelines issued by the organisation. Indeed, its general provisions have become part of Ecuadorian tax law and its regulations.

The main concern is related to export prices as well as royalties and technical service fees and interest paid to related parties. Regarding these issues, local law allows Ecuadorian entities to file a consultation with the tax authority in order to determine the parameters under which the transfer pricing valuation will be performed.

4.5 Related-Party Limited Risk Distribution Arrangements

To the best of the authors' knowledge, local tax authorities have not challenged the use of related-party limited risk distribution arrangements for the sale or provision of goods or services locally. Nonetheless, Ecuadorian tax law states that transactions between related parties should generally follow the arm's-length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Ecuador is not part of the OECD. Nevertheless, Ecuadorian transfer pricing principles and the applicable methodologies generally follow OECD guidelines. Accordingly, local transfer pricing rules and/or enforcement in theory does not vary from OECD standards.

4.7 International Transfer Pricing Disputes

Commonly, transfer pricing disputes are resolved before local tax authorities and courts. The authors are not aware of any international transfer pricing disputes being resolved through double taxation treaties. Local law does not allow mutual agreement procedures (MAPs) to resolve transfer pricing issues between tax authorities and private entities. The local tax authority has yet to publicly enter into a MAP with foreign tax authorities.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Until now, transfer pricing issues and claims have been resolved through administrative claims and judicial actions filed by private entities against the Ecuadorian tax authority. The authors are not aware of any specific MAP and or PTC process that Ecuador has been a part of.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-local corporations and local subsidiaries of non-local corporations are taxed equally. The Ecuadorian Constitution and law expressly prohibit any discrimination in the treatment applicable to local and foreign individuals and entities.

5.3 Capital Gains of Non-residents

Capital gains of non-residents on the sale of stock in local corporations are taxed in Ecuador. Indeed, the tax applies when the gain is on the shares of a non-local holding company that owns the stock of a local corporation, both directly and indirectly. The main principle provided for under Ecuadorian tax law is to tax capital gains on the sale of shares issued by local corporations whenever the indirect transfer of equity within the chain of ownership (including the one abroad) affects the ownership of an Ecuadorian entity.

5.4 Change of Control Provisions

There are no change of control provisions that could apply to trigger tax or duty charges, and, in particular, there are no such provisions that could apply to the disposal of an indirect holding much higher up in the overseas group. All issues related to the direct or indirect transfer of shares are included in previous sections of this chapter.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no formulas used to determine the income of foreign-owned local affiliates selling goods or providing services. However, transfer pricing guidelines and the arm's-length principle apply to them.

5.6 Deductions for Payments by Local Affiliates

Ecuador allows for the deduction of payments made to foreign companies, including foreign affiliates, whenever income tax is withheld and payments do not exceed some maximum limits. Ecuadorian entities may only deduct 5% of their total expenses and costs paid to a non-local affiliate. Likewise, royalties and technical service fees paid by local affiliates to their head office and related entities are allowed only up to an amount not exceeding 20% of the taxable income of the paying entity.

5.7 Constraints on Related-Party Borrowing

The general provisions applicable to interest related to foreign loans are explained in **2.5 Imposed Limits on Deduction of Interest**.

Additionally, the net amount of interest paid on loan transactions with related parties (for tax purposes) should be no greater than 20% of the net profit plus interest, depreciation and amortisation of the given fiscal year.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Ecuadorian corporations are taxed on their worldwide business income. As such, foreign income is, in principle, taxed in Ecuador. However, Ecuadorian tax law states that foreign income that has been taxed abroad is considered exempt in Ecuador.

6.2 Non-deductible Local Expenses

In general, expenses incurred to generate exempted income are non-deductible. This also applies to foreign exempt income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends paid by subsidiaries located abroad are regarded as foreign income (see **6.1 Foreign Income of Local Corporations**) and taxed accordingly.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries in their business. However, under transfer pricing principles, the local entity is obliged to charge for such use under the arm's-length principle. All related income is taxable in Ecuador.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

There are no particular provisions regarding controlled foreign corporation (CFC) rules in Ecuadorian legislation.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no rules related to the substance of non-local affiliates. Nevertheless, in order to record an expense as deductible, the latter must be related to taxable income, and the transaction must reflect economic substance. Therefore, under Ecuadorian law, transaction simulation is regarded as a felony and is therefore punishable by law.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Gains obtained by local corporations on the sale of shares held in non-local affiliates are taxed in Ecuador. No particular rule exists on the matter in local law. As such, these gains will be subject to a 25% income tax rate.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Overall, the Ecuadorian tax regime considers any practice that may involve simulating a transaction for the sole purpose of evading taxes as a felony, and will punish it as such. It is important to note that assessments from the tax authorities in recent years tend to overlook tax-relevant transactions and operations that do not reflect economic substance and/or essence.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Ecuadorian Internal Revenue Service (*Servicio de Rentas Internas*, or IRS) does not have a regular routine audit cycle. Nevertheless, audits of a fiscal year are usually conducted within three years of the date when the corresponding tax return was filed.

Tax audits are normally performed by reviewing all accounting records and their supporting documentation.

The reports issued regarding tax audits can be challenged by the IRS. Any final administrative resolution issued by the IRS can be appealed before the Ecuadorian tax court.

9. BEPS

9.1 Recommended Changes

The Ecuadorian government has already taken certain actions that are relatively aligned with Action 1 of the BEPS plan, and specifically the International Guidelines on VAT.

Despite the fact that Ecuador has not adopted BEPS within its tax regime, the following standards on the matter have been implemented.

VAT

As of 2020, the legal system expressly states that digital services are taxed with VAT whenever the consumer is a resident in Ecuador and the payment is made by such resident. Therefore, the Ecuadorian tax system provides for a registry of digital service suppliers (who are not domiciled in Ecuador). Such registry is administered by the Ecuadorian IRS.

Whenever the provider of a digital service is not registered with the Ecuadorian IRS, the consumer is obliged to act as tax collector. Nevertheless, if the payment is made through an intermediary (credit card issuer or bank), the former will be liable for collecting the VAT.

9.2 Government Attitudes

The Ecuadorian government is interested in complying with OECD standards and participating in the organisation's committees. In this sense, the Ecuadorian government ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (CAAM).

Nevertheless, there are no indications that the Ecuadorian government will sign the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.

9.3 Profile of International Tax

The authors consider that, to date, international tax does not have a high public profile in Ecuador. However, it is evident that any new development on the matter, particularly regarding BEPS, will, in a relatively short period, be adopted by local authorities as noted in relation to VAT applicable to digital services.

9.4 Competitive Tax Policy Objective

The Ecuadorian tax system is generally fair and balanced for competition between foreign and local entities.

Nevertheless, the existence of indiscriminate tax benefits creates a false sense of competitiveness. Over the past decade, Ecuador has implemented several tax benefits that have not incentivised new national and international investment. This has also been to the detriment of good tax practice by going against the principles of generality and equality that should be present in any tax regime.

Considering the particularities of the Ecuadorian tax regime regarding the characteristics of the country's productive sector, the authors do not see any pressure for BEPS to be applicable in Ecuador. The country's exposure to the international community is marginal. Therefore, the authors do not foresee pressure from the international or local community to implement tax amendments in order to comply with BEPS.

9.5 Features of the Competitive Tax System

The main issue that the authors identified in Ecuador's tax system is enforceability, as well as generalised mistrust of taxpayers by the tax authority. It is imperative to implement serious initiatives to train the officials of the local tax authority.

9.6 Proposals for Dealing with Hybrid Instruments

As previously stated, the Ecuadorian tax system lacks a strong technical background on international taxation. As such, the implementation of new mechanisms, such as actions to deal with hybrid instruments, is far from becoming a reality.

9.7 Territorial Tax Regime

In general, the current tax regime applicable to interest does not provide for restrictions tailored to territorial tax regimes (Special Economic Development Zones). Ecuador is considered to be a country that requires strong inflows of capital, including capital related to foreign loans. In this sense, imposing additional restrictions to the deductibility of interest would be inconvenient.

9.8 CFC Proposals

Ecuador has not implemented CFC rules. The authors currently do not foresee any plans to include CFC rules in local legislation.

9.9 Anti-avoidance Rules

At this time, the authors do not foresee any impacts that DTC limitations might have for both inbound and outbound investors. It is important to note that Ecuador does have complementary rules in place to avoid evasion and abuse of law.

9.10 Transfer Pricing Changes

The application of transfer pricing in Ecuador is still limited, and for now it mainly applies to export activities. In this sense, before the country implements any changes to transfer pricing, Ecuador needs to further develop its current system. The taxation of profits from Ecuadorian property is not a particular source of controversy or difficulty under Ecuador's tax regime.

9.11 Transparency and Country-by-country Reporting

The authors agree with the proposal for transparency and country-by-country reporting. However, they do not anticipate it having particular relevance for Ecuadorian taxation purposes.

9.12 Taxation of Digital Economy Businesses

As of 2020, Ecuador has implemented certain legal provisions to tax transactions effected by digital businesses operating largely outside Ecuadorian territory. Specifically, the Ecuadorian tax system has implemented a registry for foreign digital service providers. Likewise, credit card issuers and banks are responsible for collecting the VAT charged on digital services provided by entities that are not registered with the Ecuadorian IRS.

9.13 Digital Taxation

Ecuador has taken few steps in relation to the BEPS proposals for digital taxation (specifically, regarding Action 1 under the International VAT Guidelines, Ecuador has issued legal provisions in order to collect the VAT charged on digital services provided by foreign entities; see **9.1 Recommended Changes** and **9.12 Taxation of Digital Economy Businesses**).

9.14 Taxation of Offshore IP

Ecuador has not introduced any other provisions dealing with the taxation of offshore intellectual property deployed within the country. However, regarding the deductibility of royalties and technical service fees, please refer to **4.1 Withholding Taxes**.

Almeida Guzmán & Asociados is a firm of attorneys and consultants that was established in 1981, specialising in juridical-corporate advice and consulting. The firm's professional practice spans the following areas: tax law; corporate, commercial and business law; labour, migration and immigration law; competition and competitiveness law; consumer protection rights; environmental legislation; real estate, construction and public works legislation; public procurement; national and international arbitration; tourism legislation; mining law; financial, banking and stock market law; energy legislation (hydrocarbons, electricity and alternative energy); telecommunications and e-commerce legislation; and human health legislation. The organisation also retains consultants in the fields of economic sciences and accounting. The firm's experience includes legal, tax and economic consulting; consulting on project finance, investment projects, mergers, split-offs and takeovers of companies; and business restructuring.

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Trends and Developments

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Estudio Jurídico Prado ***see p.175***

Taxation of Digital Services in Ecuador

Digitalisation of the economy worldwide has generated several challenges for taxation, among them, to impose an effective tax system on digitalised transactions of goods and services.

In this regard, in 2013, the OECD adopted the base erosion and profit shifting (BEPS) initiative. Action 1 of the plan was formulated to analyse and design measures to address the tax challenges of the digital economy. In the framework of Action 1, the OECD identified risks related to the application of existing international taxation principles, base erosion and profit shifting for a digital business and the application of direct and indirect taxation.

In response to these initiatives, several countries have already implemented taxation on digital services, either directly or indirectly. However, there are still a variety of issues to be addressed, such as which jurisdiction should be the one that collects taxes, is the tax residence of the business determined by the place where it is located or by the location of the users who generate income or consumption, and, more importantly, how to tax subjects who are not residents of a country.

In Ecuador, in accordance with this need that has arisen from the globalisation of digital services, the enactment of the Tax Simplicity and Progressivity Law in December 2019 meant that digital services would be charged with value added tax (VAT), and the tax became effective on 16 September 2020. The current VAT rate in Ecuador is 12% as a general rule and 0% for specific goods and services determined by the Law.

How Are Digital Services Defined?

Ecuadorian regulations establish as a general definition that digital services are those services provided and/or contracted via the internet, which, by their nature, are automated and require minimal human intervention, regardless of the device used to download, view or make use of them.

Despite having a general definition, Ecuadorian regulations have exemplified certain services that are subsumed in this presupposition, such as the supply and hosting of web pages and sites; the supply of digitised products in general, including computer programs, as well as the access and/or download of digital books, designs, components, patterns and similar; reports; financial, data or market analysis; web services, software services; access and/or download of images, text, information, video, games of luck; online clubs or dating website services; services provided by online blogs, magazines or newspapers; and internet services provision.

Digital services in general will be taxed at a VAT rate of 12%, except for those services for which the Ecuadorian regulations have determined a 0% VAT rate, such as the supply of website domains, hosting servers and cloud computing, as well as free digital services.

When Does the Taxable Event Occur?

The taxable event for the purposes of digital services VAT has been established in Ecuadorian legislation as follows.

- For digital services provided by local providers, the tax will be verified in the effective provision of the service.
- For imported digital services, the tax will occur when a resident or a permanent establishment of a non-resident in Ecuador pays for such service to a non-resident provider.
- In order to facilitate taxation, Ecuadorian regulations have established the creation of a registry of non-resident digital service providers, which are subsumed to the taxable event. This information must be published quarterly by the tax administration on its website.
- For delivery and shipping services of corporeal movable property, the tax will be applied on the commission fee paid in addition to the value of the good acquired by a resident person or a permanent establishment of a non-resident taxpayer in Ecuador to a non-resident person.

How Should the Tax Be Declared and Paid?

To implement the tax return and collection, it has been determined who will be considered as the VAT collection agent or withholding agent for the above-mentioned operations.

Thus, the collection agents are non-resident persons who provide digital services, as long as they are registered with the Ecuadorian tax administration, and submit the VAT return monthly.

Credit and debit card-issuing companies have been appointed as withholding agents, for those payments made in the acquisition of digital services, when the service provider is not registered with the Ecuadorian tax administration. In accordance with the previous section, regarding the moment at which the taxable event for digital services VAT occurs, the procedure will be the following.

- In payments made for imported digital services, when these are made with credit or debit cards, the issuing companies will withhold 100% of the VAT generated.
- In payments made for delivery and shipping services of goods or for those for which the digital service provider charges a commission fee, the withholding will be 100% of the tax. VAT is generated on the said commission or on 10% of the total amount paid to the digital service provider, when the card surcharge does not differentiate the value of the goods or services acquired from the commission fee. Likewise, the Ecuadorian tax administration will identify in the registry which of these subjects are providers of tangible movable property delivery and shipping services.

The said withholding agents must take into account the following considerations that they need to comply with for such designation:

- to report information on the payments made to digital service providers and the withholdings performed;
- to preserve supporting documentation of the transactions for a seven-year term;
- to present information on the payments made when required by the tax administration; and
- a penalty regime when they do not withhold VAT, having the obligation to do so.

For a better understanding of how the regulations in this regard are applied, let us suppose that an Ecuadorian resident acquires a computer through a foreign digital platform and pays with a credit card; since it is a purchase of goods, it will not generate VAT for digital services, since it is not an import of this type.

On the other hand, if this Ecuadorian uses a foreign digital food delivery platform, he or she will pay the value of the food plus the commission fee for the use of the platform, and VAT will be generated on this commission fee (this last amount is the one the credit card-issuing company will withhold).

Finally, in the event that the Ecuadorian enrolls in a streaming subscription that will allow him or her to watch series and movies, in addition to the monthly membership fee, he or she will pay VAT on the amount.

What Are the Supporting Documents for the Tax Credit for VAT?

In order to have a supporting document for the tax credit, the taxpayer must issue a purchase voucher for goods or services, and if there is no intermediary in the payment process, the taxpayer will directly withhold 100% of the VAT generated.

If there is an intermediary in the payment – that is, if the service is paid with a credit or debit card – the account statement generated by the credit or debit card-issuing company will become proof of withholding and the supporting document of the tax credit.

Is There a Connection with Income Tax?

When taxpayers are compelled to keep accounting records, to support costs and expenses for the annual income tax return, they must issue a purchase voucher for goods and services. Although the regulations have conceived it as a way to support tax credit for VAT and to perform withholding, when there is no payment intermediary, the taxpayer would also be forced to make an income tax withholding to the digital services provided.

In this sense, even though Ecuadorian legislation does not formally charge income tax on the benefits generated through this type of business, indirectly the current regulations have made taxpayers subject to income tax on digital services in specific situations, such as the one described previously.

In spite of that, Ecuadorian tax legislation has not provided effective and clear mechanisms for this type of direct taxation on this kind of service.

Conclusions

After almost six months since the regulations came into force, the authors can indicate that the implementation of VAT on digital services has had good results overall for the tax administration.

A very important part of the chain for the effective collection of this tax is the appointment of credit and debit card-issuing companies as withholding agents for this tax. As has been seen, they have generated a collection of a type of service that, by its original nature, should be subject to VAT, but due to the special features of the digital economy, it was difficult to implement taxation and collection processes for non-residents of Ecuador. This has led the Ecuadorian tax administration to create a new source of tax revenue.

However, one of the problems generated is the excess withholding of the tax, since the registry established by the tax administration includes subjects that provide digital services but also that sell goods and the intermediary (credit card issuer) cannot know the concept of the invoice and only registers consumption in the registered establishment. Therefore, if a person buys goods from a supplier that is also registered as a digital service provider, VAT is generated on 100% of the amount of consumption and not on 10% of the said amount, generating an excessive withholding.

The effect of these issues on taxation is the indirect tax burden that taxpayers have, as well as the workload of the tax administration, since the only way to request the return of the said amounts is through a claim for overpaid tax, which must be resolved within 120 labour days.

Although taxation of the digital economy has been a risk that has been identified at the international level for some years now, in 2020, Ecuador began to apply measures to mitigate the risk and equally tax digital and non-digital services, in terms of VAT. Notwithstanding, there are still many points for improvement and the taxation of the digital economy is to be implemented in accordance with international standards, regarding indirect taxation as well as the design of an effective tax system related to income tax.

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Estudio Jurídico Prado was founded in Quito in 1984 and has grown into one of Ecuador's leading law firms. It is a full-service law firm that has been recognised as a leading firm in tax and finance. Among the firm's core values are its commitment to excellence, teamwork and a strong work ethic, all in the service of, and dedication to, its clients. The firm has been recognised with important national and international awards. For years it has provided legal services based on teamwork and innovation for the purpose of ensuring client satisfaction and serving society, clients and entrepreneurs. The firm's tax team, led by Dr Mario Prado, has 11 specialised professionals focused on managing clients' tax planning and offering them the best advice in accounting as well as in legal points of view, and providing them with the tools to reach the best decision-making.

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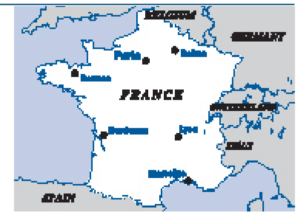

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Corporate Structures in France

Businesses set up in France usually adopt a corporate form, although it is possible to carry out a business activity in France as a sole trader. Two main categories of corporate structure (or companies) can be distinguished:

- limited liability companies (*sociétés anonymes*, *sociétés par actions simplifiées*, *sociétés à responsabilité limitée*), in which the shareholders' responsibility is limited to the amount of their contributions; and
- partnerships (*sociétés civiles*, *sociétés en nom collectif*), in which the partners' responsibility is generally joint and unlimited.

Certain forms of companies (namely the *sociétés en commandite par actions*, or SCA, and the *sociétés en commandite simple*, or SCS) have two types of partners: the general partner(s) (*associé commandité*), whose liability is joint and unlimited, and the limited partners, whose responsibility is limited to the amount of their contributions (SCAs and SCSs must have at least one general partner and one limited partner).

In practice, the *société par actions simplifiée* is by far the most commonly used.

In addition to these corporate forms that have a separate legal personality, there is a specific form of company, the *société en participation*, which is a purely contractual arrangement with no separate legal personality. The courts may also construct the existence of a company from facts (*société créée de fait* – no separate legal personality).

Tax Treatment

From a French tax law perspective, corporate entities may be treated as either of the following.

- Opaque – the entity's tax liability is assessed at its own level and the tax due is paid by the entity on its own (this regime generally applies to limited liability companies). All companies that are opaque for tax purposes are subject to French corporate income tax (CIT).
- Semi-transparent (which is a concept not entirely similar to the "tax transparency" regime applied in certain other jurisdictions) – the entity's tax liability is still assessed at its own level but the tax due is paid by the entity's partners in accordance with their own tax regime (ie, French CIT or French personal income tax) and irrespective of whether the profits have been distributed. Losses realised by the entity can be set off against the profits realised by the partners in the course of their own activity(ies).

The French semi-transparent tax regime generally applies to entities that are not limited liability companies, irrespective of whether they have a separate legal personality, and, in particular, to French partnerships.

1.2 Transparent Entities

As indicated in **1.1 Corporate Structures and Tax Treatment**, French tax law does not provide for a full tax "transparency" regime in a way that other states do (with some limited exceptions that are extremely rare in practice).

The main reason for using a semi-transparent entity in France is to take advantage of the losses realised, as the case may be, by that entity in order to set off profits realised by the entity's partners in the course of their own activity(ies).

Investment structures exist, however, under French law that can be considered as being "transparent" from a French tax perspective. Two categories of entities can be distinguished here:

- investment vehicles deprived of legal personality and thus placed outside the scope of French CIT; and
- investment vehicles that are set up as corporate entities but are entitled to a partial or full exemption from French CIT, provided certain conditions are met in terms of investments and distributions.

The main types of financial investment structures existing under French law are:

- the *fonds communs de placement* (FCP), which are joint ownership investment structures with no separate legal personality outside the scope of French CIT;
- the *société d'investissement à capital variable* (SICAV), which are created as limited liability companies (either as *sociétés anonymes* or *sociétés par actions simplifiées*) and benefit from a French CIT exemption; and
- the *sociétés de libre partenariat* (SLP), a more flexible investment vehicle inspired by the English law partnership that takes the form of an SCS and is exempt from tax.

In practice, the most commonly encountered vehicles for private equity transactions are SLP and FCP/SICAV structured as *Fonds Professionnels de Capital Investissement* (FPCI), which are funds opened only to so-called professional investors.

1.3 Determining Residence of Incorporated Businesses

A company or a partnership is considered to be resident in France for French domestic tax law purposes if it has its legal seat or its effective place of management (*siège de direction effective*) in France. A company's effective place of management can be defined as the place where the most important corporate decisions are made and corresponds ordinarily to the place where the highest-ranking corporate bodies of that company (eg, the board of directors) hold their meetings and take their decisions.

However, because French CIT is not computed on a worldwide basis, a company that is resident in France for domestic tax law purposes should only be subject to CIT in France on its:

- net income derived from business activities carried out in France;
- passive income from foreign sources; and
- other profits for which France has been granted a right to tax under a double tax treaty.

The criteria that are used under French domestic tax law to determine whether a company carries out a business activity in France are similar to those used in the OECD Model Tax Convention to determine whether a company has a permanent establishment in a state (ie, either a fixed place of business or a dependent agent) with the addition of a third criterion: a company has a French business when it has carried out a "complete commercial cycle of operations" in France (generally, where a double tax treaty applies, this last criterion has no impact).

French partnerships that are semi-transparent for tax purposes also qualify as French tax residents under French domestic law.

1.4 Tax Rates

Tax Opaque Entities

For companies subject to CIT, the standard French CIT rate has been brought down to 26.5% (to be further reduced to 25% in 2022) for fiscal years opened as from 1 January 2021. However, for companies and for tax consolidated groups that have a turnover equal to or higher than EUR250 million, the applicable CIT rate for fiscal year 2021 equals 27.5%.

A reduced 15% CIT rate applies to companies that, inter alia, have a turnover of less than EUR10 million for a given fiscal year, for the fraction of their profits up to EUR38,120 (the ordinary CIT rate of 26.5% applies for the surplus).

An additional 3.3% surtax also applies on the amount of CIT liability after deduction of an amount of EUR763,000, unless (i) the taxable entity has a turnover of less than EUR7,630,000 and (ii) at least 75% of its paid-up share capital is held by individuals or by companies that satisfy the same conditions (up to one level of intermediation).

Tax Semi-transparent Entities

Profits realised by French semi-transparent partnerships are subject to tax in the hands of their partners and according to such partners' own tax regime (ie, either CIT or French personal income tax).

Business profits accruing to individuals, directly or through a semi-transparent entity, are subject to French personal income tax (*impôt sur le revenu*, or PIT) at a progressive rate (up to 45% over EUR158,123 – an additional 3% or 4% surtax may apply depending on the overall taxable income of the taxpayer and its family, as the case may be).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits for incorporated businesses subject to French CIT are calculated based on the accounting profits determined in accordance with French generally accepted accounting principles (GAAP), realised in respect of each fiscal year, after making the required tax adjustments (either as deduction or add-backs).

The most substantial add-backs for tax purposes concern:

- certain provisions, the deduction of which is denied for tax purposes (eg, provisions for taxes or provisions for impairment of a going concern);
- certain payments for taxes (including the amount of French CIT paid itself); and
- non-deductible financial expenses pursuant to specific intra-group payment limitations and/or to the general cap (see **2.5 Imposed Limits on Deduction of Interest**).

The most substantial deductions for tax purposes concern:

- the recapture of provisions, the deduction of which was previously denied for tax purposes; and
- certain kinds of profits that benefit from a full or partial exemption for tax purposes (eg, dividends eligible to the French parent-subsidiary tax regime or capital gains on participating shares qualifying for the French participation-exemption tax regime).

Profits accruing to incorporated businesses subject to French CIT are always taxed on an accruals basis.

2.2 Special Incentives for Technology Investments

Patent Box

France has a patent box regime providing for the application of a reduced 10% tax rate to the net income accruing from the sale, lease or sub-lease of certain IP fixed assets (eg, patents, software, industrial know-how). The French patent box has been revised recently to take into account the so-called nexus approach recommended by the OECD and the EU, making its application conditional on the existence of R&D expenses incurred directly by the taxpayer or by unrelated entities.

R&D Tax Credit

Certain qualifying R&D expenses may also give rise to a specific tax credit equal to 30% of the fraction of the total amount of qualifying R&D expenses (reduced to 5% for the portion of eligible expenses exceeding EUR100 million). The tax credit available for a given year can be used to set off the amount of French CIT due in respect of the same year and the three following fiscal years, any excess remaining afterwards is paid directly to the taxpayer (certain companies can claim an immediate refund of the tax credit without having to wait three years).

2.3 Other Special Incentives

French domestic tax law allows for a great number of favourable tax regimes applicable to incorporated businesses.

Such regimes generally depend on:

- the nature of the business carried out by the taxpayer (eg, if it is innovative);
- the size of that business (especially for small or medium enterprises); or
- its location (to favour the creation of businesses in certain areas).

The incentives granted may, for example, correspond to temporary exemptions from CIT, the possibility to benefit from an immediate repayment of certain tax credits or the application of an accelerated amortisation schedule.

2.4 Basic Rules on Loss Relief

Deduction Cap

Ordinary tax losses incurred in respect of a given fiscal year may be carried forward for French CIT purposes indefinitely and without reduction of their amount. The amount of French carry-forward tax losses that can be offset against the taxable profit of any given fiscal year is capped at EUR1 million plus 50% of the taxable profit of the considered fiscal year that exceeds that amount.

Ordinary tax losses may also, under certain conditions, be offset against taxable profits of the preceding fiscal year, up to an amount of EUR1 million.

Forfeiture of Tax Losses

Ordinary tax losses do not forfeit when the company's shares are sold or when there is a change of control. However, ordinary tax losses will forfeit in the case of change of corporate object or substantial change of activity of the company. A substantial change of activity is assessed based on the variations of turnover, balance sheet and staff.

2.5 Imposed Limits on Deduction of Interest

Interest expenses are generally deductible like any other expenses: the corresponding debt needs to be (i) correctly accounted for, (ii) incurred in the entity's own interest and (iii) meet the arm's-length requirements.

General Cap

If the yearly net financial expenses of a company (or tax consolidated group) exceeds the higher of EUR3 million or 30% of its tax-adjusted EBITDA, a general deductibility cap applies, disallowing deduction of expenses that are over that threshold. The cap also includes a thin capitalisation test that, if met (at the level of the company or of the tax consolidated group), reduces the cap to the higher of EUR1 million or 10% of the tax-adjusted EBITDA (for a fraction of the financial expenses). There are possibilities for "additional" deductions and safe harbour clauses exist. Financial expenses disallowed under this rule may be carried forward under certain conditions.

Interest Rate Limitations

In addition, French domestic law restricts the deduction of interest paid to shareholders and/or related companies: interest paid to individual shareholders or to corporate shareholders that do not qualify as related companies are only deductible (i) if the share capital of the paying company has been fully paid up and (ii) up to the rate published by the French tax authorities each quarter (1.17% for the last quarter of 2020). Interest paid to related companies can be deducted at a higher rate if the payor demonstrates the arm's-length nature of such interest; the standard of proof is high and it is generally recommended to prepare a transfer pricing study as evidence. Interest disallowed under this rule cannot be carried forward and may be recharacterised as deemed distributed income (and subject to withholding tax, as the case may be).

Anti-hybrid Rule

France has introduced the new anti-hybrid rule resulting from the implementation of EU Directives ATAD 1 (2016/116) and ATAD 2 (2017/952) in replacement of its older anti-hybrid rule. The new rules are generally applicable from 1 January 2020, while the specific provisions with respect to so-called reverse hybrid mismatches will apply from 1 January 2022.

The new rule generally aims at tackling situations where there is a mismatch in the treatment of a cross-border payment (eg, deduction in the source state without inclusion in the payee's tax basis in another state, double deduction or no inclusion in either country). Such hybrid mismatches may result from differences in the tax treatment applied to financial instruments, entities or payment attribution rules between two countries. This rule generally applies only to transactions between related entities (although there are exceptions).

Depending on the nature of the hybrid arrangement, a corresponding neutralisation method is provided for under the new law, either by denying deduction or including a payment in taxable income.

Additional Limitations

A specific anti-debt-push-down rule known as "*Amendement Charasse*" limits the interest deductibility on debt incurred to acquire related-party shares following the inclusion of both entities into the same French tax consolidated group.

Interest disallowed under this rule cannot be carried forward but should not be subject to tax as deemed distributed income.

Finally, interest paid to a company located in a non-cooperative state or jurisdiction (NCST) within the meaning of the French tax code is generally not deductible.

2.6 Basic Rules on Consolidated Tax Grouping

CIT Tax Consolidated Group

Perimeter

Tax consolidation is allowed under French law for CIT purposes: a company may become solely responsible for the payment of the French CIT due by itself and by other French companies that it controls, directly or indirectly, at 95% or more (in terms of share capital and voting rights). The parent company of the group must not be held, at any time, 95% or more (in terms of share capital and voting rights) by another company subject to French CIT.

It is also possible to create a tax consolidated group if companies based in the EU or in a state party to the European Economic Area agreement (EEA) are interposed in the ownership chain (provided certain conditions are met), or where the parent company of the group is located in another EU/EEA state (in which case the tax consolidated group may include the French companies that the parent company controls, directly or indirectly, at 95% or more and one of the French subsidiaries will become the "parent" company of the tax consolidated group – so-called horizontal tax group).

Computation of the tax consolidated group's profits

The taxable profit of a tax consolidated group is calculated by taking the sum of each of the group members' own individual taxable profit and making certain adjustments to the result, especially to neutralise (either definitely or temporarily) certain transactions that took place within the consolidated group's perimeter (eg, sale of assets). Dividend distributions within the group also benefit from a 99% exemption from CIT (compared to the ordinary 95% exemption provided under the French parent-subsidiary tax regime).

The parent company is responsible for paying the CIT due, if any, to the French tax authorities.

Tax losses incurred by the tax consolidated group can be carried forward or back and offset against the group's taxable profits, like ordinary tax losses of a standalone company (the limitations mentioned in **2.4 Basic Rules on Loss Relief** apply at the group's level). However, tax losses incurred by a member before joining the tax consolidated group may only be offset against that members' individual taxable profit (after adjustments, as the case may be).

VAT tax group

Tax groups also exist for French VAT purposes, but at a much less complete level. A new system of VAT consolidated group has been introduced in French law since 2021 (to implement EU rules already adopted by other member states) but its application will only become effective as of 2023.

2.7 Capital Gains Taxation

Standard Rule

Capital gains realised by companies are generally subject to tax at the ordinary French CIT rate.

Sale of Shares

The French participation-exemption regime provides that capital gains realised on the sale of participating shares that have been held for at least two years benefit from an 88% exemption from CIT (provided certain conditions are met) and are thus only taxed effectively at 3.41% in 2021 (assuming the 27.5% CIT rate applies and factoring the additional surtax) and 3.10% as from 2022.

Capital gains realised on the sale of shares that do not qualify as participating shares (eg, shares in non-listed real estate companies or predominantly financial companies) or participating shares that have not been held for two years are subject to CIT at the standard rate.

Specific Rates for Certain Assets

Certain capital gains, although not exempt from CIT pursuant to the participation-exemption regime, may benefit from favourable tax rates. In particular:

- a 19% tax rate applies to the capital gain realised on the sale of shares in a listed real estate company;
- a 10% tax rate may apply to the capital gain realised on the sale of certain IP fixed assets pursuant to the French patent box (see **2.2 Special Incentives for Technology Investments**); and
- a 15% tax rate applies to the portion of capital gain realised on the sale of other stock into certain kinds of investment entities (eg, an FCPR or an FPCI/SLP) that has been held for at least five years, and that does not otherwise benefit from a full exemption from tax.

2.8 Other Taxes Payable by an Incorporated Business

Companies that enter into a transaction for the acquisition of assets may be liable to pay French registration duties, generally computed on the basis of the higher of (i) the purchase price or (ii) the fair market value of the asset.

The applicable rate varies depending on the purchased asset's nature; for example:

- 0.1%, 3% or 5% in respect of shares (depending on the nature of the company whose shares are purchased; intra-group sales and sales of shares that are subject to the financial transaction tax are exempt);
- up to 5% in respect of going concerns (and assimilated transactions); and
- circa 6% in respect of immovable property (although a reduced 0.715% rate may apply in certain cases).

Registration duties are generally due from the buyer, but the parties may agree that the registration duties will be paid by the seller (or by both parties) as they see fit.

The sale of shares in certain French listed companies that had a market capitalisation of more than EUR1 billion on December 1st of the previous year is subject to the financial transaction tax at a 0.3% rate (instead of registration duties).

2.9 Incorporated Businesses and Notable Taxes

Territorial Business Contribution

French companies are also subject to local taxes, notably the *contribution économique territoriale* (CET), which consists of two levies:

- the *contribution foncière des entreprises* (CFE), which is an annual tax assessed on the notional rental value of certain French real estate assets – either owned or rented – used by the taxpayer for the purposes of its activity (rates are determined by the local authorities depending on the features and location of the taxable assets); and
- the *cotisation sur la valeur ajoutée des entreprises* (CVAE), which is due by persons carrying out an activity subject to the CFE and that have a yearly turnover of more than EUR500,000. CVAE is computed on the "added value" generated by the business during the year of taxation at a progressive rate between 0.25% and 0.75% since 1 January 2021 (if the taxpayer is part of a group, the effective tax rate is determined on the basis of the group's consolidated turnover).

Property Tax

Companies may also be liable to pay property tax (*taxe foncière*) in respect of the real estate assets (built or unbuilt) that they own as at January 1st of each year. Tax rates are determined by the local authorities, according to the features and location of the assets and applied to the rental value (even if the property is not rented out by the owner) as determined by the local authorities.

Other Taxes

Other specific taxes may apply, depending on the activity performed by that business (eg, tax on numerical services, tax on electricity producers).

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses or corporations do not form a category that is distinct from other types of businesses or corporations under French tax law.

In practice, small local businesses can be set up either as sole traders (it is possible to choose between several legal frameworks and in certain cases to benefit from a limited liability regime) or take the form of a tax semi-transparent entity if there is more than one individual involved in the business. Tax opaque entities are also used; in particular, to limit the responsibility of the shareholders.

The advantage for individuals to have their business set up as sole traders or using a tax semi-transparent entity lies in the fact that profits accruing from such businesses are only subject to tax once (ie, in the hands of the trader or partners – see **1.1 Corporate Structures and Tax Treatment**), while profits realised by tax opaque entities are subject to tax twice (ie, at the level of the company and, after their distribution, in the hands of the shareholders – see **3.4 Sales of Shares by Individuals in Closely Held Corporations**).

3.2 Individual Rates and Corporate Rates

In 2021, business profits realised by individuals or accruing to tax semi-transparent entities whose partners are individuals are subject to French PIT at a progressive rate:

- taxable income fraction up to EUR10,084 – 0%;
- taxable income fraction between EUR10,085 and EUR25,710 – 11%;
- taxable income fraction between EUR25,711 and EUR73,516 – 30%;
- taxable income fraction between EUR73,517 and EUR158,122 – 41%; and
- taxable income fraction over EUR158,123 – 45%.

An additional 3% or 4% surtax may also apply, depending on the overall taxable income of the taxpayer and its family, as the case may be.

By comparison, profits accruing to companies subject to CIT are ordinarily taxed at a 26.5% rate (since 1 January 2021 – see **1.4 Tax Rates**) and the profits distributed to individual shareholders will be subject to a 30% "flat tax" in the hands of the shareholders (see **3.4 Sales of Shares by Individuals in Closely Held Corporations**).

As a result, although there are no French domestic tax rules that prevent individuals from setting up a business under a corporate form, the profits earned by such business and ultimately distributed to the individuals should be, in practice, subject to tax at a higher effective rate than the applicable CIT rate due to the effects of the economic double taxation.

3.3 Accumulating Earnings for Investment Purposes

Basically, the amount of earnings that can be accumulated by French companies is not subject to any limitation, provided no artificial/abusive scheme can be characterised (French individuals may be subject to a controlled foreign corporation (CFC) rule similar to the one discussed in **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**).

3.4 Sales of Shares by Individuals in Closely Held Corporations

As a rule, dividends and capital gains realised on the sale of shares in corporations subject to CIT realised by French tax-resident individuals are subject to a 30% "flat tax" (12.8% for the French PIT plus 17.2% for the French social security contributions). An additional 3% or 4% surtax may also apply, depending on the overall taxable income of the taxpayer and its family, as the case may be.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The same rules apply for the dividends from, and sale of shares in, publicly traded corporations as for the dividends from, and sale of shares in, closely held corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The domestic withholding tax rate applicable in the absence of a double tax treaty is as follows.

- Dividends – dividends paid by French companies to non-resident entities are subject to a withholding tax rate equal to the standard CIT rate (ie, 26.5% for 2021). Dividends may be exempt from withholding tax under certain conditions, when the beneficial owner of the dividends is a company located in the EU, in certain EEA countries or in Switzerland.
- Dividends paid by French companies to undertakings for collective investment in transferable securities (UCITS) located in the EU or in a state that exchanges information with France under a tax treaty or a tax information exchange agreement may also benefit from a withholding tax exemption, under certain conditions.
- Interest – no withholding tax is levied on interest paid by French companies to non-resident entities (provided they are not paid in a bank account opened, or a person established, in an NCST).
- Royalties – royalties paid by French companies to non-resident entities are subject to a withholding tax rate equal to the standard CIT rate (ie, 26.5% for 2021). Royalties may be exempt from withholding tax under certain conditions when the beneficial owner of the royalties is a company located in the EU.

If the payment of a dividend, interest or royalties is made to a person who is resident in an NCST or to a bank account located in an NCST, the withholding tax rate is generally increased to 75%.

4.2 Primary Tax Treaty Countries
The primary tax treaty country foreign investors use to make investments in French corporate stock or debt is Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents
The use of treaty country entities by non-treaty country residents may be challenged by the French tax authorities on the basis of the "abuse of law" doctrine that is applicable to the use of international tax treaty provisions (see **7.1 Overarching Anti-avoidance Provisions**).

4.4 Transfer Pricing Issues
As a rule, transactions (ie, transfer of goods/assets, provision of services, royalties) between companies of the same group must be concluded under normal conditions, identical to those of the market (arm's-length principle).

If the transaction is not carried out under such conditions, the French tax authorities may refuse (i) partially or totally the deduction of the expenses by the beneficiary and consequently increase its taxable profits and/or (ii) question (partially or totally) the deductibility of the VAT paid by the beneficiaries in respect of this acquisition of goods/assets or provision of services. Transfer pricing reassessments may also give rise to deemed distributed income issues.

If the French tax authorities consider that the price is lower than the arm's-length price, they could consider that the selling company or service provider grants a subsidy to the beneficiary company and increase its taxable profit accordingly.

4.5 Related-Party Limited Risk Distribution Arrangements
The French tax authorities may challenge the use of related-party limited risk distribution arrangements on the basis of the "abnormal act of management" or "abuse of law" doctrines.

For instance, in the context of an international group of companies, limited risk distribution may be used to transfer functions from a company to another one. Thus, French tax authorities may consider that the transformation of a French subsidiary from exclusive distributor to commercial independent agent may result in a transfer of customers to the foreign company and reintegrate the remuneration that the company should have received in such transfer in its taxable income. After the setting up of the arrangement, there is a risk of permanent establishment in France of the principal if the arrangement has not been set up properly and notably with sufficient substance in the jurisdiction where the principal is located.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards
French transfer pricing rules do not vary from OECD standards.

4.7 International Transfer Pricing Disputes
International transfer pricing disputes are not often resolved through mutual agreement procedures (MAPs) (statistics published in 2019 by the OECD recorded fewer than 350 cases since 2016 in France).

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
The right to compensating adjustments may be allowed by the French tax authorities. It is not provided for in all double tax treaties concluded by France, though. Moreover, some double tax treaties provide that the compensating adjustments will be allowed only if this adjustment is justified, or in the context of a MAP provided for in Article 25 of the OECD Model Tax Convention.

Compensating adjustments must be treated in such a way as to put the company back in the position it would have been in if the transfer prices had been determined in accordance with the arm's-length principle. They will be made for the fiscal years during which the taxable income of the company has been reassessed.

However, the French tax authorities may refuse to enter into a MAP in certain circumstances (eg, when a company is subject to serious penalties, if the taxpayer does not provide evidence of the double taxation).

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations
As a rule, French branches of a non-resident corporation are taxed in the same way as French subsidiaries. However, given that French branches do not have a separate legal personality, specific rules may apply.

Profits realised in France by non-resident companies through French branches may be subject to a "branch tax" (ie, the French branch's profits are deemed distributed to the shareholders who do not have their tax residence in France). The standard branch tax rate is 26.5 % (in 2021) but may be increased to 75% if the foreign entity is resident in certain NCSTs. However, the application of the French branch tax may be prevented by the provisions of an applicable double tax treaty. Furthermore, profits deemed distributed to non-resident companies located in an EU or EEA state are exempt from branch tax.

5.3 Capital Gains of Non-residents

A 26.5% withholding tax may apply to a non-resident company that realises capital gains on the disposal of:

- French real estate properties;
- French real estate rights;
- shares in unlisted real-estate companies; or
- shares in real estate investment trusts.

Unless otherwise provided in a double tax treaty, a 26.5% withholding tax also applies to capital gains realised by non-resident companies on the disposal of "substantial" shareholdings (ie, representing more than 25% of the financial rights) in French companies. However, for capital gains realised by foreign companies located in certain NCSTs, the rate is increased to 75% irrespective of the percentage of financial rights held by the seller.

It must be noted that, in recent case law, the French Administrative Supreme Court ruled that the withholding tax provided for capital gains on "substantial" shareholdings did not comply with the freedom of establishment guaranteed under EU legislation (CE, 14 October 2020, No 421524, "Sté AVM International"). In addition, the Administrative Court of Appeal of Versailles ruled that the same withholding tax did not comply with the principle of free movement of capital also guaranteed under EU law (CAA Versailles, 20 October 2020, No 18VE03012, "Sté Runa Capital Fund I LP"). As a result, this withholding tax on capital gains from sales of substantial shareholdings should not be applicable any more to non-resident companies, whether located in the EU or in a third-party state.

5.4 Change of Control Provisions

There are generally no change of control provisions that may trigger adverse tax consequences in France.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Subject to French CFC rules, foreign-owned local affiliates that do not carry on any business in France are generally not subject to tax in France (see **1.3 Determining Residence of Incorporated Businesses**).

5.6 Deductions for Payments by Local Affiliates

In order to be deductible, management and administrative expenses paid by local affiliates to non-resident affiliates must (i) be incurred under normal conditions, identical to those of the market (arm's-length principle) and (ii) correspond to useful services effectively rendered by the non-resident company (which receives the payment) to the French affiliate company (which pays for services); eg, the services must not be identical to functions already performed by the president/director(s) of the company.

If the transaction is not carried out accordingly, the tax authorities may deny all or part of the deduction of the expenses. The French affiliates should be able to substantiate the services provided.

5.7 Constraints on Related-Party Borrowing

Some of the interest deduction limitations described in **2.5 Imposed Limits on Deduction of Interest** apply to related-party borrowings specifically.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Please refer to **1.3 Determining Residence of Incorporated Businesses**.

6.2 Non-deductible Local Expenses

Foreign income attributed to a foreign permanent establishment is not subject to French CIT; accordingly, local expenses attributed to the foreign permanent establishment are generally not deductible for French CIT purposes.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by a French company from foreign subsidiaries are subject to French CIT at the standard rate (26.5% in 2021).

However, dividends received by a French parent company from a qualifying subsidiary (whether French or foreign) may benefit from the participation exemption regime. 95% of such dividends will be exempt from CIT (leading to an effective CIT rate of 1.325%) if certain conditions are met:

- the shares of the subsidiary must be in registered form;
- the parent company must be subject to CIT and hold directly shares representing at least 5% of the distributing subsidiary's share capital;
- the parent company has held, or commits to holding, such a participation for at least two years;
- the hybrid mismatch rules (see **2.5 Imposed Limits on Deduction of Interest**) do not apply; and
- the subsidiary is not located in an NCST.

The 5% taxable portion may be reduced to 1% for dividends paid by companies located in the EU or EEA, under certain conditions.

6.4 Use of Intangibles by Non-local Subsidiaries

In order to use the intangibles developed by French companies, a foreign subsidiary has to pay royalties to the French company corresponding to an arm's-length remuneration. If not, the French tax authorities could add back into the taxable profit of the French company an amount equal to the royalties it should have received.

Royalties received are subject to French CIT at the standard rate (unless otherwise provided under the double tax treaty or unless they are eligible for the IP Box).

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

When a French company subject to French CIT operates a business or holds directly or indirectly more than 50% of the shares, units, financial rights or voting rights in a subsidiary established outside of France in a state where it is subject to a favourable tax regime, the profits of the foreign branch or the foreign subsidiary are subject to CIT in France. The control threshold may be lowered to 5% in certain circumstances.

The low-tax nature of the foreign jurisdiction is assessed by reference to French CIT, and the difference must exceed 40% (ie, assuming a French CIT rate of 25%, a foreign tax rate below 15% could trigger French CFC rules).

Profits of a foreign subsidiary are treated as distributed income received by the French company (in proportion of the shares, units or financial rights it holds in the foreign subsidiary), while profits of a foreign branch are treated as French business profits of French headquarters (provided that no applicable double tax treaty provides otherwise).

Safe harbour clauses are provided:

- for subsidiaries or branches that are located in an EU member state (provided they are not purely artificial structures intended to avoid French tax); or
- if the company demonstrates that the main purpose and effect of the foreign subsidiary's or branch's set-up is not to shift income in a state or territory where it is subject to a favourable tax regime.

6.6 Rules Related to the Substance of Non-local Affiliates

Pursuant to the "abuse of law" doctrine (see **7.1 Overarching Anti-avoidance Provisions**), the French tax authorities can disregard an entity with no substance and, accordingly, deny the benefit of certain exemptions, favourable tax regimes, deduction of interest or other payments, or the application of an international tax treaty.

A structure in which a holding company is interposed should be organised for sound commercial and economic reasons and should not be implemented solely or, in particular, to obtain a tax advantage.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

French companies are subject to CIT on capital gains derived from the sale of shares in foreign subsidiaries (under the same rules as for the sale of shares in French subsidiaries – see **2.7 Capital Gains Taxation**), subject to any contrary provisions under applicable double tax treaties.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Historically, French domestic tax law has had two overarching anti-avoidance mechanisms: the "abuse of law" doctrine (*abus de droit*) and the "mismanagement act" theory (*acte anormal de gestion*). Additional anti-abuse rules have been specifically introduced in relation to CIT matters and to reorganisations.

Abuse of Law (Exclusive Purpose Test)

The abuse of law principle is a general anti-abuse rule that allows the French tax authorities to disregard any legal transaction (or step thereof) on one of two grounds:

- because it is a sham transaction (simulation); or
- because it seeks to benefit from a literal application of the law, going against its spirit, and is exclusively motivated by the avoidance or mitigation of tax liabilities that would have been incurred had such transaction not been implemented (*fraude à la loi*).

Under such rules, abusive arrangements incur specific penalties of up to 80%. In turn, taxpayers benefit from a specific rights-protective procedure and the onus is on the tax authorities to prove that a given transaction is solely tax driven and has no other purpose, however insignificant.

Corporate Tax Anti-abuse Rules (Principal Purpose Test)

The new anti-abuse provisions introduced by the Finance Act for 2019, transposing Article 6 of the ATAD, seek to disregard arrangements that meet both of the following requirements: (i) they have been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the purpose of the applicable tax law, and (ii) they are not genuine having regard to all relevant facts and circumstances. Unlike the general abuse of law theory, which extends to all taxes provided the exclusive purpose test is met, the new anti-abuse rule applies only to CIT but is broader in scope, targeting principally tax-driven arrangements. It does not incur the specific anti-abuse penalties of up to 80% applicable to the general abuse of law (but other standard penalties could apply).

A specific anti-abuse rule applies with respect to mergers, divisions and transfers of assets, whereby the benefit of tax neutrality can be withdrawn if a transaction pursues tax evasion or tax avoidance as its main or one of its main objectives.

Mismanagement Act

As a general rule, taxable income for CIT purposes is determined by taking into account profits and expenses resulting from transactions carried out in the taxpayer's own interest. To this end are disregarded so-called abnormal acts of management (*acte anormal de gestion*), by which an enterprise decides to impoverish itself for purposes that are not in line with its corporate interest (assessed on a standalone basis, as opposed to the level of the group to which it might belong). Traditional examples include the disallowance of expenses that are not incurred for sound business reasons and the reassessment of taxable income when the taxpayer deliberately gives up a potential profit (eg, not charging rentals/interest, selling at a loss, buying at a price above market value).

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no routine audit cycle per se, and no specific rules on the frequency of tax audits in general. Broadly, tax audits are subject to the constraints of the statute of limitations, and in the case of some taxpayers, the audit cycle may coincide with such period.

The statute of limitations in CIT matters generally expires at the end of the third calendar year following that during which the tax is due (eg, the fiscal year ending on 31 December 2021 may be audited and reassessed until 31 December 2024). By way of exception, due to the COVID-19 health crisis, fiscal year 2017 will be time-barred on 14 June 2021 (instead of 31 December 2020).

An extended ten-year statute of limitations applies in the case of undisclosed activity and this is frequently used when the tax authorities seek to establish the presence of an unreported permanent establishment in France.

9. BEPS

9.1 Recommended Changes

Regarding Action 1 ("Address the tax challenges of the digital economy"), France has introduced a tax on digital services as a temporary measure, awaiting a multilateral solution to be reached at international level (see **9.12 Taxation of Digital Economy Businesses** for further details). France also implemented a mechanism for the effective collection of VAT in respect to B2C cross-border transactions of electronic services, in line with the OECD's International VAT/GST Guidelines.

Regarding Action 2 ("Neutralise the effects of hybrid mismatch arrangements"), ATAD 1 and ATAD 2 contain specific provisions for the neutralisation of the asymmetrical effects of such arrangements based on BEPS Action 2, which have been transposed into French domestic law by the Finance Act for 2020 (see **9.6 Proposals for Dealing with Hybrid Instruments** for further details).

Regarding Action 3 ("Strengthen CFC rules"), France already has robust rules for countering the shifting of profits into low-tax jurisdictions, which were implemented prior to BEPS. No update is pending in this respect in the near term (see **9.8 CFC Proposals** for further details).

Regarding Action 4 ("Limit base erosion via interest deductions and other financial payments"), the Finance Act for 2019 has revamped French interest limitation rules in line with the provisions of ATAD 1 and BEPS Action 4, notably by introducing a general deduction limitation of financial expenses, pursuant to which, net financial expenses deduction is capped at 30% of the adjusted EBITDA (see **2.5 Imposed Limits on Deduction of Interest** for further details).

Regarding Action 5 ("Counter harmful tax practices more effectively"), the OECD currently considers that no harmful tax regime is present in French law.

Regarding Action 6 ("Prevent treaty abuse"), French courts have historically considered that the domestic abuse of law principle can apply to double tax treaties, even ones that do not contain a specific anti-abuse provision (see **9.9 Anti-avoidance Rules** for further details). Furthermore, the OECD Multilateral Instrument (MLI) already entered into force in respect of certain tax treaties to which France is a party and anti-abuse provisions are now constantly introduced in new tax conventions negotiated by France.

Regarding Action 7 ("Preventing the artificial avoidance of permanent establishment status"), the permanent establishment definition adopted by France in its most recent double tax treaties (eg, with Luxembourg) follows the OECD's recommendations and notably includes provisions covering commissionaire arrangements and anti-fragmentation rules.

Regarding Actions 8–10 ("Assure that transfer pricing outcomes are in line with value creation"), French tax authorities and courts apply the OECD transfer pricing guidelines and the arm's-length principle (see **9.10 Transfer Pricing Changes** for further details).

Regarding Action 12 ("Require taxpayers to disclose their aggressive tax planning arrangements"), France has transposed into domestic law the EU "DAC 6" directive, which requires intermediaries and taxpayers to report to the French tax authorities specific information on cross-border arrangements meeting certain hallmarks.

Regarding Action 13 ("Re-examine transfer pricing documentation"), country-by-country reporting requirements and master/local file filing requirements have been implemented by France (see **9.11 Transparency and Country-by-Country Reporting** for further details).

Regarding Action 14 ("Make dispute resolution mechanisms more effective"), France has elected to apply the mandatory binding arbitration provided for in the MLI.

Regarding Action 15 ("Multilateral Instrument"), France has been particularly proactive on this matter and has participated in the ad hoc group that negotiated the MLI. The MLI was signed by France on 7 June 2017, ratified on 12 July 2018 and entered into effect on 1 January 2019.

9.2 Government Attitudes

The French government has shown a positive and involved attitude towards BEPS, working consistently towards a comprehensive implementation of BEPS-related measures into domestic law and actively participating in the OECD's international forums towards the prevention of international tax avoidance. On occasion, France has gone even further than the OECD consensus, as in the case of digital taxation (see **9.13 Digital Taxation** for further details).

9.3 Profile of International Tax

As a founding member of and active participant in the OECD (which is, incidentally, headquartered in Paris and has appointed a former French official as the head of its Centre for Tax Policy), France plays an important role in shaping the international tax debate on anti-avoidance, harmful tax practices and the taxation of digital multinationals. In turn, French domestic legislation is heavily influenced by the developments on the international stage and the main BEPS recommendations have already been implemented in some form or other.

9.4 Competitive Tax Policy Objective

The main competitive tax policies currently pursued by the French government are (i) the progressive alignment of CIT rates with the OECD average and (ii) the lowering of local business taxes levied on real estate values and turnover, which are seen as stifling economic growth and investment. Such policies should not be directly affected by BEPS, which targets an entirely different set of tax practices.

9.5 Features of the Competitive Tax System

The key competitive features of the French tax system include:

- a tax consolidation regime (with a compensation of profits and losses) for French-based groups (see **2.6 Basic Rules on Consolidated Tax Grouping**);
- carry forward of tax losses without time limitation (see **2.4 Basic Rules on Loss Relief**);
- participation-exemption regime for dividends (95% exemption – see **6.3 Taxation on Dividends from Foreign Subsidiaries**) and capital gains (88% exemption – see **2.7 Capital Gains Taxation**);
- no withholding tax on interest payments to non-resident companies (NCSTs excluded – see **4.1 Withholding Taxes**);
- a generous R&D tax credit scheme to incentivise research and innovation expenditure (*crédit d'impôt recherche*) (see **2.2 Special Incentives for Technology Investments**); and
- a "patent box" regime, in line with the OECD's modified nexus approach, with a preferential 10% rate for certain IP income (see **2.2 Special Incentives for Technology Investments**).

As of the latest review of harmful tax practices published by the OECD in November 2020, no French tax features were singled out. The previous French preferred tax scheme for IP income had been highlighted in the 2015 BEPS Action Report on harmful tax practices but has since been amended in line with the OECD's nexus approach.

9.6 Proposals for Dealing with Hybrid Instruments

France has transposed the provisions of ATAD 1 and ATAD 2 on hybrid instruments. As such provisions are directly derived from BEPS Action 2, French tax legislation is rather consistent with the standard contained in such action.

Interest Payment Mismatches

The provisions of ATAD 1 and ATAD 2, which deal with hybrid mismatches, have replaced the previous (rudimentary) French anti-hybrid rules (see **2.5 Imposed Limits on Deduction of Interest**).

Dividend Payment Mismatches

Specific provisions deal with mismatches arising in respect of inbound dividends, which qualify for the French participation-exemption regime. Where such dividends may be tax exempt in France but deductible from the taxable income of the distributing entity (eg, mismatch in the debt/equity classification between jurisdictions), the benefit of the French participation-exemption regime is denied.

9.7 Territorial Tax Regime

The French CIT system is based on the territoriality principle, meaning that a nexus has to be established between the French territory and any taxable income or deductible expenses (including interest charges – see **1.3 Determining Residence of Incorporated Businesses**). Thus, interest expenses incurred in connection with an activity carried out outside France (eg, foreign branch of a French company) should not be taken into account for the purpose of French interest limitation rules (see **2.5 Imposed Limits on Deduction of Interest** with respect to the domestic rules on interest deductibility).

9.8 CFC Proposals

While France runs a territorial tax regime (see **9.7 Territorial Tax Regime**), French CFC rules are a notable exception to this principle and an important anti-avoidance tool (see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**).

Due to their sweeping nature and the fact that they had originally established a quasi-presumption of tax avoidance and profit shifting, French CFC rules have been challenged on several occasions before the French and EU courts over the years and, as a result, been substantially amended (the last change having, however, occurred in 2014). Current CFC rules include safe harbour provisions in favour of:

- EU entities, provided they are not purely artificial structures intended to avoid French tax; and
- non-EU entities, if the taxpayer evidences that the main purpose of the foreign CFC is not to shift profits to the low-tax jurisdiction where it is established.

Sweeper CFC rules that would tax the profits of offshore entities regardless of their substance could prove to be harmful, contrary to EU law and would generally risk putting French-resident companies and their foreign branches/subsidiaries at a competitive disadvantage (notably on account of the increased risk of double taxation).

9.9 Anti-avoidance Rules

Even prior to the BEPS recommendations and signature of the MLI, the French tax authorities used to apply the domestic abuse of law doctrine (see **7.1 Overarching Anti-avoidance Provisions** on the exclusive purpose test) to disregard cross-border arrangements deemed abusive with regard to the provisions of applicable tax treaties, such approach having been confirmed by case law even in the absence of specific anti-abuse provisions in the relevant treaty.

While the new anti-avoidance rules in the MLI are not likely to revolutionise the current interpretation of tax treaties in France, they will probably expand the scope of the tax authorities' reclassification powers. Indeed, the new MLI anti-abuse provisions are based on a principal purpose test, as opposed to the exclusive purpose test under the French domestic rules previously applied (as in the case of the above-mentioned case law). According to the French tax authorities' interpretation of the MLI, an analysis allowing to "reasonably" conclude as to the existence of such principal purpose would be sufficient to disallow a treaty benefit. The "reasonable" nature of the analysis is as yet undefined and will have to be tested in court, on a case-by-case basis.

9.10 Transfer Pricing Changes

The French transfer pricing regime has not been radically changed as a result of BEPS Actions 8 to 10. Indeed, French transfer pricing rules were already aligned with the arm's-length principle and the traditional OECD methods of functional analysis and profit allocation, to which both the French tax authorities and tax courts generally adhere. For instance, recent case law on the arm's-length interest rate between related parties (see **2.5 Imposed Limits on Deduction of Interest**) has confirmed that such rate can be evidenced by any means, based on internal or external comparable transactions, in line with the OECD's transfer pricing guidelines.

With regard to IP and intangibles, there is limited administrative guidance available, one of the main rules being that the making available of an intangible asset should be remunerated via royalties or a cost-sharing agreement. Royalties are generally set as a percentage of the company's turnover, and case law has admitted that it can range from around 0.5% to 5%, depending on the fact pattern. Tax authorities pay a particular attention to excessive levels of royalties or the lack thereof.

9.11 Transparency and Country-by-country Reporting

France has already implemented country-by-country (CbC) reporting requirements as part of the Finance Act for 2016 and has signed on 27 January 2016 the CbC Multilateral Competent Authority Agreement, agreeing to automatically exchange information with the other signatories (currently around 88 other countries).

While the CbC threshold is set at EUR750 million turnover (which excludes 85 to 90% of multinational enterprises (MNEs) from its scope, according to the OECD) and the filing requirements are not excessively cumbersome by themselves, French taxpayers need to take into account the fact that the reported financial information could be used by tax authorities in various countries to assess the group's transfer pricing policy and potentially readjust it. Against this background, CbC rules introduce some legal insecurity for taxpayers, which will need to ensure that data reported over various jurisdictions is consistent and comprehensive, in order to mitigate reassessment risks.

9.12 Taxation of Digital Economy Businesses

French Digital Service Tax

On 24 July 2019, France introduced a digital services tax (*taxe sur les services numériques*, or DST), with retroactive effect as from 1 January 2019. The DST is intended as a stopgap measure that should be replaced once an international consensus is reached (in which case, past DST liabilities could potentially give rise to a refund or offset claim for taxpayers).

In January 2021, the French government and the Biden administration indicated that negotiations would continue with a view to reaching an international agreement on the digital tax framework in the course of the year. In the meantime, the DST continues to apply, at a rate of 3%, on turnover attributable to certain digital intermediation and advertising services provided in France by companies with digital revenues exceeding EUR750 million on a worldwide basis and EUR25 million in France.

Definition of the Permanent Establishment

In a landmark decision on 11 December 2020 (Conversant/Valueclick), the French Administrative Supreme Court (*Conseil d'État*) ruled that the scope of the dependent agent, as defined in the France–Ireland double tax treaty (pre-BEPS and MLI), includes French companies that play a leading role in the negotiation of contracts that are formally signed by an entity based in another country. The nexus rules have thus been reinforced and so-called marketing services companies arrangements, in particular, are increasingly at risk of being reclassified as permanent establishments of the foreign-based principals.

9.13 Digital Taxation

As a member of the OECD/G20 Inclusive Framework on BEPS, France has participated in multilateral negotiations on the proposed two-pillar global solution:

- Pillar One, focused on new nexus and profit allocation rules in favour of market jurisdictions; and
- Pillar Two, designed to ensure that MNEs pay a minimum level of tax regardless of where they are headquartered or operate.

A study by the French Council of Economic Analysis (No 54, November 2019), commissioned by the French government to assess the effectiveness of the OECD proposals, has put forward a twofold recommendation: on one hand, to implement a worldwide minimum effective corporate tax rate, in line with Pillar Two, which is seen as a crude but effective method to reduce profit shifting and generate additional tax revenues, and on the other hand, to redesign the current proposals under Pillar One, deemed excessively complex and not sufficiently impactful.

9.14 Taxation of Offshore IP

Under domestic rules (and subject to double tax treaties), a withholding tax is applicable on the gross amount of royalties paid by a debtor carrying out an activity in France to persons or entities that do not have a permanent establishment in France. Such withholding tax is levied at the standard CIT rate (ie, 26.5% in 2021), which is increased to 75% if the payment is made in an NCST.

Outbound royalties are exempt from withholding tax if their beneficial owner is an associated company that is established in the EU and meets certain requirements (in particular, a 25% shareholding threshold), in line with the EU Interest and Royalties Directive (see **4.1 Withholding Taxes**).

Most of the tax treaties signed by France eliminate or reduce the withholding tax on IP royalties.

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Trends and Developments

Contributed by:
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The Valueclick/Conversant Case: A Lesson on the Interpretation of Pre-BEPS Tax Treaties and the Agency PE in the Digital Age

In a landmark decision on 11 December 2020, the French Supreme Administrative Court granted France jurisdiction to tax the profits of an Irish resident company providing online advertising services to French clients, marking a new trend in the interpretation of international tax treaties and the concept of permanent establishment under pre-BEPS rules.

Introduction

The year 2020 was somewhat of a turning point in the field of digital taxation. It marked the end of a decade that saw the emergence of several major trends. First, the increasing awareness of the tax authorities and governments worldwide of the tax challenges arising from digitalisation. Second, the inception of a global collaboration to address such challenges, via the OECD's base erosion and profit shifting package (BEPS), leading to a wide-ranging but incomplete reform of international tax treaties. And third, the recent fragmentation of the co-ordinated approach to solve digital taxation, with a proliferation of digital levies at national level, notably in France.

The Valueclick ruling of the French Supreme Administrative Court is a good example of such trends coming together. It sheds new light on the current attitude of the French courts and tax authorities with respect to the interpretation of tax treaties and the taxable nexus with France.

The Elusive Nature of Online Business and French Efforts to Tax It

It is a given that the current international tax system was primarily designed for the "bricks-and-mortar" economy and is no longer suitable when it comes to the digital businesses that have flourished over the past decades, such as the online advertisement business. France has generally been at the forefront of initiatives to redesign the old set of rules in line with the new online service economy. It has pushed for reform at European Union level, supporting a 2018 draft directive package for the introduction of a "digital" or "virtual" permanent establishment concept (based on "significant numerical presence" in a member state) and a special tax on digital services. Neither has been adopted by the EU, though.

In July 2019, France decided to unilaterally introduce a tax on digital services (*taxe sur les services numériques*), in response to the stalemate in negotiations at EU and OECD level. The French digital service tax is meant as a stopgap measure that should be repealed once an international consensus is reached.

Furthermore, the French tax authorities have been involved, for several years, in a tug-of-war with certain multinational companies, with a view to bring a portion of the profits derived from French customers within the remit of French corporate income tax. One of their preferred methods has been the characterisation of a permanent establishment (PE) in France, to which a portion of the multinational's profits could be allocated and taxed.

In a recent Google case, the French tax authorities argued that Google Ireland had a "dependent agent" PE in France, within the meaning of the France–Ireland double tax treaty of 1968. They deemed that the employees of related entity Google France were, in fact, negotiating and concluding contracts in the name of Google Ireland. The French tax authorities lost both in the first instance and on appeal, as the administrative tax courts upheld a legalistic approach to the definition of "dependent agent" PE. In particular, the courts ruled out such PE on the grounds that contracts were ultimately approved by Google Ireland. Despite winning in court, Google agreed to settle the case with the French prosecutors for the record sum of EUR1 billion, which covered the reassessed tax amounts as well as related tax fraud charges.

The Google case is representative of so-called market service company (MSC) arrangements, which have been widespread in the digital sector since the 2000s. As part of such structures, an online advertising activity is deployed from abroad in a so-called market jurisdiction with the help of a local company. Usually remunerated on a cost-plus basis in respect of mere promotion and back-office services, the local company works on behalf of the foreign entity (which books the major share of the profits) and, in practice, exercises more or less extensive powers in negotiating with local clients and preparing contracts (which are then formally approved abroad).

BEPS and the Overhaul of the PE Definition

Following the 2010 Zimmer case and until recently, MSC structures, together with "commissionaire" arrangements, have been generally viewed as more or less immune to PE reclassification in France. Historically, double tax treaties concluded by France (including the one with Ireland) have closely followed the OECD Model Tax Convention. Until 2017, the OECD Model used to provide a narrow definition of the so-called agency PE (ie, the habitual exercise of the authority to conclude contracts in the name of an enterprise).

Following its post-BEPS update of 2017, the OECD Model Convention lays out an expanded definition of the dependent agent. It now includes persons that play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. As a result, it is widely recognised that MSC and commissionaire arrangements could no longer avoid PE status under the updated language of the Model Convention.

Signatories to the Multilateral Instrument (MLI), developed by the OECD to bring existing double tax treaties up to BEPS standards, had the option between keeping the existing PE definition or replacing it with the new one (by updating the relevant provisions in the treaties).

As a result, from the point of view of PE standards, tax treaties can be broken down into three categories:

- post-BEPS treaties that have been designed from the start in line with the 2017 Model (such as the France-Luxembourg treaty, signed in 2018);
- pre-BEPS treaties that have been updated by the MLI and as a result have replaced the old PE definition with the new one; and
- other pre-BEPS treaties that have not been updated by the MLI with respect to the specific definition of dependent agent PE.

The France–Ireland tax treaty is part of the last category. Even though some of its provisions have been updated as from 1 May 2019, by operation of the MLI, Ireland has rejected any modification of the agency PE definition. The France–Ireland treaty will thus continue to apply the dependent agent PE provisions in their original 1968 state, unaltered by the MLI, for the foreseeable future (unless either country decides to denounce the treaty – a precedent was set in 2008 with the denunciation of the France–Denmark treaty by the Danish party).

While MSC and commissionaire arrangements would be unlikely to prosper under the revamped tax treaties, the question was whether they could survive unchallenged under pre-BEPS treaties such as the one with Ireland.

The French Supreme Administrative Court (*Conseil d'État*) has settled this question in the Valueclik decision of 11 December 2020, No 420174, which was rendered in a tax plenary session (reserved for the most important cases). The Court's landmark ruling came as somewhat of a surprise and has since generated considerable debate in France. In a nutshell, the Court adopted a substance-over-form approach and ruled that a French company is a dependent agent PE where it decides on transactions that are merely endorsed by a foreign enterprise and thus binding on it, despite the fact the French company does not formally conclude contracts in the name of the foreign enterprise.

The Facts of the Valueclick Case

Valueclick Inc. was the US parent ("USCo") of the Valueclick group, which carried out an online advertising business.

The group provided two main lines of services to its customers. First, an affiliated marketing service, where the online platform operated by the group allows businesses to advertise their products on third-party websites on a continuous basis. Second, an instantaneous advertising campaign service, where advertisers bid in real time to display their ads on websites that a given user is browsing, with the highest bidder winning the auction and the chance to instantaneously display the ad.

The Valueclick group played the role of intermediary between advertisers and publishers, calculating the commissions owed by the former to the latter, on the basis of views and sales generated by the ads.

Valueclick International Ltd was an Irish company ("IrishCo") wholly owned by USCo. In 2008, IrishCo signed an IP licensing and cost-sharing agreement with USCo, receiving the right to commercially exploit the Valueclick technology in all international markets (outside North America).

The same year, Valueclick France SARL ("FrenchCo") concluded an intra-group services agreement with IrishCo for the provision of marketing support services and administrative assistance. In consideration for such services, IrishCo agreed to remunerate FrenchCo on a cost-plus basis with an 8% mark-up.

Following a search at FrenchCo's premises, the French tax authorities proceeded to audit the period from 2008 to 2011. Considering that IrishCo had carried out a concealed activity in France (*activité occulte*) via a fixed place of business/dependent agent PE (through FrenchCo), the French tax authorities applied the estimated taxation procedure (*taxation d'office*) and notified IrishCo with French corporate income tax reassessments amounting to EUR1.6 million (increased by 80%, as penalties for concealed activity).

The Decisions of the French Tax Courts in Valueclick

The first-instance Paris Administrative Tribunal held in favour of the tax authorities and ruled that IrishCo had a fixed place of business PE within the premises of FrenchCo, for both corporate income tax and value-added tax purposes. On appeal, the Administrative Court of Appeal overturned the lower court's judgment and rejected the tax authorities' claims that FrenchCo was a fixed place of business PE or dependent agent of IrishCo, discharging the latter's tax reassessments.

The Paris Administrative Court of Appeal's decision in March 2018 would prove to be in line with its ruling in the Google case a year later. Following a strict legal approach, the Administrative Court of Appeal considered that the formal approval of contracts abroad prevented the characterisation of a French PE. The fact that contracts were entirely negotiated in France and the client accounts managed by French employees were not deemed sufficient to change this analysis. Many criticised the decision of the Administrative Court of Appeal, highlighting the circumstances of the case and the fact that it showed hallmarks of PE avoidance. Nonetheless, it was not unreasonable to contemplate the Supreme Administrative Court ultimately upholding the same position, based notably on the Zimmer doctrine.

In a somewhat unexpected turn of events, the French *Conseil d'État* took the opposite view, revisiting its earlier case law, notably as regards treaty interpretation in light of subsequent OECD commentaries.

The Supreme Administrative Court deemed irrelevant the fact that FrenchCo did not formally enter into contracts in the name of IrishCo. The Court also disregarded the circumstance that IrishCo provided the template of the contracts concluded with the French advertisers and set out the general pricing conditions. Instead, the Court viewed the French entity as a dependent agent based on the fact that it chose to contract with the advertisers and carried out all of the tasks that were necessary to enter into such agreements, which IrishCo merely endorsed.

The Factual Approach to PE Status Assessment

The Court ruled with regard to Article 2§9(c) of the France–Ireland treaty, according to which a dependent agent is characterised where it "habitually exercises in that State, an authority to conclude contracts in the name of the enterprise". As a reminder, this language is extremely common in many other pre-BEPS tax treaties, and remains relevant for those that have not been updated by the MLI (ie, France–Ireland, France–Netherlands, etc).

According to the Court's interpretation thereof, as revealed in the opinion of the Court's Public Rapporteur, the "authority to conclude contracts" does not necessarily mean the act of materially signing or validating the contracts and thus giving them binding force. Rather, this should be interpreted as the de facto power to decide whether the contract should be signed in the name of the foreign enterprise; in particular, under where such signature is a routine formality.

It should be stressed that, unlike the Paris Administrative Court of Appeal in the Valueclick and Google cases, the Supreme Administrative Court had never previously rejected the classification of agency PE in a situation where contracts were consistently validated on a purely formal basis. However, the Supreme Administrative Court did famously rule, in the 2010 Zimmer case, in favour of a legalistic view of the PE concept (as opposed to a fact-based approach). The decision of the *Conseil d'État* in the Valueclick case could therefore be seen as a departure from the strict Zimmer doctrine, in favour of a return to a more factual, substance-over-form approach.

Looking at the facts of the case from this perspective, there should be little doubt over the PE status of IrishCo. The role of FrenchCo's employees was to prospect clients, check their creditworthiness, negotiate with them the terms of the online advertising agreements, and provide them with software technical training and invoicing assistance. IrishCo's role was limited to providing the general terms of the contracts and the pricing grid. Its validation of contracts negotiated by FrenchCo was pure rubber-stamping (which the French tax authorities were able to evidence before the court).

Substance also must have played a role in the assessment. FrenchCo employed around 50 workers dedicated to the French market, including account managers and sales representatives. IrishCo's headcount comprised five to seven employees, who were in charge of the group's worldwide operations, not just the French ones.

In a nutshell, as highlighted by the Public Rapporteur, the Valueclick case was a rather extreme one, where FrenchCo was basically doing almost all of the work of the foreign enterprise.

It is interesting to note that the services agreement between IrishCo and FrenchCo stipulated that FrenchCo was not an agent of IrishCo and did not have the vested power to bind it or contract in its name. Such provisions are naturally dismissed by the courts and the tax authorities where the contractual arrangement does not reflect the genuine nature of the relationship.

The Dynamic Interpretation of Tax Treaties and Its Effects

To further substantiate its opinion, the Supreme Administrative Court has referred in its decision to the OECD commentaries under the Model Convention. In practice, it is quite common for the French courts and tax authorities to rely on the OECD commentaries as a source of "soft law" with persuasive value. However, since at least the Andritz case of 2003, the Supreme Administrative Court has upheld a so-called static interpretation of tax treaties and OECD commentaries. In other words, drawing on the OECD commentaries in order to interpret a tax treaty was allowed, provided the commentary in question pre-dated the treaty. Such static interpretation was also in line with the positions of the German and Spanish Supreme Tax Courts, recently confirmed.

In the Valueclick decision, the *Conseil d'État* has revised its earlier case law by expressly referring to paragraphs 33 and 32.1 of the commentaries on Article 5§5 of the OECD Model Convention (that was in force at the time of the facts). Such commentaries had been respectively added in 1977 and 2003, and were thus clearly issued after the entry into force of the France–Ireland tax treaty of 1968.

Henceforth, the French Supreme Administrative Court seems to be moving towards a so-called dynamic or "ambulatory" interpretation of tax treaties, by taking into account posterior commentaries. If such approach is confirmed in the future, it would mean that the reading of tax treaties in light of OECD commentaries by the French courts is converging with the positions of the tax courts in the USA and UK, as well as with that of the Court of Justice of the EU.

The Public Rapporteur's opinion under the Valueclick decision sheds further light on the scope of the dynamic interpretation and its limitations. In particular, the original intention of the parties to the tax treaty cannot be inferred from subsequent commentaries (as they did not yet exist at the time of the signature). Neither can later commentaries be taken into account if they have been issued in connection with an OECD Model Convention that has been adopted after the treaty in question (eg, the new commentaries specific to the 2017 OECD Model Convention cannot be used to interpret the 1968 France–Ireland treaty).

On the other hand, where the commentary is interpretative in nature and seeks to merely clarify a concept that was already present in both the OECD Model Convention and the tax treaty in question, it is only natural to take it into account. This enables tax treaties to "live" and adapt to on-the-ground economic realities and the latest practices of multinationals, including those that the original parties to the convention could not have foreseen at the time of its signature.

The Valueclick decision is a good example of the power of such dynamic interpretation.

Paragraph 32.1 of the OECD commentary (to which the French Supreme Administrative Court referred) states that "the phrase 'authority to conclude contracts in the name of the enterprise' does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent."

Paragraph 33 observes that "A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority 'in that State', even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation."

The commentaries' sharpness on such issues is a reminder that, even in the pre-BEPS world, the existing concepts and tools are less rudimentary than they might seem in hindsight, and could well suffice to quash some of the more extreme PE avoidance schemes. By adjusting its earlier rules on treaty interpretation, the Supreme Administrative Court is thus contributing to restore pre-BEPS international standards to their full effect.

This could lead, to a certain extent, to a convergence of pre- and post-BEPS interpretations of the dependent agent PE. Undoubtedly, pre-BEPS treaty provisions would never be able to reach the same anti-avoidance standards as post-BEPS ones. However, in light of subsequent OECD commentaries in particular, they could prove effective enough to tackle some of the PE avoidance schemes.

The above raises nonetheless an interesting question regarding the weight to be attributed to the intentions of the parties to the treaty – should a constructive interpretation of the France–Ireland treaty and posterior OECD commentaries by the French courts be allowed to take precedence over the fact that Ireland has expressly elected to exclude any MLI/BEPS modification of the agency PE definition in the treaty? This is where the decision of the French Supreme Administrative Court might be viewed as somewhat contradictory. Indeed, why should a subsequent commentary from the OECD be taken into account for interpretative purposes, while the undisputed current intentions of one of the parties to the treaty are ignored? According to the Public Rapporteur, Ireland's aims in 2018 are not indicative of its intentions in 1968 (but then again, why should the OECD's comments be?). Even more telling are his conclusions on this point – as a national jurisdiction, the French Supreme Administrative Court is not bound by the interpretation of the treaty retained by the other party and, should any double taxation arise, the mutual agreement procedure should allow mitigation of it.

Questions Left Outstanding

The Supreme Administrative Court has overturned the decision of the Paris Administrative Court of Appeal but has not definitively decided the issues at stake. Instead, it has referred the case to the same court, which will have to rule again on the facts and merits of the case, based on the principles laid down by the Supreme Administrative Court.

In particular, the Administrative Court of Appeal will have to rule on the allocation of taxable profits to IrishCo's dependent agent PE in France. This raises transfer pricing questions, notably regarding the level of remuneration that should be paid to such agency PE. For instance, if IrishCo was able to evidence that the cost-plus 8% fee paid to FrenchCo was actually an arm's-length remuneration, in line with its functions and risks as an agent in charge of prospecting and contract negotiation, then no additional profits would need to be allocated to FrenchCo.

As part of their reassessment, the French tax authorities had estimated the PE's taxable income on the basis of money collected from customers on French bank accounts, after applying a fixed 80% deduction for expenses. The first-instance Administrative Tribunal had validated this approach – it remains to be seen whether the Administrative Court of Appeal will follow.

Such transfer pricing issues are bound to become more acute if PE reassessments multiply in the coming years, as a result of both BEPS-compliant treaties coming into play and pre-BEPS treaties being reinterpreted in a more extensive manner in the wake of the Valueclick case law.

Conclusion

The Valueclick case is another reminder of the difficulty in applying international tax rules designed for bricks-and-mortar companies to digital businesses. To be able to tax such online businesses in circumstances where local companies established in the market jurisdiction play an important role in the negotiation and sourcing of commercial transactions, while foreign related entities routinely approve the finalised transactions and pocket a large share of the profits, the French tax authorities increasingly seek to characterise a dependent PE where France is a market jurisdiction. While post-BEPS tax treaties generally facilitate such reclassifications, it was unclear whether they could prosper under pre-BEPS treaties, such as the one between France and Ireland.

In the Valueclick case from 11 December 2020, the French Supreme Administrative Court gives the agency PE provisions of the France–Ireland treaty their full and most extensive effect, notably by referring to OECD commentaries issued after the treaty's entry into force, and thus breaking up with its previous position on the matter. This decision also ignores Ireland's refusal to adopt the BEPS/MLI definition of dependent agent – what weight does this refusal carry if France is able to override it through its domestic case law?

While it represents the start of a more extensive way of tax treaty interpretation – in particular, through a substance-over-form approach – the Valueclick case does not revolutionise international taxation, nor does it signal the emergence of a digital PE concept that would allow a tax nexus to be established based solely on virtual presence in the market jurisdiction. In the end, any PE reclassification should remain extremely fact-driven, as was the case in Valueclick, where the extreme de facto powers granted to the French subsidiary, coupled with the insufficient substance of the Irish entity and its routine approval of contracts, proved sufficient grounds to justify French PE status.

Noteworthy questions remain outstanding, though, such as the profit allocation to Valueclick's French PE. Following the Supreme Administrative Court's decision, the case has been referred back to the Paris Administrative Court of Appeal, which should definitively rule on such issues.

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The firm would like to thank partners Xenia Legendre and Ludovic Geneston for their contribution to the chapter.

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt the form of a limited liability company (GmbH) or a joint stock company (AG). These corporations are taxed as separate legal entities. The key differences between the two relate to the treatment each receives under commercial law.

Under a GmbH, the shareholders are authorised to give instructions to a managing director, there is a low degree of fungibility of shares and there is a wide range of possibilities for the design of the articles of association.

Under an AG, a supervisory board and a management board are mandatory, with both operating independently from the shareholders regarding the business decisions. There is personal liability for the management and supervisory board, and there is a high degree of fungibility of shares.

1.2 Transparent Entities

The type of partnership most commonly used for transparent entities is the *Kommanditgesellschaft* (KG). The KG is most commonly adopted for investment purposes due to its limitation of liability. Only one shareholder (*Komplementär*) is unlimitedly liable as the general partner (GP), while the liability of the other shareholders (*Kommanditist*) is limited to their compulsory contribution. It is also possible to choose a GmbH as the GP; this means that no individual is subject to unlimited liability. This kind of partnership is referred to as a GmbH & Co. KG and is usually chosen for private equity structures.

1.3 Determining Residence of Incorporated Businesses

According to German tax law, the residence of incorporated businesses depends on the question of where the following are situated: (i) the place of management and (ii) the statutory/registered seat. Usually, double taxation treaties provide regulations that the place of effective management is decisive in the case of a double residence of a corporation (the "tie-breaker rule").

Due to the special circumstances caused by the COVID-19 pandemic, there is a possibility that the place of actual business management may be affected. According to an OECD guideline published on 21 January 2021, when deciding where the place of effective management is located, the place where it is usually located (without the COVID-19 pandemic) should be taken into account.

1.4 Tax Rates

Taxation of Corporations in Germany

Corporations with a registered seat or place of management based in Germany are subject to unlimited tax liability in Germany. Non-resident corporations are only taxed on their German-sourced income. The income of a corporation is qualified as business income that is subject to corporate tax and municipal trade tax at an approximate total rate of 30%.

The corporate tax rate (including a solidarity surcharge) stands at 15.825%. A special tax rate applies for shares held in other corporations. Dividends received (as of 1 March 2013, only where the shareholding exceeds 10%) and capital gains recognised from the disposal of shares are tax exempt, although 5% of the proceeds are deemed non-deductible expenses, resulting in an effective corporate tax burden of approximately 0.7%.

Municipal trade tax rates range from 13% to 17%, depending upon the municipality the business operates in. For trade tax purposes, capital gains from the sale of shares are generally tax exempt, whereas dividends received from a German-located corporation are only tax exempt if the shareholding amounts to at least 15% (or 10% if the shareholding is received from an EU company). However, 5% of the proceeds are deemed non-deductible expenses, resulting in an effective trade tax burden of approximately 0.7%.

However, there is currently a discussion as to whether the tax exemption for capital gains for corporate income tax, as well as trade tax purposes, will only apply for shareholdings of at least 10% in future.

Partnerships

Partnerships such as a KG are transparent for income/corporate tax purposes so that profits and losses are taxed at the partners' level. Assets, liabilities and income of the partnership are generally allocated to the partners in proportion to their partnership interests. Municipal trade tax, however, is levied at the level of the partnership (if it conducts a trade or commercial activity).

Individuals

The taxation of the income of individuals (who own a business or are a partner in a transparent partnership carrying out a business), generated either by themselves or through the partnership, generally depends upon their personal tax rate; tax rates are up to 47.5%, including a solidarity surcharge of 5.5%, and also possibly a church tax. However, dividend payments, as well as capital gains from the sale of shares that are realised in the context of a business, are subject to so-called partial-income procedures, so that only 60% of the income deriving from dividends or capital gains will be taxed.

As of 2021, the exemption limit on which no solidarity surcharge applies will be increased for individuals and there will be a mitigation zone in which the full solidarity surcharge will not apply. However, the solidarity surcharge will continue to be levied on the corporate income tax of corporations (ie, in particular GmbHs and AGs) as before.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As corporations are legally obliged to keep records, they have to determine their income through the comparison of business assets and annual financial statements. Generally, tax accounts depend on the financial accounts according to the principle of "decisiveness" (*Maßgeblichkeitsgrundsatz*). However, there are some deviations of tax accounts from financial accounts, such as the restriction of the application of current value tax depreciation to cases of permanent depreciation, the prohibition of provisions for onerous contracts, and the discounting requirement for long-term interest-free liabilities, with interest at below the market rate.

Where taxpayers are obliged to balance (eg, corporations), profits are taxed on an accrual basis (the "realisation principle").

2.2 Special Incentives for Technology Investments

On 1 January 2020, a law was passed that is intended to promote R&D with tax benefits (Forschungszulagengesetz). Essentially, all companies are entitled to subsidies, but projects shall benefit only if they fall into the categories of basic research, applied research or experimental development within the meaning of this act. The subsidy consists primarily of a proportionate reimbursement of the wage costs for the employees of the respective beneficiary. The maximum grant is EUR1 million.

2.3 Other Special Incentives

Germany provides special investment incentives to small and medium-sized companies by way of an additional capital allowance of up to 20% of the original costs and investment, and a deduction of up to 40% of the prospective original costs.

2.4 Basic Rules on Loss Relief

Regarding income and corporate tax, loss relief is granted through the application of the following instruments.

Firstly, the positive and negative income of one year is netted.

Secondly, taxpayers may choose to carry back the losses to the previous year, or they may choose to carry forward the losses indefinitely. In the case of carry-back, any losses may be offset against the profits of the preceding year up to EUR1 million. Due to the COVID-19 pandemic, the loss carry-back for the years 2020 and 2021 is EUR5 million and will be EUR1 million again from 2022 onwards. An offset by way of carry-forward is possible up to EUR1 million annually without restriction. Regarding negative income that exceeds the EUR1 million threshold, in each subsequent year only 60% of additional income can be offset against such losses carried forward. The transfer of a share percentage over 50% may result in a total forfeiture of carry-forward not yet offset. These rules exceptionally do not apply if there are hidden reserves taxable in Germany reaching the amount of the carry-forward not yet offset. Furthermore, these regulations do not apply in the case of intra-group acquisitions of shareholdings (ie, group relief). However, the requirements for this are very strict and hard to meet.

A case is currently pending before the Federal Constitutional Court in which it is to be clarified whether the 50% limit is unconstitutional. It is likely that this regulation is also declared unconstitutional. In the case of trade tax, trade earnings may be reduced by loss carry-forward; carry-back is not provided. An offset is possible without restriction against losses of up to EUR1 million; regarding losses exceeding EUR1 million annually, only 60% of losses may be offset against subsequent trade earnings. The rules regarding forfeiture of carry-forward are the same as for corporate tax.

However, there is another possibility to prevent the forfeiture of the loss carry-forward not yet offset if more than 50% of the shares are transferred. This requires that strict conditions are met cumulatively (eg, time-limited application in the tax declaration, continuation of the same business). Furthermore, no so-called harmful event must have taken place (eg, discontinuance of the business, an additional business area is added). When these strict conditions are met, the loss carry-forward not yet offset is determined separately as so-called accumulated loss carried forward (*fortführungsgebundener Verlustvortag*) and can be offset against the profits. This accumulated loss carried forward is determined annually. As soon as one of the strict conditions is no longer met, the accumulated loss carry-forward is fully lost unless it is covered by hidden reserves subject to domestic tax.

2.5 Imposed Limits on Deduction of Interest

German tax law provides interest barrier regulations. Interest expenses may be deducted without restriction up to the amount of interest income obtained in the same business year; amounts in excess are only deductible up to the amount of 30% of EBITDA. This restriction does not apply if interest income does not exceed EUR3 million each business year, or if the company is only partially part of a group of companies (the "standalone clause"), or if an equity comparison shows an equity equal to or higher than the equity of the group of companies (the "escape clause").

The standalone clause does not apply to corporations in the case of harmful debt financing (interest payable to the shareholder exceeding 10% of such interest payable that exceeds interest income) by shareholders/persons related to shareholders/third parties with considerable influence on shareholders holding more than 25% of shares in the corporation. The escape clause is not applicable in the case of harmful debt financing within the whole group of companies. Interest exceeding the 30% threshold may be carried forward indefinitely, except in the case of the sale of more than 50% of the shares within five years.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping (*Organschaft*) enables groups of companies to offset the losses and profits within a group of subsidiaries against the profits of their parent company (and profits transferred to the parent company from other subsidiaries). It requires that:

- the parent company holds the majority of voting rights in the subsidiary;
- the parent company has unlimited tax liability in Germany; and
- a profit transfer agreement has been concluded and executed for at least five years prior.

However, it should be noted that the parent company is also liable for the losses of its subsidiaries.

2.7 Capital Gains Taxation

Effectively, 95% of capital gains deriving from the sale of shares in other corporations are tax exempt, resulting in an effective tax rate of 1.5%. However, from time to time it is discussed that the tax exemption for capital gains will only apply for shareholdings of at least 10% in future.

2.8 Other Taxes Payable by an Incorporated Business

If immovable property is transferred, real estate transfer tax (RETT) becomes due. The applicable tax rate depends on the question of where the immovable property is situated in Germany and varies between 3.5% and 6.5%. If at least 95% of the shares in a corporation or, similarly, at least 95% of the partnership interest in a partnership owning real estate situated in Germany is directly or indirectly transferred to one purchaser or a group of related parties, then the transaction could trigger RETT. Furthermore, if at least 95% of the partnership interest in a partnership owning real estate situated in Germany is directly or indirectly transferred to new shareholders within five years, RETT could be triggered.

There is currently a draft law that contains the following changes:

- to lower the thresholds to 90%;
- to extend the period for partnerships from five to ten years; and
- to apply that ten-year period to corporations as well.

The original plan was to implement them on 1 January 2020.

However, the federal government has suspended the implementation of these changes. It is expected that they will be discussed again during 2021.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are generally subject to VAT; however, they are usually able to claim input VAT as well.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses are mostly structured as limited liability companies (GmbH) or as limited partnerships with a limited company as general partner (GmbH & Co. KG).

3.2 Individual Rates and Corporate Rates

If an individual professional does not intend to retain the profits of the corporation, but instead pay out the profits, by way of either salary or dividends, then they face an overall tax burden of up to 50% – in the case of dividends, this is split into two levels: corporate/trade tax at the level of the corporation as well as individual tax at a flat rate. Thus, there is no benefit.

3.3 Accumulating Earnings for Investment Purposes

There are no measures in place to prevent closely held corporations from accumulating earnings for investment purposes. The retained earnings of corporations are taxed at a lower rate than distributed profits.

3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no special taxation rules for closely held corporations; the general rules apply (see below).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Where shares are part of the private assets of an individual, dividends are taxed with a flat tax rate of 25% with an additional 5.5% solidarity surcharge, resulting in a final valid tax rate of 26.375%. Capital gains on the sale of shares are also taxed at this flat tax rate if the individual's stake is below 1%.

The "partial-income procedure" (taxation of only 60% of proceeds at the progressive tax rate) is applicable if the stake equals or exceeds 1%, resulting in a maximum tax rate of approximately 30%. For the determination of income from capital gains, a lump sum of EUR801 is deducted generally.

If the stake is below 1%, regarding the offset of losses from capital gains, there are several restrictions – for example, only gains of the same kind of income may be offset. If the stake equals or exceeds 1%, there is no restriction regarding the offset of 60% of the losses from capital gains.

If the shares are part of the individual's business assets, the flat tax rate of 26.375% is replaced by the personal tax rate for both dividends and capital gains. However, only 60% of dividends for capital gains are taxed and only 60% of operating costs are deductible.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The withholding tax is principally levied on dividends at a rate of 26.375% (including a solidarity surcharge). Non-EU corporations with limited tax liability may request a reimbursement of two fifths (40%) of withheld tax so that the tax burden effectively amounts to 15.825% (including a solidarity surcharge) and is therefore equal to the tax burden for German corporations. The application of this regulation requires that the non-EU corporation is active within Germany. EU corporations that are subject to a limited tax liability benefit from the Parent-Subsidiary Directive. Under this directive, they may obtain a 100% tax exemption for dividends, provided that the parent company has held a direct stake of at least 10% in the subsidiary for a continuous period of 12 months or more. Certain activity requirements need to be met. Furthermore, withholding tax might be reduced as well, according to treaties.

The European Court of Justice (ECJ) ruled on 26 February 2019 in the context of the so-called Danish Cases that even if the criteria are met, no withholding tax exemption applies in the case of abusive structures. Whether a structure is classified as abusive depends on certain criteria (eg, conduit only).

Under current German law, an EU corporation must prove sufficient substance in the form of an equipped business and that the income was generated by its own economic activities. However, it should be noted that these requirements were recently declared to be not compliant with EU law by the ECJ. Nevertheless, German tax authorities still apply such rule. On 20 November 2020, a proposed new version of the rule was published as part of a draft law. This new regulation requires an own business activity of the company that does explicitly not apply in the case of a conduit situation (Danish Cases).

Only specific interest is subject to withholding tax; this includes profit-related interest, interest collateralised by real estate in Germany and exceptions such as interest resulting from "over-the-counter transactions" and interest attributed to other types of income.

In all other cases, interest income is not subject to limited tax liability and is therefore not subject to withholding tax. Interest paid from an EU corporation to an EU corporation may be tax exempt if the Interest and Royalties Directive is applicable.

Royalty payments are subject to limited tax liability and withholding tax at an amount of 15.825%, which is levied from the gross income.

4.2 Primary Tax Treaty Countries

Due to the favourable taxation measures granted to EU corporations, most foreign investors invest via EU member states. The most common tax treaty countries are the Netherlands and Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

German tax law has several anti-treaty-shopping clauses in order to prevent the abuse of tax treaties. German tax authorities therefore check whether an entity claiming for tax relief with reference to a tax treaty generates its income through its own activities and whether there are considerable reasons to act via the tax-privileged entity in question.

Furthermore, there are subject-to-tax clauses that prevent certain income from being taxed in neither of two treaty countries.

4.4 Transfer Pricing Issues

The main issue in tax audits regarding transfer pricing is ensuring compliance with the arm's-length principle. Other issues are the examination of the transfer pricing methodologies chosen, the assessment of the attribution of beneficial ownership in the companies' assets as declared, and ensuring the fulfilment of formal requirements when issuing the obligatory reports.

4.5 Related-Party Limited Risk Distribution Arrangements

All transactions within a group of companies must meet the requirements of the arm's-length principle.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Germany makes explicit reference to OECD standards in the circulars issued by the Federal Ministry of Justice and case law; furthermore, legal provisions, such as Section 1 of the Foreign Tax Act, are based on the OECD standards.

4.7 International Transfer Pricing Disputes

Germany has concluded double taxation treaties (DTAs) with 96 countries. Most of these DTAs follow the internationally used OECD Model Convention, which contains provisions on mutual agreement procedures (MAPs). More recent DTAs often contain provisions requiring arbitration to resolve the conflict following an unsuccessful MAP. About half of the MAPs are transfer pricing disputes and about 90% of these disputes are resolved by MAPs between the two states. MAPs are quite commonly used by the German tax authorities.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, German tax authorities scrutinise compensating adjustments critically and recognise them only subject to strict conditions. Consequently, compensating adjustments must be based on a previously agreed pricing method that is applied in predefined scenarios of uncertainty and leads to an "arm's-length" result.

The underlying Principles of Administrative Procedure have not been updated since 2005 and, despite international developments (eg, by the EU Joint Transfer Pricing Forum), an update is not expected in the near future. There are no reports on any particular difficulties in operating MAPs. On the contrary, based on recent MAP statistics of December 2017, only 1% of completed procedures involving Germany could not be settled. Hence, the overall operation of MAPs is deemed satisfactory.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Generally, there are no differences between local branches of non-local corporations and local subsidiaries of non-local corporations; however, in practice, there are usually problems, or at least discussions, regarding the allocation of income/expenses and assets.

5.3 Capital Gains of Non-residents

Capital gains of non-residents on a sale of stock in local corporations are taxed if the shareholding is at least 1%. However, the tax treaties usually eliminate such taxation.

5.4 Change of Control Provisions

A change of control might result in the forfeiture of tax losses carried forward in the case of a change of at least 50% of the shareholding (see **2.4 Basic Rules on Loss Relief**).

Furthermore, RETT could be triggered by certain transactions with corporations/partnerships owning real estate (see **2.8 Other Taxes Payable by an Incorporated Business**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no specific formulas used to determine the income of foreign-owned local affiliates selling goods or providing services, but it must be ensured that the determination follows the arm's-length principle.

5.6 Deductions for Payments by Local Affiliates

There are no specific rules regarding deductions for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. However, in general, the arm's-length principle and the transfer pricing rules must be taken into consideration.

5.7 Constraints on Related-Party Borrowing

Any borrowing between related parties must comply with the arm's-length principle. The granting by a local affiliate of an interest-free loan or of one with an interest below market standards may result in a hidden profit distribution. In comparison, a loan granted with an interest that is above market standards may result in a hidden contribution.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

In principle, the worldwide income of local corporations is taxed in Germany. The part of the income of a local corporation that originates from foreign sources that are taxed in the state of source with a tax comparable to German corporate tax is taxed in Germany, taking into account the tax paid abroad. If a double tax treaty applies, the regulations laid down there have priority. A 95% tax exemption applies for dividends and capital gains from foreign sources if the shareholding is at least 10% (for corporate income tax) and 15% (for trade tax).

For controlled foreign corporation (CFC) taxation, see **6.6 Rules Related to the Substance of Non-local Affiliates**.

6.2 Non-deductible Local Expenses

If foreign income is tax exempt in Germany, corresponding expenses that are economically directly connected to such income are not deductible in Germany.

6.3 Taxation on Dividends from Foreign Subsidiaries

Under German tax law, for income to qualify as dividend income, the same rules apply regardless of the origin of the dividends from foreign or local sources. Thus, under income tax aspects, 95% of dividend income is tax exempt, except dividend income deriving from free float below 10%.

For trade tax, the tax exemption for proceeds resulting from foreign subsidiaries is granted if the local corporation holds at least 15% of the subsidiary. Under certain provisions (especially activity), even a sub-subsidiary may benefit from this privilege.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles may be transferred or let (royalties) at arm's-length conditions resulting in taxable income (transfer price or royalties) at regular rates.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Generally, passive low-taxed income of non-local subsidiaries (dominated by Germans) is taxed in Germany.

The income is added to that of the local corporation and is then subject to regular German tax rules. In the case of passive investment income, the income will be taxed in Germany even in cases where German shareholding is 1% or below.

On 17 November 2020, a draft law was published, containing several significant adjustments to the CFC taxation regime. However, this draft law is still under discussion.

6.6 Rules Related to the Substance of Non-local Affiliates

German CFC rules do not generally relate to the substance of non-local affiliates. However, the carve-out from CFC rules that is provided for EU corporations requires – besides other conditions – that the non-local affiliate carries out an actual economic activity.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

The gains made by local corporations on the sale of shares in non-local affiliates enjoy the same 95% tax exemption as granted for the sale of shares in local subsidiaries. However, for trade tax purposes, this requires that the non-local affiliate carries out only or almost only an active activity. Furthermore, it is still under discussion as to whether to apply the tax exemption for capital gains only for shareholdings of at least 10% in future. To date, no concrete steps have been planned.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Section 42 of the General Tax Code provides for a general anti-avoidance rule that applies in the case of abusive tax structures. On the level of the EU, the Anti-Tax Avoidance Directive (ATAD) establishes a common minimum level of anti-avoidance rules that every member state has to ensure compliance with.

Beginning 1 July 2020 Germany has implemented a mandatory disclosure regime for cross-border arrangements, if one or more specified characteristics (hallmarks) are met and concern either more than one EU country or an EU country and a non-EU country (DAC 6). These hallmarks are aimed at aggressive tax avoidance structures, but are drafted much more broadly, hence non-tax motivated transactions may also be caught. If one or more hallmarks are met, the person or company who markets, designs or organises a cross-border tax arrangement or makes these arrangements available for use by third parties (intermediary) has several reporting obligations. Failure to comply with these rulings could lead to significant sanctions under local law.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no audit cycle prescribed by law. However, audits generally tend to take place once every three to four years.

9. BEPS

9.1 Recommended Changes

At year-end 2016, the BEPS 1 Implementation Act passed the German legislation process. This was the first step to implement the recommendation of the BEPS process into domestic law.

BEPS Action 13

The BEPS 1 Implementation Act leads to an extension of co-operation obligations in cross-border situations that is based on BEPS Action 13 – Transfer Pricing Documentation and Country-by-Country Reporting. As a result, the transfer pricing documentation now consists of:

- a master file;
- a country-specific and company-related local file; and
- a country-specific country-by-country report.

Furthermore, the information exchange standards and reporting obligations arising from the amendments to the EU Mutual Administrative Cooperation Directive have been implemented into German law. The amended transfer pricing documentation rules are applicable for the first time to fiscal years starting after 31 December 2016.

BEPS Action 5

As of 1 January 2017, tax rulings (ie, advance cross-border rulings and advance pricing arrangements) issued, reached, amended or renewed after 31 December 2014 must be automatically exchanged amongst the EU member states. These amendments take the recommendations made in BEPS Action 5 – Measures to Counter Harmful Tax Practices – into account.

Furthermore, Germany has introduced a provision to limit the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (such as intellectual property, licence or patent boxes) that are incompatible with the OECD nexus approach of BEPS Action 5 – Measures to Counter Harmful Tax Practices.

Additionally, the BEPS 1 Implementation Act introduced a new regulation into domestic law in order to prevent double taxation of business expenses (ie, double deduction) for partnerships effective from 1 January 2017.

OECD Multilateral Instrument

Germany also signed the OECD Multilateral Instrument (MLI) in June 2017. As a first step, Germany would like to amend over 30 of its 96 double tax treaties, provided that the other countries agree. In November 2020, the MLI was introduced as part of a national legislative procedure; however, the implementation law only covers 14 double taxation treaties. In compliance with the recommendation of BEPS Action 12 and the EU Directive on Administrative Cooperation in the field of taxation, the German government managed to implement an obligation to notify cross-border tax arrangements into national law within the set deadline of 31 December 2019 (see **7.1 Overarching Anti-avoidance Provisions**).

EU Anti-Tax Avoidance Directive

Since the end of 2019, the Federal Ministry of Finance has been working on the implementation of the EU Anti-Tax Avoidance Directive; on 24 March 2021, the federal government passed a draft law.

9.2 Government Attitudes

The broad implementation of the recommendations and standards of the BEPS project is explicitly mentioned in the 2018 coalition agreement of the German governmental parties. The German government has ever since fully supported the BEPS project and Germany played a prominent role in the project, both politically and professionally.

As Germany already has comparably strict tax laws, the intention of the German government with regard to BEPS is, in particular, to enforce stricter international taxation standards in the EU and other countries in order to achieve fair tax competition between countries. Due to his aspirations to become the new chairman of his party, the current Minister of Finance is under considerable pressure to succeed, which may accelerate legislative procedures and hence the implementation of the BEPS measures.

9.3 Profile of International Tax

There is public concern as to whether the current applicable international tax law is able to keep up with the challenges of globalisation or enables tax avoidance and allows base erosion and profit shifting advantages. The discussion was sparked in 2012 by media reports of Starbucks avoiding taxes on a large scale in the UK and was then extended to global IT firms and swept over other EU countries.

Developments such as "the Luxembourg Leaks" and "the Panama Papers" particularly influenced public and political discussions on aggressive tax structures (such as intellectual property boxes) and underlying tax rulings, which led to tax rates of less than 5%. As a result, not only the German business and political press but also the tabloids frequently reported about such developments. However, neither the BEPS project nor the implementation of its recommendations receives significant media attention.

9.4 Competitive Tax Policy Objective

As a strong export country, Germany does not pursue a competitive tax policy objective. In fact, Germany has already introduced anti-abuse and CFC rules in order to limit base erosion and profit shifting. As a result, Germany seeks to achieve international standards for fair and realistic tax competition.

9.5 Features of the Competitive Tax System

Germany does not have a competitive tax system that might be particularly affected by anti-BEPS measures.

9.6 Proposals for Dealing with Hybrid Instruments

Hybrid instruments have mainly been used in Germany for cross-border financing. Meanwhile, Germany has implemented a domestic anti-abuse rule (the "correspondence principle") for interest income and dividend payments from hybrid instruments of foreign corporations that is applicable as of the 2014 assessment year. Furthermore, the very same correspondence principle has been considered in the EU Parent-Subsidiary Directive.

In line with the BEPS 1 Implementation Act, a separate regulation to prevent double deduction of business expenses for partnerships has been introduced into Germany domestic law, effective from 1 January 2017. The recommendations of BEPS Action 2 have been largely incorporated into the EU Anti-Tax Avoidance Directive 2 (ATAD 2). On 17 November 2020, the German Federal Ministry of Finance submitted a new draft legislation on the deduction of operating expenses with regard to hybrid structures in line with the provisions of ATAD 2. The current draft legislation has not been passed by the German government, but this is expected in the course of 2021.

9.7 Territorial Tax Regime

The German tax regime is not territorial but residence-based. Germany generally taxes worldwide income, subject to tax treaties that usually exempt interest income of foreign shareholders from taxation. Originally, this was the reason for introducing thin capitalisation rules. However, the interest deduction limitation rules far exceed this scope and cover national structures as well. See **2.5 Imposed Limits on Deduction of Interest**.

9.8 CFC Proposals

With respect to EU law, conflicts may be looming with the general drift of the CFC proposals, particularly with regard to the freedom of establishment. The ECJ has decided in the case of Cadbury Schweppes that CFC rules unjustifiably restrict the freedom of establishment, unless the specific objective of a CFC rule is to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out in national territory. Thus, the case law of the ECJ has limited the application of CFC rules. It is questionable whether the BEPS proposals consider this fact.

Apart from that, German tax law already provides for strict CFC rules for offshore subsidiaries whose passive income is taxed at a "low rate" of less than 25%. On 23 March 2021, a draft law was published, containing several significant adjustments to the CFC taxation regime. Among others, the concept of domestic control will be replaced by the concept of related parties for the determination of CFC taxation. In addition, distributions can be classified as passive income under certain conditions (eg, shareholding below 10%). However, this draft law is still under discussion.

9.9 Anti-avoidance Rules

To address the inappropriate granting of treaty benefits and other potential treaty abuse scenarios, Germany implemented domestic "anti-treaty shopping rules" several years ago. According to these regulations, benefits will not be granted if a company's main purpose is to gain access to advantageous conditions derived from DTC and/or EU directives (eg, the EU Parent-Subsidiary Directive). Furthermore, domestic subject-to-tax clauses to prevent under-taxation and non-taxation due to DTC or EU directive benefits and CFC rules are in place. Thus, German tax law already provides adequate regulations to address the abuse of benefits and tax avoidance in general.

9.10 Transfer Pricing Changes

Transfer pricing matters for intellectual property are a crucial issue for companies and advisers in Germany, as the evaluation, benchmarking and documentation of intellectual property are always challenged in German tax audits.

As a result of the transfer pricing documentation concept with the implemented country-by-country reporting, as well as the master file and the local file, intellectual property must be documented more extensively. Therefore, comments must be made regarding the creation, beneficial ownership, chances and risks, etc of intellectual property. The concept does not radically change things; however, intellectual property will be more transparent for tax authorities in Germany and other countries. Consequently, there are certain concerns that this could lead to more challenging tax field audit procedures, including income corrections in Germany and other countries.

9.11 Transparency and Country-by-country Reporting

Due to German transfer pricing reporting and documentation requirements, a certain transparency with regard to intercompany cross-border transactions already existed prior to the BEPS project. Furthermore, there are disclosure obligations if a German tax resident (an individual or a legal entity) establishes permanent enterprises or partnerships abroad or acquires shares in foreign corporations.

In connection with the country-by-country reporting that has been implemented by the BEPS 1 Implementation Act, concerns must be raised, as companies will face further significant administrative barriers in the future. Finally, increased bureaucracy is to be expected due to the new disclosure obligations for cross-border tax arrangements based on BEPS Action 12 (see **9.1 Recommended Changes**).

9.12 Taxation of Digital Economy Businesses

Prompted by BEPS Action 1, the EU Commission adopted two legislative proposals in March 2018 relating to the taxation of digital activities in the EU. One of the two draft directives seeks to reform corporate tax rules so that profits are registered and taxed where businesses have significant interaction with users through digital channels. The 2018 coalition agreement of the current German governmental parties is generally supportive of an adequate taxation of the digital economy. However, the EU draft directive relating to the taxation of digital economy businesses has not been adopted yet and no German draft legislation has yet been published to this effect.

9.13 Digital Taxation

The second legislative proposal relating to the taxation of digital activities that was adopted by the EU Commission in March 2018 (see **9.12 Taxation of Digital Economy Businesses**) sought to impose an interim digital tax but was rejected at the EU finance ministers' meeting in March 2019. As one of the opposing EU members, Germany had rejected the proposed European digital tax in order not to pre-empt an international solution at G20 level in 2020; the USA withdrew from negotiations on a digital tax with the EU in June 2020. Should the efforts at an international level fail, Germany is considering a European or even national solution.

9.14 Taxation of Offshore IP

As of January 2018, Germany has restricted the tax deductibility of licence fees or royalty payments to foreign-related parties that benefit from preferential tax regimes (ie, licence or patent boxes) in order to discourage harmful tax practices relating to offshore intellectual property. This restriction, however, does not apply if a preferential tax regime is compliant with the nexus approach of BEPS Action 5 and hence requires a sufficient degree of substance and research activity on the part of the licensor.

POELLATH is an internationally operating firm, with more than 150 lawyers and tax advisers providing high-end advice in Berlin, Frankfurt and Munich. More than half of its professionals specialise in the tax implications of the firm's primary areas of expertise: transactions, asset management and private equity. It is particularly renowned for its close combination of tax and legal advice regarding all the main practice areas of POELLATH, such as M&A, private equity, real estate transactions and family businesses. Corporate tax services include the structuring of national and international M&A and subsequent reorganisations, corporate tax planning and the structuring of national and international groups of companies, and the application and interpretation of double taxation treaties.

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GIBRALTAR

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form that has a separate legal personality and is taxable as a separate legal entity. The 2014 Companies Act allows for the incorporation of both private companies and public companies.

Private Company

A private company under Gibraltar law is one that restricts the right to transfer its shares and does not offer its shares to the public. The following four types of private companies may be incorporated under Section 4(2) of the 2014 Companies Act:

- a company limited by shares;
- a company limited by guarantee and having share capital;
- a company limited by guarantee and not having share capital; and
- an unlimited company with or without share capital.

Public Company

A public company under Gibraltar law is one whose certificate of incorporation states that it is a public company, has share capital and meets the requirements of the 2014 Companies Act in terms of share capital and net assets.

Two types of public companies may be incorporated under Section 4(1) of the 2014 Companies Act:

- a company limited by shares; and
- a company limited by guarantee and having share capital.

Shares of different classes are permitted, including preference and redeemable shares, and shares with limited or no voting rights. Shares of no par value, however, are not permitted.

Gibraltar companies need only one shareholder. Nominee shareholdings are permitted. The names of registered shareholders must be included in the annual report filed with the Registrar of Companies, which is available for public inspection.

There are no formal minimum capital requirements, and it is possible for an entity to have an authorised share capital in most major currencies (including USD, EUR, GBP, etc).

1.2 Transparent Entities

Limited Partnership

Limited partnerships are commonly used and are regulated by the Limited Partnerships Act 1927. Under Gibraltar law, a limited partnership must consist of one or more general persons or "general partners" (who are liable for all debts and obligations of the limited partnership and responsible for its management), and one or more persons called "limited partners" (at the time of entering such a partnership, the limited partners must contribute either a sum or sums as capital or property valued at a stated amount, and their liability to creditors is limited to the capital that they have introduced). Accordingly, this vehicle is typically used in order to limit the liability of limited partners and in some tax planning structures.

In October 2020 a Bill was published, which, once passed by Parliament, will repeal the Limited Partnerships Act 1927 and replace it with the Limited Partnerships Act 2020. Amongst other things, this will provide for:

- the interests of limited partners being represented by shares, bonds, notes, loans or other debt securities or instruments;
- limited partners undertaking a more active role in the affairs of the limited partnership without forfeiting their limited liability; and
- general partners being able to elect whether or not the limited partnership is to have legal personality.

A Protected Cell Limited Partnerships Bill was also published in October 2020. Once this is passed by Parliament and becomes law, it will allow funds to use limited partnerships to create one or more cells in order to protect and segregate cellular assets from non-cellular assets and to keep each cell separate and separately identifiable from other cells.

Limited partnerships are generally treated as transparent for taxation; as such, the partners are the taxable persons in respect of their share of taxable income generated by the partnership.

Limited Liability Partnership

Limited liability partnerships are regulated under the Limited Liability Partnerships Act 2009. All of the partners in a limited liability partnership benefit from limited liability in respect of the partnership. Their liability is limited to funds they have invested in the partnership, undrawn profits and any guarantees they have given to raise finance. All of the partners may participate in its management.

Limited liability partnerships are generally treated as transparent for taxation; as such, the partners are the taxable persons in respect of their share of taxable income generated by the partnership.

Trust

A popular vehicle in tax planning is the Gibraltar trust, which is based on the English trust and is mainly regulated by the Trustees Act.

The trustees of a trust are chargeable for tax on any taxable income of the trust.

Private Foundations

The Private Foundations Act 2017 provides the legal framework for the establishment and operation of foundations. A foundation has a separate legal personality and, as such, can hold property in its own right, as the absolute and beneficial owner. The Foundation Charter and Foundation Rules establish the foundation and set out its purposes and the rules for its administration. They also set out the details of the beneficiaries and the guardian. The founder provides the initial assets as an irrevocable endowment, and may reserve powers for him or herself, such as the ability to appoint or remove the Guardian or Councillors, or to amend the constitution.

A foundation is not transparent for tax purposes; any taxable income of a foundation is chargeable on the foundation itself.

1.3 Determining Residence of Incorporated Businesses

A company is ordinarily resident in Gibraltar if it is managed and controlled in Gibraltar, or if it is managed and controlled outside Gibraltar by persons that are ordinarily resident in Gibraltar. "Managed and controlled" refers to the highest level of oversight, generally determined in accordance with UK case law on the matter. There is no separate concept of "residence" as opposed to ordinarily resident.

A trust is resident in Gibraltar if one or more of the beneficiaries is ordinarily resident in Gibraltar, or if the class of beneficiaries (other than those irrevocably excluded from benefit) includes an individual who is ordinarily resident in Gibraltar.

A foundation is resident in Gibraltar unless persons who are ordinarily resident in Gibraltar and the issue of such persons have been irrevocably excluded from benefit.

1.4 Tax Rates

Corporate Tax

All companies are chargeable for taxable profits at a rate of 10%, except for utility, energy and fuel supply companies and companies deemed to be abusing a dominant market position, which are subject to tax at a rate of 20%. Profits or gains of a company are only taxable if the income is "accrued in or derived from" Gibraltar (see **2.1 Calculation for Taxable Profits**).

Transparent Entities

Partnerships, limited partnerships and limited liability partnerships are treated as transparent entities for the purposes of taxation. As such, their partners – whether corporate entities or individuals – are assessable for tax on any taxable profits that are generated by the partnership. The tax rates that apply are those that apply to the partners – ie, either corporate rates as described above, or personal tax rates that apply to them as individuals, as described below.

Trusts and Foundations

Trusts and foundations are treated in a very similar manner for tax purposes, albeit that in the case of a trust it is the trustee that is chargeable for tax in respect of the trust. Any taxable profits or gains of a trust or foundation are taxed at a rate of 10%.

Individual Tax

Individuals are taxable at different tax rates, depending on the level of taxable income and the tax status of the individual. The effective (overall) tax rate never exceeds 25% (the exceptions to this are a non-resident's rental income from property located in Gibraltar, and the income of a "Category 2" individual from employment, business or rental income from Gibraltar; Category 2 is a special tax status that must be applied for).

Capital Gains Tax

Neither individuals nor companies are taxed on capital gains.

Withholding Tax

Withholding tax is not imposed on the payment of interest or dividends.

Stamp Duty

On share or loan capital transactions, the fixed amount per transaction is GBP10.

The following percentages of stamp duty apply to the first and second-time purchase of residential real estate in Gibraltar:

- first GBP260,000 of purchase price: 0%;
- balance from GBP260,001 to GBP350,000: 5.5%; and
- balance above GBP350,000: 3.5%.

For other buyers of real estate in Gibraltar:

- purchase price of up to GBP200,000: 0%;
- purchase price between GBP200,001 and GBP350,000: 2% on first GBP250,000, and the balance at 5.5%; and
- purchase price over GBP350,000: 3% on first GBP350,000, and the balance at 3.5%.

Tax on Sale of Shares

Tax is not payable on the transfer of shares in a Gibraltar company unless that company owns Gibraltar real estate (directly or indirectly), in which case stamp duty would generally apply on the underlying real estate.

Dividends

Withholding tax is not imposed on the payment of dividends. Dividends paid to shareholders who are ordinarily resident in Gibraltar have a tax credit equal to the tax paid by the company on the profits from which the dividend is being paid. Dividends received by a company from another company are not taxable.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are generally calculated on an accruals basis; they are based on Gibraltar, UK or international accounting standards, or other such accounting standards as approved by the Commissioner of Income Tax, and then subject to any adjustments according to specific provisions in the Income Tax Act 2010.

Adjustments include the following:

- non-deductibility of certain costs, such as depreciation and amortisation;
- costs not incurred wholly and exclusively in the production of income;
- taxation charged in Gibraltar on profits;
- certain entertaining expenses;
- restrictions on the deductibility of costs incurred in respect of connected companies where not on an arm's-length basis; and
- capital losses.

Adjustments are also made for income not assessable for taxation, such as many types of investment income (including dividends and bank interest) and capital gains.

Gibraltar taxes corporations on a territorial basis, so any income that is not accrued in or derived from Gibraltar is not assessable to tax in Gibraltar. "Accrued in or derived from" is defined in terms of the location of the activities giving rise to the profits. Generally, this is interpreted by reference to case law, mostly from Hong Kong, applied to the relevant facts and circumstances. Exceptions to this are inter-company interest income (Class 1A) and royalty income, which are deemed to be accrued in and derived from Gibraltar where the company receiving the income is registered in Gibraltar. Also, where a company's underlying activity requires a licence and regulation in Gibraltar, its activities are deemed to be located in Gibraltar, with the exception of the overseas activities of a branch or permanent establishment located overseas.

2.2 Special Incentives for Technology Investments

There are no special incentives for technology investments.

2.3 Other Special Incentives

There are no special incentives that apply to specific industries, transactions or businesses.

2.4 Basic Rules on Loss Relief

Losses can be carried forward indefinitely against future profits of the same company, unless there is both a change in ownership of the company and a major change in the nature or conduct of the activities of the company, within a period of three years. Losses cannot be carried back.

A budget measure was announced by the Gibraltar government in July 2018 that would allow companies to carry forward losses against a business's future profits when the business has been transferred to another company as part of a group restructure. This would only apply where there is no change in ultimate ownership and no change of business within a period of three years. A Bill to amend the Income Tax Act 2010 to put this into effect as from 1 July 2018 was published in November 2020, but has not yet been passed by Parliament.

2.5 Imposed Limits on Deduction of Interest

The general rule for expenses is that, unless the Act states to the contrary, they are deductible if they are wholly and exclusively incurred for the purposes of the income of a trade, business, profession or vocation.

A literal interpretation of the legislation would be that interest expense is not deductible against non-trading interest income (ie, interest on inter-company loans and advances, which, although taxable, is not trading income). Established practice is that this restriction does not apply if the interest income is taxable, on the basis that this was not the intention of the restriction (the restriction pre-dates the introduction of inter-company interest as a taxable class of income, but it was not amended when that class of income was introduced).

A deduction is not allowed for any interest paid or payable to a person not resident in Gibraltar if, and so far as, it is interest at more than a reasonable commercial rate.

A deduction is not allowed for any interest paid or payable on money borrowed other than for the purposes of the trade or profession that generates the income, or for acquiring the capital employed in acquiring the trade or profession that generates the income.

Where a person (eg, an individual or a company) has interest income that is not taxable, no deduction is allowed for any interest expense incurred for the purpose of generating the interest.

Interest paid to a connected party in excess of an arm's-length amount may be:

- deemed to be a dividend paid by the person, and received by the connected party; and
- not a deductible expense.

As well as the general arm's-length rule, thin capitalisation rules apply in limited circumstances, again where interest exceeds an arm's-length amount:

- where a company pays interest to a connected party that is not a company; and
- in the case of interest paid by a company to an unconnected party, where the loan is secured on assets belonging to a connected party who is an individual.

In such cases, the interest will be treated as a dividend paid by the company to the connected individual if the loan capital to equity ratio is greater than five to one. There is an exception for credit institutions or deposit takers regulated under the Banking Act. Regardless of accounting treatment, preference shares are treated as equity for the purposes of the thin capitalisation rules.

Where a person pays interest to an arm's-length lender (eg, a bank loan) and a substantial part or all of the loan is secured by a cash deposit made with the lender, or a connected person of the lender, or by a person connected to the borrower, or secured by certain investments, and the income from those cash deposits or investments is not taxable, then the interest will not be deductible.

Gibraltar has implemented the EU Anti-Tax Avoidance Directive (2016/1164), which contains interest limitation rules that in Gibraltar apply to accounting periods commencing on or after 1 January 2019. Financial undertakings and standalone entities are excluded from the scope of the rules. For entities within the scope of the rules, a deduction for interest is restricted to 30% of earnings before interest, tax, depreciation and amortisation (EBITDA) or EUR3 million (the latter being for the entire group), whichever is greater. This does not apply to loans contracted prior to 17 June 2016 (excluding any subsequent modifications to such loans), nor to certain long-term public infrastructure projects. Excess (non-deductible) borrowing costs may be carried forward indefinitely. Unused interest capacity in a given tax period may be carried forward for a maximum of five years.

2.6 Basic Rules on Consolidated Tax Grouping

There is no provision in Gibraltar legislation for tax consolidation or group relief.

2.7 Capital Gains Taxation

Capital gains (and losses) are outside the scope of taxation in Gibraltar.

2.8 Other Taxes Payable by an Incorporated Business

Other taxes that may be payable on a transaction include:

- property rates, based on the rateable value of property; and
- stamp duty, payable on the acquisition of real estate in Gibraltar at between nil and 3.5% overall; it is also payable on the issue or increase of authorised share capital or the issue of loan capital at a nominal amount of GBP10 per transaction.

2.9 Incorporated Businesses and Notable Taxes

Gibraltar has implemented the exit tax provisions contained in EU Directive 2016/1164, which applies an exit tax to the transfer of assets, business or residence from Gibraltar to another jurisdiction. A transfer of assets is defined as occurring for this purpose when Gibraltar loses the right to tax the assets in question, whilst the assets remain under the ownership of the same taxpayer. The tax is applied to the difference between the market value of such assets transferred, minus their value for tax purposes.

The fact that this does not apply to transfers from one legal entity to another, and that it only applies where there may have been assessable income arising from the assets in question, means that the exit tax is not expected to arise frequently. Instances where it is more likely to arise would include re-domiciliations of companies out of Gibraltar, or a move of a company's residence from Gibraltar to another jurisdiction.

Incorporated businesses are not subject to any other notable taxes.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form.

3.2 Individual Rates and Corporate Rates

Employees are required to be taxed at source under the Pay As You Earn (PAYE) system. There are no specific rules to stop self-employed professionals generating income through a company; however, where the facts and circumstances indicate that an individual is in substance an employee, the employer is required to treat them as such for PAYE purposes.

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules to stop closely held corporations from accumulating earnings for investment purposes. There are general anti-avoidance provisions, however, which apply to transactions or arrangements deemed to be artificial or fictitious.

3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no specific rules that apply in this respect to closely held corporations.

Ordinarily resident individuals are taxed on dividends at normal personal tax rates, with a tax credit given for Gibraltar tax suffered by a company in generating the profits being distributed. Generally, only dividends that represent the distribution of profits that were taxable in Gibraltar on the underlying company that generated those profits are taxable on the individual once distributed. There are specific rules that determine how a dividend is allocated to historic profits and between profits that were taxable and non-taxable on the company.

Persons not ordinarily resident in Gibraltar are not taxable in Gibraltar on dividends received.

Capital gains are outside the scope of taxation in Gibraltar, so the gain on a sale of shares would not be taxable, subject to the general anti-avoidance provisions that apply to transactions or arrangements deemed to be artificial or fictitious.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends from a company whose shares are quoted on a recognised stock exchange are not taxable. Capital gains are outside the scope of taxation in Gibraltar, so the gain on a sale of shares would not be taxable.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

There is no withholding tax on dividends, interest or royalties.

4.2 Primary Tax Treaty Countries

A double tax treaty was agreed with the United Kingdom in 2019 and entered into force on 24 March 2020.

A double tax agreement was signed between Spain and the United Kingdom concerning Gibraltar taxation and other financial matters in 2019, and ratified in the United Kingdom and Spain in March 2021. Under the terms of the agreement, it is therefore now in force although some of its provisions do not actually take effect until the start of the following tax year in the respective jurisdictions (namely 1 July 2021 for Gibraltar and 1 January 2022 for Spain).

No other double tax treaties or agreements are in place with Gibraltar.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Gibraltar's double tax treaty with the United Kingdom entered into force in 2020 and its double tax agreement with Spain entered into force in March 2021 (save that, for the latter, some provisions do not take effect until the following tax year in each jurisdiction). Gibraltar has no double tax treaties or agreements in place with any other jurisdiction. It is too early to comment on whether local tax authorities are likely to challenge the use of treaty country entities by non-treaty country residents.

4.4 Transfer Pricing Issues

There is currently relatively little focus on transfer pricing by the Gibraltar tax authorities, given the relatively low tax rate in Gibraltar (therefore, there is usually little incentive to bias pricing to the detriment of profits in Gibraltar). If issues arise, they generally concern significant management and similar charges from overseas group companies, and head office charges to branches in Gibraltar.

There is likely to be more focus on transfer pricing as a result of the Organisation for Economic Co-operation and Development's (OECD) initiatives on Base Erosion and Profit Shifting (BEPS), and the forthcoming implementation of legislation following such initiatives.

4.5 Related-Party Limited Risk Distribution Arrangements

There are no provisions in the legislation specifically regarding related party limited risk distribution arrangements, nor is it an area on which the Gibraltar tax authorities tend to focus.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Gibraltar's legislation provides that its general anti-avoidance provisions shall be construed in a manner that best secures consistency between those provisions and publications by the OECD. The Commissioner may apply general anti-avoidance powers where a transaction or arrangement is artificial or fictitious. The definition of "artificial and fictitious" makes reference to being inconsistent with OECD Transfer Pricing guidelines. However, to date there has been relatively little focus on OECD transfer pricing rules.

It seems likely that more specific legislation will be implemented at some point in the future that is in line with the OECD's BEPS initiatives.

4.7 International Transfer Pricing Disputes

Gibraltar's double tax treaty with the United Kingdom entered into force in 2020 and its double tax agreement with Spain entered into force in March 2021 (save that, for the latter, some provisions do not take effect until the following tax year in each jurisdiction). Gibraltar has no double tax treaties or agreements in place with any other jurisdiction. The tax authorities in Gibraltar issued guidance on the use of mutual agreement procedures in March 2020. However, given the recent entry into force of Gibraltar's only respective double tax treaty and agreement, no international transfer pricing disputes have been known to be resolved through the double tax treaty in place, nor through mutual agreement procedures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

There is very limited application of specific transfer pricing mechanisms.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

The income of any company – whether a Gibraltar company or an overseas company – falling within any of the taxable classes of income is assessable for tax if it is accrued in or derived from Gibraltar (see **2.1 Calculation for Taxable Profits**).

Important points to note regarding branches include the following:

- there is an automatic restriction on the deduction available for head office expenses (as defined in the Income Tax Act 2010) to 5% of the gross income of the Gibraltar branch; and
- the Commissioner of Income Tax has previously stated that if a branch is registered in Gibraltar, then the company to which the branch pertains is treated as being "registered in Gibraltar" for the purposes of inter-company interest (Class 1A). Inter-company interest and royalty income are deemed to be accrued and derived from Gibraltar and are therefore subject to tax in Gibraltar where a company is registered in Gibraltar. Consequently, if an overseas company has a branch in Gibraltar, this may result in the interest and royalty income of the company being taxable in Gibraltar. Unilateral double tax relief is available, subject to conditions.

5.3 Capital Gains of Non-residents

Capital gains are outside the scope of tax in Gibraltar.

5.4 Change of Control Provisions

Stamp duty is payable on the transfer of ownership of real estate located in Gibraltar, even where such ownership is indirectly held through intermediate holding companies.

A change in control – direct or indirect – can result in tax losses not being available for set-off against future profits, where there is both a change in ownership of the company and a major change in the nature or conduct of the activities of the company, within a period of three years.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are not used by the tax authorities to determine the income of foreign-owned local affiliates (though a taxpayer could of course decide to base their transfer pricing on a formula).

5.6 Deductions for Payments by Local Affiliates

Where a company incurs expenses in favour of a connected party and the Commissioner regards the arrangements as being in place in order to reduce taxation, there is a restriction on the deduction for such expenses. That restriction is either 5% of turnover (as defined) or 75% of the profit before taking the expenses in question into account, whichever is lower.

There is an automatic restriction on the deduction available to branches for head office expenses (as defined in the Income Tax Act 2010) of 5% of the gross income of the branch.

5.7 Constraints on Related-Party Borrowing

A deduction is not allowed for any interest paid or payable to a person not resident in Gibraltar if, and so far as, it is interest at more than a reasonable commercial rate.

For other restrictions on the deductibility of interest expense, see **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Income not accrued in or derived from Gibraltar is not taxable (see **2.1 Calculation for Taxable Profits**), subject to CFC rules (see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**).

6.2 Non-deductible Local Expenses

Expenses that are not wholly and exclusively incurred in the production of taxable income are treated by the tax authorities as non-deductible. Therefore, local expenses attributed to exempt foreign income would not be deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by a company from another company are exempt from tax. In addition, dividends that represent the distribution of profits that were not subject to tax in Gibraltar on the underlying company that generated those profits are not assessable for tax.

6.4 Use of Intangibles by Non-local Subsidiaries

In practice, intangibles can be developed by local corporations to be used tax-free by non-local subsidiaries, as the tax authorities are unlikely to deem there to be royalties or fees for tax purposes when no royalties or fees are payable. This may be subject to change in principle going forward, although there is little evidence to suggest that this scenario is widespread or involves significant amounts.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Gibraltar has implemented the EU Anti-Tax Avoidance Directive (2016/1164), which contains provisions relating to CFCs that apply to accounting periods commencing on or after 1 January 2019.

Where the tax paid by a CFC (as defined) of an entity is less than 50% of the tax that would be paid in Gibraltar on the CFC's income, the non-distributed income of the CFC arising from non-genuine arrangements put in place for the essential purpose of a tax advantage will be included as income of the entity. This does not apply in the case of a CFC with accounting profits of no more than EUR750,000 and non-trading income of no more than EUR75,000, nor to a CFC whose accounting profits are no more than 10% of its operating costs (as defined).

There are specific rules detailing how any tax payable in respect of a CFC would be calculated.

The CFC rules apply to a permanent establishment resident outside of Gibraltar in essentially the same manner as they apply to an entity resident outside of Gibraltar.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no specific rules that relate to the substance of non-local affiliates, other than the impact that a lack of significant people functions may have in determining whether an arrangement is "non-genuine" for the purposes of applying the CFC rules described in **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains are outside the scope of tax in Gibraltar.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

General anti-avoidance provisions empower the Commissioner of Income Tax to disregard part or all of any arrangements or transactions that are deemed to be artificial and/or fictitious, the purpose of which is to reduce or eliminate the tax payable.

"Artificial and fictitious" is defined as meaning not real and not genuine, or not consistent with the arm's-length principle as defined by the OECD in its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

The deductibility of expenses in respect of connected companies is subject to restrictions and limitations if the Commissioner of Income Tax regards the arrangements as having been put in place in order to reduce taxation (see **5.6 Deductions for Payments by Local Affiliates**), and in respect of interest expenses (see **2.5 Imposed Limits on Deduction of Interest**).

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no routine audit cycle. Queries are frequently raised by the tax authorities, but normally on an ad hoc and relatively informal basis (ie, reference to "tax audit" or "investigation" is very infrequent).

9. BEPS

9.1 Recommended Changes

The implementation in Gibraltar of BEPS recommended changes so far has been carried out by the adoption of EU Directives, including the following:

- anti-avoidance provisions added to the application of the Parent-Subsidiary Directive – Council Directive 2014/86/EU of 8 July 2014;
- country-by-country reporting – Council Directive (EU) 2016/881 of 25 May 2016;
- exchange of information with member states on tax rulings – Council Directive (EU) 2015/2376 of 8 December 2015;
- the Anti-Tax Avoidance Directive – Council Directive (EU) 2016/1164 – includes CFC Rules, Interest Limitation rules and Hybrid Mismatch Rules, which apply in Gibraltar to accounting periods commencing on or after 1 January 2019. The provisions in the Directive on Exit Taxes and on hybrid mismatches with third countries have also been implemented in Gibraltar and apply to accounting periods commencing on or after 1 January 2020, in accordance with the Directive; and
- EU Directive 2018/822 (DAC6) on Reportable Cross-Border Arrangements – the EU version of the OECD's Mandatory Disclosure Regime (MDR) – was implemented in Gibraltar and came into operation on 1 July 2020. This Directive requires the disclosure of cross-border arrangements to the tax authorities if they meet any of a number of defined hallmarks. However, following the UK's lead, Gibraltar amended its legislation with effect from 1 January 2021 such that reporting is only required in the case of hallmarks listed under "Category D" in DAC6, which covers arrangements that have the effect of undermining the automatic exchange of financial information, or involve the obscuring of ultimate beneficial ownership. This aligns Gibraltar's legislation to the OECD's model rules on MDR.

The first deadline for disclosure is 30 January 2021.

9.2 Government Attitudes

Gibraltar's government recognises that many of the BEPS recommendations are inevitable, and has stated and clearly indicated by its actions that it is fully committed to complying with international obligations. There is also a feeling that Gibraltar has to – and does – go further than many jurisdictions to prove that it is compliant, due to the small size of the jurisdiction.

9.3 Profile of International Tax

International tax has a relatively high profile in Gibraltar. It is a small jurisdiction, with significant activity in sectors such as financial services, tourism, internet gaming and, more recently, distributed ledger technology. Therefore, much of its business caters to international markets and/or is the subject of inward and outward investment.

Other factors influencing the implementation of BEPS recommendations include:

- a desire to demonstrate compliance with international obligations, whilst offering a business-friendly environment; and
- being subject to political or other commitments by the UK to maintain EU or equivalent standards post-Brexit.

9.4 Competitive Tax Policy Objective

It is reasonable to say that a key objective of Gibraltar's government is to offer a business-friendly jurisdiction. Keeping taxation to a level that does not discourage economic activity whilst ensuring that the jurisdiction and its tax system remain internationally compliant form part of its strategy.

9.5 Features of the Competitive Tax System

Key features of Gibraltar's tax system include the following:

- it is a territorial system, whereby companies are taxable only on activities located in Gibraltar; the tax residency of a company is not – in itself – a factor that determines whether income is taxable in Gibraltar;
- Gibraltar has a relatively low rate of corporate tax, at 10%;
- Gibraltar has no VAT or equivalent sales tax;
- Gibraltar has no capital gains tax; and
- Gibraltar has only one double tax treaty in place, with the United Kingdom. Gibraltar's government is understood to be keen to conclude double tax treaties with other countries.

9.6 Proposals for Dealing with Hybrid Instruments

The implementation by Gibraltar of BEPS recommended changes so far has been carried out by the adoption of EU Directives, including:

- implementing the anti-avoidance amendments to the Parent-Subsidiary Directive, designed to ensure that dividends paid between EU member states that obtain a deduction in one member state will be subject to tax in the recipient member state; and
- implementing the EU Anti-Tax Avoidance Directive – Council Directive (EU) 2016/1164, which includes Hybrid Mismatch Rules. Most of this Directive applies in Gibraltar to accounting periods commencing on or after 1 January 2019. The remaining part – in respect of hybrid mismatches with jurisdictions outside the EU, hybrid permanent

establishment mismatches, hybrid transfers, imported mismatches and dual resident mismatches – applies to accounting periods commencing on or after 1 January 2020.

9.7 Territorial Tax Regime

Gibraltar has a territorial tax system for companies (see **2.1 Calculation for Taxable Profits**). Its tax legislation already contains a number of provisions to restrict deductions claimed for interest where these are at more than an arms-length rate. There is little evidence that investment in Gibraltar is currently encouraged by any ability to claim deductions for interest paid.

9.8 CFC Proposals

The OECD's Action Plan in respect of CFCs appears to be logical for the most part.

The focus of the Action Plan (and the EU CFC rules) on a scenario with a parent resident in one jurisdiction with a CFC that is resident in another jurisdiction appears to be based on a presumption that entities are subject to tax on the basis of residence. This could lead to some anomalies when applied to a territorial jurisdiction that applies tax on the basis of location of activity rather than residence, although there have been few issues in this regard to date.

The idea of a "sweeper" rule that would apply CFC provisions regardless of the substance located in a particular jurisdiction may lead to tax arising overseas on the profits of businesses that operate wholly on a local basis and with local customers, purely because the parent is located in a country with relatively high tax. This does not appear to be consistent with the primary objective of BEPS, and would go beyond dealing with the issues that BEPS aims to address.

9.9 Anti-avoidance Rules

Proposed DTC limitation of benefit and anti-avoidance rules are unlikely to have a significant impact in the short or medium term. Gibraltar has only one double tax treaty and one double tax agreement in force with the United Kingdom and Spain respectively.

9.10 Transfer Pricing Changes

It is likely that more specific transfer pricing requirements will be introduced in Gibraltar, given that there are few specific provisions in place. Although this could significantly increase the amount of documentation required to be compiled by local entities who are part of multinational groups, it remains to be seen whether this would have any other impact on such entities.

There are no specific beneficial regimes in place for profits from intellectual property. Royalties received or receivable by Gibraltar-registered companies are taxable at a rate of 10%. There is little evidence to suggest that intellectual property is being moved to Gibraltar for tax purposes, so there is little negative impact on Gibraltar from BEPS proposals involving intellectual property.

9.11 Transparency and Country-by-country Reporting

Gibraltar's government appears to be fully committed to tax transparency. All EU Directives in this respect were implemented up to the end of the Brexit transition period on 31 December 2020 and remain in place, with the exception of the Directive on Administrative Compliance (DAC6), which was implemented but subsequently amended to align with the OECD model rules on the Mandatory Disclosure Requirement.

9.12 Taxation of Digital Economy Businesses

No changes have been made in relation to the taxation of digital economy businesses operating from outside Gibraltar, and there are no proposals in this respect, as far as is known.

9.13 Digital Taxation

No specific position has been taken by Gibraltar in relation to BEPS proposals for digital taxation.

9.14 Taxation of Offshore IP

There are no provisions in Gibraltar's tax legislation that deal specifically with intellectual property deployed within Gibraltar. However, in the case of a company incurring expenses in favour of a connected party and where the Commissioner regards the arrangements as being in place in order to reduce tax, there is a restriction on the deduction for such expenses, which is either 5% of turnover (as defined) or 75% of the profit before taking the expenses in question into account, whichever is lower.

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Trends and Developments

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Gibraltar: Succeeding Brexit

Differentiated Schengen Arrangements

The Brexit issue has been (and may well continue to be) a vexing topic for the United Kingdom for quite some time. Gibraltar is the only British Overseas Territory that was erstwhile part of the European Union, pursuant to the UK's membership. Nearly 96% of Gibraltarians voted against exiting the EU in the Brexit Referendum, with 83.64% of registered voters casting their ballot. This was perhaps unsurprising given Gibraltar's physical connection to mainland Europe and its reliance on the free flow of (in particular) people across the land frontier with Spain. Indeed, approximately 15,000 people cross the border daily, primarily servicing Gibraltar's financial services (including gaming, insurance, banking, e-money and more recently fintech) and tourism/hospitality industries, which are its key sectors. In fact, Gibraltar is the leading gaming jurisdiction of choice, with no VAT at all (including, crucially, on services), attracting the top multinational gaming companies to set up their primary operations on the Rock.

Gibraltar companies insure one in five cars in the UK, and the jurisdiction also created and continues to grow and evolve the first regulatory environment for the provision of financial services relating to distributed ledger technology.

The high levels of unemployment in neighbouring Spain (circa 35% in immediate neighbour La Linea, compared to circa 1% for Gibraltar), combined with Gibraltar accounting for 25% of the GDP of the wider Spanish Campo de Gibraltar, mean that the stakes are high on both sides of the frontier. An added complexity (even before Brexit) is the continuing irreconcilable positions of the UK and Gibraltar (on the one hand) and Spain (on the other) regarding the status of Gibraltar, which have plagued relations for over 300 years and hampered opportunities for concerted development of the wider region as a whole.

With Gibraltar not having been included in the UK-EU Trade and Cooperation Agreement reached on 24 December 2020, the prospect of a "hard Brexit" loomed upon the termination of the Brexit transition period at the end of 2020. It was against this backdrop that an in-principle agreement regarding a proposed framework for a UK-EU legal instrument setting out Gibraltar's future relationship with the EU was reached and announced on the very last day: 31 December 2020. This preliminary accord has no doubt been a long time in the making (and the parties have given themselves a further six months within which to conclude the detail and form of the full treaty), but the very fact that the parties have (whilst fully maintaining their positions on the issues) demonstrated a pragmatic preparedness to work around their incompatible stances on the sovereignty, jurisdiction and control of Gibraltar (in a bid to seek constructive, practical solutions to a hitherto intractable and otherwise mutually problematic situation) augurs the most hope for its success.

The common intention is to seek to provide for an arc of shared prosperity covering Gibraltar and the nearby Spanish hinterland by "the application in Gibraltar of the relevant parts of the Schengen acquis necessary to achieve the elimination of the control on the movement of persons between Gibraltar and the Schengen area." It also foresees "a bespoke solution, based on an adaptation of a customs union between the EU and Gibraltar," allowing for the removal of "the physical barriers between Gibraltar and the EU, suppressing the customs checkpoint at La Linea and making unnecessary the control of people for the purposes of customs checks," with authorisation and entry into Gibraltar and the Schengen area to be carried out cumulatively by first Gibraltar and thereafter Schengen operatives (using their respective databases) for arrivals at Gibraltar's airport and port facilities.

The preliminary agreement also envisages Gibraltar authorities issuing residence permits (subject to alignment with EU and Spanish standards and based on the existence of real links with Gibraltar) allowing access to short- and long-term Schengen visas. All of this adds to the existing attractive proposition of Gibraltar for high net worth individuals, as well as others looking to relocate to a stable, tax-friendly, English-speaking, common law jurisdiction, with a Mediterranean climate, a variety of good private and state schools and other amenities (including its own modern airport), and with border-less travel within the Schengen area.

The text of the in-principle agreement also anticipates substantial future alignment by Gibraltar (including in terms of similar duties, trade policy and relevant EU customs, excise and VAT legislation, as well as on security, environmental, state aid, transport, IT systems, data and citizens' rights matters, amongst others) in order to avoid distortions in the internal market, whilst yet affirming Gibraltar as "a separate customs territory from the EU." How this materialises in practice will determine the precise scope and opportunities available as a result, but the express aspiration for a "bespoke solution", acknowledgment of Gibraltar as a "separate customs territory" and the limitation of alignment re EU customs, excise and VAT measures to those that are "relevant" offers an indication that the architects of the treaty will be striving for a differentiated Schengen style agreement in relation to Gibraltar. The expectation is that VAT measures will be limited to goods and not extend to services, thus preserving the incentive for the continuing provision of financial services from the Rock.

UK/Gibraltar market access

Prior to Brexit, financial services firms in Gibraltar, the UK and all other EU countries enjoyed passporting rights allowing them to sell their services to each other's jurisdictions without additional regulatory clearance. The departure of the UK (and thereby Gibraltar) from the EU brought this to an end (both between the UK/Gibraltar and the rest of the EU states and between the UK and Gibraltar themselves in as much as arising automatically under EU law).

The UK-EU Trade and Cooperation Agreement reached on 24 December 2020 did not (and was not intended to) address questions of market access for financial services firms between the UK and the EU. As a result, this presently relies on the satisfaction of individual country requirements or equivalence determinations, generally only issued in circumstances where there is considered to be sufficient alignment. Given that the EU has thus far only granted equivalence on a time-limited basis in two areas it considers important to it (derivatives clearing and the settling of Irish securities) and that EU equivalence determinations can be withdrawn with 30 days' notice, pending a more substantial and substantive equivalence agreement being reached between the UK and the EU, there is obviously far greater complexity, cost and uncertainty with the current proposition.

From Gibraltar's perspective, however (especially noting that the majority of Gibraltar passporting activity pre-Brexit has been UK-centric), mutual access for a wide range of specified UK and Gibraltar financial services firms is already afforded under previously concluded arrangements, and the establishment of a new Gibraltar legal and institutional framework will align relevant Gibraltar law and practice with that of the UK in order to allow for this. Such access currently exists under transitional arrangements (which are renewable by HM Treasury for successive periods of 12 months), which have recently been extended until 31 December 2021.

It is no surprise, therefore, that we have already seen a number of financial services firms relocate their UK-facing EU operations (which previously had automatic passporting rights pre-Brexit) to Gibraltar, in order to avail themselves of the current exclusive market access with the UK that Gibraltar enjoys. It also remains to be seen whether the form of Schengen-style arrangements relating to Gibraltar (as these materialise) will also serve to allow for greater fluidity and market access between Gibraltar and the wider EU on financial services matters as well.

Gibraltar limited partnerships

Limited partnerships is another area of recent, continuing development in Gibraltar, where the Limited Partnership's Bill seeks to modernise existing limited partnership legislation. The most notable changes are to allow for limited partnerships to make a one-time election whether or not to have legal personality, with provisions affording limited partners a statutory basis on which to play a more active role in the affairs of the limited partnership (in certain permissible ways), as well as giving them the ability to vote on permissible actions pro rata to their interests in the limited partnership, in each case without vitiating their limited liability. The Gibraltar Funds sector has been key in driving these changes, which shall also see the partnership interests of limited partnerships become capable of being represented by shares, bonds, notes, loans or other debt securities or instruments.

The changes to the statutory framework also include the Protected Cell Limited Partnerships Bill, under which funds shall be capable of being structured as a special form of limited partnership with one or more segregated cells, allowing for the creation of distinct sub-funds and arrangements within the same limited partnership, but with the benefit of statutory protection over the segregation of the assets and liabilities of each cell.

There are also potential tax implications and opportunities from the changes, and the legislators are alive to international tests for opacity/transparency as well as recent aggressive stances being taken by the EU and similar bodies through blacklisting mechanisms.

Summary

Evolution is by definition a continuing process, but recent trends and developments in Gibraltar demonstrate that the jurisdiction is focused on and prepared to benefit from the potential opportunities presented by the ongoing significant current and future changes to the wider tax, legal and regulatory landscapes.

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Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Greece most commonly adopt the forms of:

- a société anonyme (*Ανώνυμη Εταιρεία* or AE),
- a limited liability company (*Εταιρεία Περιορισμένης Ευθύνης* or ΕΠΕ); or
- a private company (*Ιδιωτική Κεφαλαιουχική Εταιρεία* or IKE).

All of these forms of companies are referred to as "capital companies" (*κεφαλαιουχικές εταιρείες*). One of their features, as opposed to partnerships, is that the liability of their shareholders or members is limited.

Large companies will most commonly take the form of an AE, which unlike the ΕΠΕ and IKE is subject to a minimum capital requirement (EUR25,000 as of 1 January 2019). The popularity of the IKE form for small and medium-sized businesses has risen in recent years, as it offers a more flexible structure compared to an ΕΠΕ.

Small- and medium-sized enterprises engaged in service provision and family businesses often take the form of a general partnership (*Ομόρρυθμη Εταιρεία* or OE) or limited partnership (*Ετερόρρυθμη Εταιρεία* or EE).

Corporations and partnerships alike are taxed as separate legal entities.

1.2 Transparent Entities

In general, business entities are not transparent. Exceptions include Greek Venture Capital Mutual Funds (ΑΚΕΣ) and Greek Alternative Investment Funds (O.E.E.).

The taxation of Greek undertakings for collective investment in transferable securities (ΟΣΕΚΑ) is calculated as a percentage of their net assets, and exhausts the tax liability of the undertaking and its shareholders.

The taxation of Greek real estate investment companies (ΑΕΕΑΠ) is calculated as a percentage of the average of the fair market value of their investments. This tax also exhausts the tax liability of the undertaking and its shareholders.

1.3 Determining Residence of Incorporated Businesses

Subject to the operation of double taxation treaties, incorporated businesses are deemed to be resident in Greece if:

- they are formed in accordance with Greek law;
- their registered seat is in Greece; or
- the place of their effective management is in Greece.

The place of effective management is determined on the basis of facts and circumstances, with particular consideration being given to the places where:

- day-to-day business is undertaken;
- strategic decisions are adopted;
- annual shareholders', board of directors and other executive meetings are held;
- books and records are kept; and
- the directors' place of residence.

The place of residence of the majority shareholders may potentially be considered. The rules on residence do not apply to certain companies operating under special shipping regimes.

1.4 Tax Rates

From fiscal year (FY) 2019 onwards, the ordinary income tax rate of 24% is applicable to:

- businesses incorporated in the form of an AE, ΕΠΕ or IKE;
- partnerships in the form of an OE or EE; and
- all other legal persons and entities defined in the Income Tax Code, including local permanent establishments of non-resident entities.

This does not apply for credit institutions that have opted to apply a scheme available for enhancing capital adequacy, converting deferred tax assets into deferred tax credits against the Greek State, which are taxed at a rate of 29%.

Business income of individuals who are directly engaged in a business forms part of their taxable basis, including any salary and pension income, and is taxed at a progressive scale ranging from 9% to 44%.

Reduced tax rates are available to companies formed as AEs or ΕΠΕs on certain non-taxed profit reserves formed under growth incentive laws if converted into share capital. Prerequisites for this include, in certain cases, restrictions to ensure the continuity of the relevant company and the preservation of capital.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable profits of incorporated businesses are based on accounting profits, subject to the special rules and classifications provided for in the income tax legislation. In general, taxable profits equate to the aggregate of revenues after subtracting business deductible expenses, depreciation allowed for tax purposes and certain provisions for bad debts.

Additionally, all business expenses, in order to be deductible, must have:

- been actually incurred;
- been incurred for business purposes or in the ordinary course of business; and
- been properly recorded in the books and supported by adequate documentation.

Non-deductible Expenses

Categories of business expenses that are not deductible are explicitly defined, and include:

- provisions (except specifically allowed bad debt provisions);
- penalties and fines;
- payments for goods or services exceeding EUR500 if not effected through banking transactions;
- unpaid social security contributions;
- payments to persons resident in the jurisdictions deemed non-co-operative or preferential unless the taxpayer proves that there is no tax avoidance or evasion; and
- certain other types of expenses.

Payments to EU and EEA residents that are deemed to be preferential are deductible in principle. Specific limitations apply to the deduction of interest. Expenses related to participations yielding tax-exempt dividends and capital gains are not tax deductible in principle.

Taxable Profits

As a general rule, the profits of incorporated businesses are taxed on an accruals basis.

Any profits that are distributed or capitalised without having previously been taxed are subject to tax upon such distribution or capitalisation.

2.2 Special Incentives for Technology Investments

R&D Expenses and Patents

Subject to a governmental or simplified audit procedure, a supertax deduction of an additional percentage of certain R&D expenses, including any depreciation of machinery and equipment used for R&D purposes, is available at the time such expenses are realised. This was initially 30% and increased to 100% as of 1 September 2020.

Profits derived by a business from the sale of assets produced by deploying its own patents, and from services provided with the use of its own patents, are exempt from corporate income tax for a period of three years, starting from the year when the relevant revenues were first accrued. The relevant profits are taxed when they are distributed or capitalised.

Certain instruments and equipment used for R&D that are set by governmental decision can be amortised at a 40% rate annually.

Special Regime of Law 89/1967

The cost-plus regime of Law 89/1967, providing a special framework for the establishment in Greece of shared-services centres rendering certain services specified in the law to associated companies, has recently been expanded to include within its scope software development, IT support, data management and storage and computer-based call centres. The regime provides for the full deductibility of business expenses, which concur to form the taxable gross revenues for income tax purposes after addition of a profit mark-up, which cannot be inferior to 5% and which is acknowledged in advance by the tax authorities. Eligibility under the regime presupposes annual expenditures of at least EUR100,000 and employment of at least four persons (one of whom can be part-time).

2.3 Other Special Incentives

The current EU-compliant framework for the establishment of private investment aid schemes for a country's regional and economic development includes state grants in the form of tax exemptions for eligible investments.

EU-compliant tax incentives for the production of audiovisual content, the provision of ancillary services and the development of source code for computer game software provide for a 30% deduction of eligible expenses, incurred in Greece, from taxable income.

Incentives for the creation of new jobs are also available and consist, subject to a maximum limit specified in the law, of a 50% super deduction for the relevant social security contributions payable by employers.

Specific tax incentives, such as exemption from real estate transfer tax, are available to entities that acquire property and commence activities in special industrial zones and entrepreneur parks.

Green Incentives

Incentives for sustainable development include a 130% super-deduction for expenses related to environmental protection, ie, in relation to zero or low emission vehicles or public transportation season tickets. Explicit deductibility for corporate income tax purposes of expenses related to CSR activities has also been introduced as an incentive for sustainable development.

Strategic Investments

During 2019, new legislation was introduced with the aim of streamlining the existing framework for attracting strategic investments in all sectors of the Greek economy through the grant of incentives. The rules define strategic investments as those which are capable of producing material quantitative and qualitative results towards expanding employment, reconstructing production and enhancing the country's natural and cultural environment. Accordingly, such investments will be approved by a governmental committee if they meet certain criteria, eg, for investments within certain industrial zones, having a budget in excess of EUR25 million and creating at least 50 new jobs.

Strategic investments would mostly embrace extroversion, innovation, competitiveness, comprehensive planning, the preservation of natural resources in the context of the circular economy and high added value, notably in the business sectors of international trade and services. The tax incentives offered by are:

- the stabilisation of the tax rate for 12 years;
- scalable tax incentives such as tax exemptions for certain categories of investments exceeding certain thresholds;
- accelerated depreciation; and
- beneficial taxation for expatriate executives.

Shipping Tax Regime

A tonnage tax regime applies in respect of ship-owning companies as well as companies chartering bare vessels (bareboat charterers) or companies leasing vessels (ship lessees) under a foreign flag. The tax is calculated on the basis of the capacity and age of the vessels. In relation to specified types of vessels under the Greek flag, the tonnage tax exhausts any further income tax obligation of the ship-owning company, bareboat charterer or ship lessee as well as such entities' shareholders with respect to income arising from the operation and exploitation of the vessels.

With respect to vessels under foreign flags, tonnage tax is imposed only in relation to those vessels that are managed in Greece by companies that have established offices in Greece for such management, under a specially regulated regime. Under this regime, the income of such management companies is exempt from tax. In addition, vessels flying flags of EU or EEA member states can also be subject to the tonnage tax regime in respect of defined types of vessels, regardless of the place of management.

Greek companies and foreign companies that have established an office in Greece under the aforementioned special regime and engage in activities other than the management of vessels, such as chartering, insurance and damage settlement, in respect of ships under the Greek or a foreign flag of total tonnage over 500 shipping tons, are subject to an annual contribution calculated on the basis of the amount of foreign exchange that is required by law to be imported into Greece annually in order to cover their operating expenses.

Family Offices

A recently introduced regime offers tax incentives for the establishment in Greece of family offices managing and administering the wealth and assets of Greek tax resident individuals and their families. Qualifying family offices should incur annual expenditure of at least EUR1 million and should employ at least fiv employees. The taxable gross revenues of family offices are determined by adding a 7% profit mark-up on all costs incurred, thereby ensuring the full tax deductibility of the relevant costs. Services provided between the family office and its members shall fall outside the scope of VAT.

2.4 Basic Rules on Loss Relief

Tax losses incurred due to the conduct of a business within a certain fiscal year can be carried forward to be offset against profits made over the next five consecutive years. Previously untaxed profits that are taxed as a result of their distribution or capitalisation cannot be offset against tax losses incurred in the relevant year. Special rules apply for the amortisation of losses arising from an exchange of bonds under the Greek PSI programme, as well as in respect of banks, financial leasing and factoring companies from specified debt write-offs and disposals of loans and credits.

Tax losses incurred abroad can neither be used to determine taxable profit in the same fiscal year nor carried forward, with the exception of final tax losses arising from the conduct of business through permanent establishments in EU/EEA member states, provided that the relevant profits are not exempt from Greek income tax by virtue of a double taxation treaty between Greece and the relevant EU or EEA member state.

2.5 Imposed Limits on Deduction of Interest

According to a recent rule transposing part of the EU Anti-Tax Avoidance Directive into Greek domestic law, subject to a de minimis threshold of EUR3 million annually, "exceeding borrowing costs" are not deductible by local corporations and local permanent establishments of non-resident entities to the extent that they exceed 30% of EBITDA, with a possibility to carry forward the non-deductible portion without any time limitation. "Exceeding borrowing costs" is defined as the amount by which the otherwise deductible borrowing costs of a company exceed taxable interest revenue and other economically equivalent taxable revenue. This limitation does not apply to several types of financial undertakings, such as credit institutions, insurance companies, and specific institutions for occupational retirement. Regarding related-party transactions, this rule is applied after any transfer pricing adjustment.

Another restriction on the deduction of interest is that the portion of interest expenses corresponding to any rate exceeding the interest rate for credit lines to non-financial corporations referred to in the most recent Bulletin of Conjunctural Indicators of the Bank of Greece (as at the time of the loan) is not deductible. This limitation does not apply to interest on bank loans or bond loans, nor to interest paid to related parties.

2.6 Basic Rules on Consolidated Tax Grouping

There is no consolidated tax grouping regime in Greece.

2.7 Capital Gains Taxation

Capital gains from the disposal of assets including shares in other corporations are fully included in the taxable basis of corporations for income tax purposes in the fiscal year in which they are realised.

As per a recent amendment to the Income Tax Code, Greek legal persons are exempt from tax on capital gains arising from the disposal of shares in EU Parent-Subsidiary Directive-qualifying subsidiaries (see **6.3 Taxation on Dividends from Foreign Subsidiaries**) insofar as they hold at least 10% participation in those subsidiaries for a minimum holding period of 24 months. The provision shall apply for income generated from 1 July 2020 onwards.

Under a grandfather clause, losses arising from the transfer of shares realised until 31 December 2022 shall be deductible for tax purposes after 1 January 2020 to the extent that losses had been reflected in financial statement valuations having occurred until 31 December 2019.

Capital gains derived from certain qualifying corporate reorganisations, such as mergers, divisions, partial divisions, transfers of assets and exchanges of shares, are exempt from tax at the time of the relevant operation, subject to specific anti-abuse rules.

2.8 Other Taxes Payable by an Incorporated Business

Value-Added Tax

Value-added tax is levied on virtually all transactions relating to goods and services. The standard VAT rate is 24%, although reduced rates are also available in certain cases (eg, for certain agricultural supplies, hotel accommodation, certain social services, etc). VAT is imposed on the total consideration received for the supply of goods or services, excluding the tax itself. VAT is not a burden for companies with the right to fully deduct input VAT.

Stamp Tax

Stamp tax is levied on documents issued or executed in Greece in respect of certain transactions that are not subject to VAT.

The most common transactions that are subject to stamp tax are certain commercial leases, certain loans and transfers of ongoing business concerns.

Stamp tax is applied at different rates depending on the type of parties to a transaction. Business transactions falling under the scope of stamp tax are, in principle, subject to a 2.4% rate applied on their value. The rate for commercial leases is 3.6%.

Real Estate Transfer Tax and VAT Treatment

The transfer of real estate is subject to real estate transfer tax, which is imposed on a value imputed for tax purposes (either "objective value" or the actual transfer value agreed, whichever is higher) and is borne by the purchaser: the tax rate is 3%. An additional 3% municipality tax is applied on the amount of the real estate tax, so that the overall tax burden adds up to 3.09%. Reduced rates of real estate transfer tax apply in certain corporate reorganisations, such as mergers.

Between 2020-22, the sale by constructors of buildings that would normally be subject to 24% VAT shall be exempt from VAT, upon the filing of a relevant application. The exemption shall cover buildings that have been completed with building permits following 1 January 2006, as well as those that will be built within the aforementioned three-year period. The constructor will waive the right to deduct the VAT on the construction cost, and any VAT already deducted or refunded should be refunded to the State, through the filing by the constructor of an extra-ordinary VAT return, at the time of the sale of the building. Any non-recoverable VAT can be deducted as an expense for income tax purposes.

Listed Shares Sales Tax
A transfer tax at the rate of 0.2% is levied on sales and stock lending in respect of listed shares.

Banking Levy
An annual banking levy, Law 128 contribution, applies on loans and credits granted by Greek and foreign credit and financial institutions. The applicable rates depend on the type of credit, and range between 0.12% and 0.6%.

2.9 Incorporated Businesses and Notable Taxes
Unified Real Estate Tax
Incorporated businesses owning property rights on real estate located in Greece are subject to a unified real estate tax (*Ενιαίος Φόρος Ιδιοκτησίας Ακινήτων*), commonly referred to as ENFIA, which consists of a main and a supplementary tax. The main tax applies to each property separately and is computed based on a formula that varies depending on the type and location of the real estate assets and a number of other parameters set in the law. The basis rate for the main tax (which is then multiplied by set coefficients depending on the particular case) ranges from EUR0.001 to EUR13 per square metre, depending on the type of property.

The supplementary standard tax rate is set at 0.55%, with properties that are used by the taxpayer for its business activities being subject to a supplementary tax of 0.1%. A number of exemptions from the tax or reduced rates are available for specific categories of properties and/or taxpayers (eg, real estate investment companies).

Special Real Estate Tax
A special real estate tax (*Ειδικός Φόρος Ακινήτων*) imposed on real estate owned as of 1 January of each calendar year at a rate of 15% of the value of the real estate imputed for tax purposes is imposed for the purposes of tackling the ownership of Greek real estate by non-transparent structures. It is, in practice, not applicable to a great number of incorporated businesses owning Greek real estate, based on a number of exemptions. Recent amendments to the Special Real Estate Tax legislation harmonise the regulated investment vehicle exemption with the domestic and EU legislation that applies to relevant schemes.

Capital Accumulation Tax
A special tax is imposed on capital accumulation (*φόρος συγκέντρωσης κεφαλαίων*), at a rate of 1%. This applies on capital in cash or in kind contributed to legal entities of any form in the context of a capital increase. Such tax is not imposed on the capital accumulated upon the establishment of an entity. A duty of 0.1% on share capital is additionally imposed on companies taking the form of an AE in favour of the Greek Competition Committee.

Municipal Taxes and Taxes in favour of Third Parties
Depending on the precise form of their activity, corporations may be liable to various municipal taxes/duties, such as cleaning, lighting and advertising duties.

A property duty is levied by each municipality at a rate ranging between 0.025% and 0.035% on the objective value of immovable property located in the territory of the relevant municipality.

A number of taxes in favour of third parties, such as the Lawyers' Pension Fund, universities, other funds and non-profit organisations, are applicable to incorporated businesses and other taxpayers, as the case may be.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses
Closely held local businesses usually operate in corporate forms, as companies with legal personality. Small and medium-sized enterprises and family businesses often take the form of a general partnership (OE) or limited partnership (EE).

Operation as a sole proprietorship is preferred only for very small-scale businesses.

3.2 Individual Rates and Corporate Rates
An individual professional is taxed at progressive tax rates which, depending on the level of the income, may or may not lead to an effective rate that is lower than the combined effective rate of corporate taxation, together with tax imposed on profits distributions, where applicable (see **3.4 Sales of Shares by Individuals in Closely Held Corporations**).

3.3 Accumulating Earnings for Investment Purposes
There are no tax rules that prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations
Greek tax-resident individuals are subject to 5% income tax on profits and dividends from closely held corporations acquired as of 1 January 2020. Profits of small partnerships (in the form of an OE or EE) keeping single-entry books are taxed only at company level, with no further income taxation on profit distributions at the level of partners. AE, ΕΠΕ and IKE companies cannot keep single-entry books.

Capital Gains
Capital gains of Greek tax-resident individuals derived from the sale of shares in closely held corporations are subject to 15% income tax. Gains on the sale of shares in closely held corporations are, in certain circumstances, calculated on an imputed manner set in the relevant rules on the basis of the level of the corporation's equity.

Capital gains realised by employees and shareholders as a result of transferring shares in non-listed start-up companies purchased through the exercise of stock option rights acquired within a period of five years as of the company establishment are subject to 5% capital gains tax on the condition that a minimum period of three years shall have lapsed between the stock options grant and the disposal of the relevant shares. In the case of all other companies except start-ups, employees are subject to 15% capital gains tax on the condition that a minimum period of two years shall have lapsed between the the stock options grant and the disposal of the relevant shares. If minimum holding periods are not met, the relevant benefits are classified and taxed as employment income.

Capital gains are included in the taxable base of individuals for purposes of the application of a "special solidarity" contribution. This was first enacted in 2011 as a temporary measure in the context of Greece's austerity measures, but has become a permanent feature which has been incorporated into the Income Tax Code. The special solidarity contribution is applied on a progressive scale, with the maximum rate being 10%.

Capital Losses
Capital losses from sales of shares and other securities can be carried forward for five years to be set off against future capital gains deriving from similar transactions only.

Exemptions
Under domestic legislation, foreign tax-resident individuals are exempt from tax on capital gains derived from the sale of shares in Greek companies, provided they are resident in a jurisdiction that has a double taxation treaty with Greece. They can also be exempt from the special solidarity contribution under double taxation treaties.

Withholding Tax
Foreign tax-resident individuals are subject to withholding tax on distributions of dividends and profits from Greek companies, subject to relief or reduced rates under double taxation treaties.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations
The individuals' tax regime provided for dividends from shares held in closely held corporations (described in **3.4 Sales of Shares by Individuals in Closely Held Corporations**) is also applicable in relation to shareholdings in publicly traded corporations.

Greek and foreign tax-resident individuals are exempt from income tax on gains derived from the sale of exchange-listed shares, except where they hold at least 0.5% of the total share capital and the shares have been acquired on or after 1 January 2009, in which case they are taxed at 15%. Such exempt gains however are included in the taxpayer's taxable basis for the purposes of special solidarity contribution.

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Under domestic legislation, entities or individuals that are not resident in Greece will be subject to income tax in Greece only by way of withholding on Greek-source interest, royalties and dividends. Any tax so withheld exhausts their Greek tax liability. This is provided that they do not have a permanent establishment in Greece to which the relevant profits would be attributable.

Under domestic law, 5% withholding tax applies on dividends acquired as of 1 January 2020. Dividends distributed to qualifying EU parent companies are exempt from any withholding tax, provided that:

- the parent company participates in the subsidiary with a minimum holding of 10% in the capital or voting rights for at least 24 months;
- the beneficiary company receiving the dividend payment is included in the list of companies referred to in Annex I Part A of the EU Parent-Subsidiary Directive;
- the beneficiary company is tax-resident in an EU member state and, under the terms of an income tax treaty concluded with a third state, is not considered as resident for tax purposes outside the EU; and
- the beneficiary company is subject to one of the taxes listed in Annex I, Part B of the Directive, without the possibility of an option or of being exempt, or to any other tax that may be substituted for any of those taxes.

Until completion of the minimum holding period, a bank guarantee for the amount of withholding tax that would otherwise be due can be deployed instead of payment of the withholding tax and a posterior refund claim. A special anti-avoidance rule prohibits the withholding tax exemption on the above qualifying dividend payments to the extent that the relevant exemption is claimed in the context of artificial arrangements that are not put in place for valid commercial reasons reflecting economic reality, but are instead aimed mainly at obtaining a tax advantage.

Under domestic law, 20% withholding tax applies on Greek-source royalties and 15% withholding tax applies on Greek-source interest.

Interest and Royalties

Interest and royalties paid to qualifying EU associated companies are exempt from any withholding tax, provided that:

- the beneficiary company receiving the interest or royalties participates in the payor with a minimum holding of 25% in the capital or voting rights for at least 24 months, or the payor participates in the beneficiary company with the same minimum holding, or a third company participates in the payor and the beneficiary with the same minimum holding;
- the beneficiary is included in the list of companies referred to in the Annex to the EU Interest Royalties Directive;
- the beneficiary is tax-resident in an EU member state and is not considered as resident for tax purposes outside the EU under the terms of an income tax treaty concluded with a third state; and
- the beneficiary company is subject to one of the taxes listed in the EU Interest Royalties Directive, without the possibility of an option or of being exempt, or to any other tax that may be substituted for any of those taxes.

Until completion of the minimum holding period, a bank guarantee for the amount of withholding tax that would otherwise be due can be deployed instead of payment of the withholding tax and a posterior refund claim.

Further Exemptions

Withholding tax exemptions on the above types of payments also apply, under similar conditions to those applicable to payments to EU qualifying companies, in respect of payments to beneficiaries in Switzerland.

Interest payments effected as of 1 January 2020 towards non-resident individuals and legal entities that do not maintain a permanent establishment in Greece are exempt from interest withholding tax insofar as such interest is on corporate bonds listed on trading venues within the EU or on organised markets outside the EU, provided such markets are regulated by an authority accredited by the International Organization of Securities Commission.

Treaties

Domestic withholding tax rates on interest, dividends and royalties can be reduced or eliminated if payments are made to beneficiaries in income tax treaty jurisdictions.

Greece currently has income tax treaties in force with countries throughout the world. All tax treaties follow the OECD Model in principle, except for those concluded with the USA and the UK.

4.2 Primary Tax Treaty Countries

Based on data from the Bank of Greece, the primary tax treaty countries that foreign investors use to make investments in local corporate stock or debt are Germany, France, Switzerland, Cyprus, Canada, the USA, China, Luxembourg, the Netherlands and Spain.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

To the extent that appropriate documentation, which includes a tax residence certificate signed by the competent foreign authorities, is available, it is uncommon for local tax authorities to challenge the use of treaty country entities by non-treaty country residents. In any event, on 26 January 2021 Greece ratified the OECD Multilateral Instrument implementing the tax treaty-related BEPS measures (MLI) and has adopted the principal purpose test preventing arrangements and transactions whose main purpose is to obtain the benefits of the tax treaty.

4.4 Transfer Pricing Issues

Taxable profits are subject to readjustment in the case of transactions between related parties which are not in line with the arm's-length principle. An individual or legal entity participating directly or indirectly in the capital or management of an enterprise is defined as a related party for transfer pricing purposes. A 33% threshold applies with respect to the minimum direct or indirect participation in the capital or the exercise of voting rights, above which entities are defined as related. The exercise of managerial control or decisive influence over an enterprise is also used as a means to define related parties, irrespective of any participation in the controlled enterprise's capital or voting rights.

Most transfer pricing disputes had revolved around the applicability of more lenient penalties for failure to comply with transfer pricing documentation requirements and the burden of proving compliance with the arm's-length principle. This latter issue has evolved over time. Administrative courts have confirmed that, as long as the taxpayer produces the appropriate transfer pricing documentation, the burden lies with the tax authority, which is required to justify any challenge made to the taxpayer's position.

More recently, the role of each related party in the development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangible assets has been an element of increasing significance in the scrutiny of related-party transactions between domestic licensees and foreign IP-holding entities. Matters concerning the reliability of comparable data, the definition of related parties, the use of full or interquartile range, the reasonableness of comparability adjustments and, lately, the appropriateness of selected transfer pricing methods have also been coming into the discussion.

As tax authorities focus increasingly on transfer pricing, the discussion surrounding it are expected to increase.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements are extensively applied by multinational enterprises doing business in Greece. Tax authorities are carefully scrutinising these arrangements in the context of transfer pricing audits, focusing primarily on whether the return of the local entity can be considered consistent with the arm's-length principle following in-depth reviews of its functional and risk profile.

The reliability of comparables is also challenged in this context. In some instances, the tax authorities challenge the selection of the transfer pricing method or of the tested party.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The current legal framework fully endorses the arm's-length principle, defined in Article 9 of the OECD Model Tax Convention and interpreted by the OECD Transfer Pricing Guidelines, following the revisions introduced as a result of Actions 8–10.

4.7 International Transfer Pricing Disputes

Lately, Greek tax authorities have focused on providing the procedural framework for MAPs and on aligning the domestic framework with the recommendations received in the context of the MAP Peer Review Report (Stage 1). Until recently, however, the application of MAPs processes was rare and therefore the local tax authorities have not yet developed any consistent practice or view in this respect.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed under Greek legislation.

Greece has incorporated MAPs into most of its bilateral tax treaties. A Greek corporation may therefore request a competent authority's assistance with the adjustment of its income in cases where a transfer pricing adjustment in a foreign country, in respect of a transaction to which such corporation is a party, may lead to double taxation. In addition, Greece has ratified the OECD MLI. In respect of MAP, Greece chose to apply Part VI introducing the mandatory binding arbitration mechanism, with:

- a reservation as to the period within which the mandatory binding arbitration must be concluded;
- opting for a for a reasoned opinion arbitration instead of baseball arbitration; and
- excluding from the scope certain cases, such as those involving the application of domestic anti-abuse rules.

Until recently, the application of MAPs processes was rare. This has mostly been due to the lack of legal and procedural framework. Having committed to the implementation of the OECD BEPS Action 14 minimum standard, Greece enacted the legislation required to establish clear procedural rules on access to and use of MAPs.

The application of this legislation was then rendered possible after the determination of several procedural details (such as the competent authority, form and substance requirements, compatibility with cases pending before court, legal type and results of MAPs decision, communication requirements, etc) by means of administrative guidelines, which have been recently amended in light of findings of the MAP Peer Review.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

In general, local branches of non-local corporations are not taxed differently, in respect of their Greek profits, to local subsidiaries of non-local corporations. A tax on remittance of profits to the head office that was previously applicable has now been repealed. In practice, the deductibility of interest payments to the head office may sometimes be challenged by the tax authorities.

5.3 Capital Gains of Non-residents

Capital gains of non-resident corporations on the sale of stock in local corporations are not subject to tax, provided that the stock is not held through a permanent establishment in Greece. Under a rule whose application has been suspended several times, and which is still in suspension until 31 December 2022, gains derived from the transfer of real estate property, as well as from the transfer of shares in companies that derive more than 50% of their value, either directly or indirectly, from real estate by individuals who are not engaged in business activities, are subject to capital gains tax at 15%. In view of the consecutive suspensions, it has not been clarified whether such rules may also apply to non-resident companies directly or indirectly transferring stock in local corporations.

5.4 Change of Control Provisions

Tax losses carried forward are forfeited if the direct or indirect participation in the capital or voting rights of a local company changes by more than 33% within a fiscal year, while at the same time – within the same or the next fiscal year – the local company changes its business activity in a way that affects more than 50% of its turnover as compared to the turnover prior to the change.

Tax losses are not forfeited if the company is able to prove that the activity change is grounded on reasons that are economically justifiable in the context of the company's business, such as cost cutting, achieving economies of scale or achieving an intercompany restructuring.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Currently, no formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services.

Tax authorities can determine taxable income through indirect techniques, such as by an analysis of the price to turnover ratio or cash position, and also through other techniques set out in the legislation.

Taxable profits are subject to readjustment in the case of transactions between related parties that are not in line with the arm's-length principle.

5.6 Deductions for Payments by Local Affiliates

Payments by local affiliates for management and administrative expenses incurred by a non-local affiliate may be disallowed to the extent they are not in accordance with arm's-length standards, if they are not considered to serve the business purposes of the local affiliate or if they are not properly documented and recorded in the books reflecting the transactions of the relevant fiscal period. Payments to persons residing in states deemed as non-co-operative or preferential are not deductible, unless the taxpayer proves that these expenses are incurred for real transactions and do not result in profit-shifting aimed at tax avoidance or evasion.

If the states in question are EU/EEA member states, payments to persons that are resident in such states are, in principle, deductible. The regimes that are deemed to be non-co-operative or preferential are set annually by means of governmental decision on the basis of criteria set in the law, including, for preferential regimes, the criterion of taxation of profits or gains at a rate that is equal to or less than 50% of the applicable Greek income tax rate for corporations.

5.7 Constraints on Related-Party Borrowing

There are no constraints relating specifically to related-party borrowing by foreign-owned local affiliates paid to non-local affiliates, except that interest must be in line with the arm's-length standard.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on their worldwide income, with the exception of business income attributable to a permanent establishment in one of the few jurisdictions that has a double taxation treaty with Greece that provides an exemption method. Any foreign tax paid can be credited against the Greek income tax payable, to the extent that the foreign tax does not exceed the Greek tax corresponding to such income.

6.2 Non-deductible Local Expenses

There are no local expenses that are treated as non-deductible because of attribution to exempt foreign income in particular. Limitations on the deductibility of interest on loans used to finance participations that yield tax-exempt dividend and capital gains income apply equally to foreign and domestic income.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries are included in the tax basis of local corporations for income tax purposes.

An underlying tax credit in respect of tax paid on the profits from which dividends are derived at the source state is allowed with respect to dividends sourced from countries with which Greece has concluded a double tax treaty that provides for such a credit mechanism (such as the United Kingdom, China and Cyprus).

Inbound dividends received by Greek companies from qualifying EU subsidiaries are exempt from income tax under the conditions detailed in **4.1 Withholding Taxes**.

The exemption from Greek income tax on dividends received by Greek companies from qualifying EU subsidiaries applies to the extent that such profits are not deductible by the subsidiary. This amendment targets hybrid instruments and aims at preventing situations of double non-taxation due to mismatches in the tax treatment of profit distribution between the states in which the subsidiary and the parent company are situated.

6.4 Use of Intangibles by Non-local Subsidiaries

Gains or royalties derived from the transfer or licensing of an intangible developed by a local corporation to a non-local subsidiary are included in the taxable basis of the local corporation for income tax purposes. Transfers of intangibles between related parties due to business restructurings, whereby intangible assets or a transfer package consisting of functions, assets, risks and business opportunities are being transferred, whether within or outside Greece, should be made in exchange for arm's-length remuneration, and any gain is taxable without the possibility of payment of the relevant tax in instalments.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Local corporations can be taxed on the income of their non-local subsidiaries and permanent establishments as earned, under CFC rules. In accordance with such rules, which were recently revised to incorporate part of the EU Anti-Tax Avoidance Directive as well as the BEPS measures into Greek domestic law, profits earned by a CFC are added to the taxable profits of the local corporation, under the following conditions:

- the local corporation by itself – or together with its associated enterprises – holds directly or indirectly a participation of more than 50% in the voting rights, or owns directly or indirectly a percentage of more than 50% of the capital, or is entitled to receive more than 50% of the profits of the relevant CFC (legal person or entity);
- the actual corporate tax paid on the CFC's profits is less than 50% of the corporate tax that would have been charged on such profits in Greece; and
- 30% or more of the income before taxes accruing to the CFC falls within the following categories:
  - (a) interest or any other income generated by financial assets;
  - (b) royalties or any other income generated from intellectual property;
  - (c) dividends and income from the disposal of shares;
  - (d) income from financial leasing and income from insurance, banking and other financial activities; and
  - (e) income from companies that undertake invoicing and realise income from sales and services and income from goods and services purchased from and sold to associated enterprises, adding no or little economic value.

CFC rules do not apply to companies or permanent establishments resident in EEA member states, provided that such entities carry on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by all relevant facts and circumstances. In such cases, the tax authorities bear the burden to prove the absence of a substantive economic activity.

In the case of distribution by a CFC of profits that are included in the taxable basis of the local corporation, any CFC income taxed in a previous fiscal year is deducted from the relevant taxable basis.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no uniform rules related to the substance of non-local affiliates. Guidelines can be found on a case-by-case basis with respect to certain specific anti-avoidance provisions. Factors that can be taken into account are physical presence, full-time employees, active VAT number and taxation. Financial statements and information about the business organisation can also be taken into account, along with the other factors.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Gains on the sale by local corporations of shares in non-local affiliates are fully included in the taxable basis for income tax purposes, with the exception of gains on the disposal of shares in EU Parent-Subsidiary Directive-qualifying subsidiaries in respect of which legal persons are exempt under certain conditions (see **2.7 Capital Gains Taxation**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Apart from the specific anti-avoidance provisions mentioned above, on 1 January 2014 a General Anti-abuse Rule was introduced for the first time in Greece, as part of the wider measures to combat tax evasion or avoidance. Such rule was recently amended to incorporate part of the EU Anti-Tax Avoidance Directive into Greek domestic law. The rule allows tax authorities to ignore an arrangement or a series of arrangements which, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all relevant facts and circumstances.

An arrangement is to be regarded as non-genuine to the extent that it is not put into place for valid commercial reasons that reflect economic reality. In such cases, the tax liability is determined as the tax liability that would arise in the absence of such an arrangement.

In accordance with the relevant guidelines, the burden of proof is on the tax authorities. Moreover, no avoidance is considered to exist solely by reason of a taxpayer seeking to reduce its tax burden.

A specific anti-abuse rule applies in respect of tax-neutral corporate reorganisations such as mergers, share-for-share exchanges, spin-offs and demergers effected under the framework of the Income Tax Code, according to which tax benefits are withdrawn in whole or in part where the principal objective or one of the principal objectives behind the reorganisation is tax evasion or avoidance.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Tax authorities can audit the accuracy of tax returns, as well as the general compliance of taxpayers with their tax obligations, on the basis of procedures provided for in the Tax Procedures Code currently in force, and pursuant to the legislation applicable to periods prior to the Code's enactment in 2013, depending on the year audited. The state's right to assess taxes in addition to those deriving from a taxpayer's tax return is, in principle, time-barred, and lapses after a period of five years as of the end of the year when a tax return is due to be filed (ie, effectively after six years as of the audited year).

There are a number of derogations from this principle, either on the basis of specified exceptions or due to the operation of transitional provisions in relation to the regime applicable prior to the enactment of the Code. Exceptions include cases of tax evasion, where the prescription period is ten years in principle, and cases where the Greek tax authorities have requested information from foreign authorities, in which case the right is time-barred to lapse one year after the receipt of the information.

Legislative Extensions

As regards the legislative extension of prescription periods immediately prior to expiry (a practice consistently followed in the past), in a landmark decision that was issued in 2017 and has been endorsed by the Greek tax authorities, the Supreme Administrative Court ruled that the legal provisions extending prescription periods should be in accordance with the constitutional principle of limited retroactivity of tax laws, and therefore should be enacted no later than one year after the year when the relevant tax obligation arose.

Audits and Tax Assessments

The Greek tax authorities are obliged to publish annually the number of full and partial tax audits prioritised for the following year on the basis of risk-analysis criteria and other available information, and they are subject to percentage-based audit targets.

In general, all large businesses can be expected to be audited within the time limits described above.

Taxpayers can challenge a tax assessment by filing an out-of-court administrative appeal against such assessment.

9. BEPS

9.1 Recommended Changes

Greece is largely compliant with the principles developed and the measures recommended by the OECD/G20 BEPS action plan. In addition, being an EU member state, Greece is bound to transpose into domestic law the EU Directives that implement OECD/G20 BEPS conclusions at an EU level.

Since the introduction of a new income tax code on 1 January 2014, Greece has implemented various measures in compliance with the BEPS principles, also as implemented by the EU, namely CFC rules, interest deduction limitations, rules neutralising the effects of hybrid mismatch arrangements and rules on the mandatory disclosure of potentially aggressive tax planning arrangements.

Hybrids

In relation to hybrids, Greece has transposed the provisions of the EU Anti-Tax Avoidance Directive and of EU Directive 2017/952 amending the EU Anti-Tax Avoidance Directive as regards hybrid mismatches with third countries. In addition, Greece had previously transposed into domestic law the amendments made to the EU Parent-Subsidiary Directive, in accordance with which dividends paid by EU-based qualifying subsidiaries are not taxed to the extent that such profits are not deductible by the subsidiary. Greece has also transposed into domestic law the EU Directives providing for the automatic exchange of information on cross-border tax rulings and advance pricing agreements between EU member states.

Updated Domestic Frameworks

Greece has recently updated its domestic legal framework regarding the mutual agreement procedure provided under tax treaties and the EU Arbitration Convention, through the introduction of special rules in the Tax Procedures Code and the publication of administrative guidelines. Also, by ratifying the MLI, mandatory binding arbitration mechanisms for resolving issues under MAP shall be available.

Also, the current legal framework fully endorses the arm's-length principle, as defined in Article 9 of the OECD Model Tax Convention and interpreted by the OECD Transfer Pricing Guidelines, following the revisions introduced as a result of Actions 8–10.

As regards Action 13, Greece has also introduced into domestic legislation the automatic exchange of CbC reports amongst EU member states, as well as amongst the signatories of the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (concerning multinational enterprises with an annual consolidated turnover exceeding EUR750 million). A relevant bilateral agreement has also been concluded with the USA.

9.2 Government Attitudes

In general, the Greek government fully endorsed the BEPS project from the outset, was eager to adopt legislation in this direction and actively participated in the BEPS-related works, by means of including representatives of the General Secretariat of Public Revenue in the relevant working groups. Currently, this approach continues through, among others, the participation of the Independent Authority for Public Revenue in all the meetings of the Inclusive Framework on BEPS, where countries collaborate on the implementation of the BEPS package.

9.3 Profile of International Tax

International tax has a high public profile in Greece, most notably with respect to transfer pricing and the general objective of transparency. Transfer pricing has become an area of primary focus, both in terms of public opinion and at the level of tax authorities. A fully dedicated team within Greece's Independent Authority for Public Revenue deals with the transfer pricing legislative framework, including the issuance of decisions on APAs and MAPs.

An example of the tax authorities' commitment in addressing international tax issues, is that detailed guidance was issued in 2020 with respect to the interpretation of the provisions of tax treaties in view of the situations created as a result of COVID-19, in line also with OECD recommendations.

9.4 Competitive Tax Policy Objective

At this time, the primary focus in Greece is on the collection of taxes and the enhancement of attitudes towards tax compliance. Concurrently, one of the government's tax policy goals is the creation of an attractive business environment through the reduction of tax rates affecting businesses. Such measures do not appear to be conflicting with the BEPS outcomes. It should be ensured that BEPS-related measures in particular and anti-tax avoidance rules are not implemented by the tax authorities in an overly restrictive manner.

9.5 Features of the Competitive Tax System

There are no significant features of Greece's tax system that are particularly vulnerable to measures aiming to achieve the BEPS objectives in particular.

9.6 Proposals for Dealing with Hybrid Instruments

As regards proposals for dealing with hybrid instruments, as mentioned in **9.1 Recommended Changes**, Greece has transposed into domestic law the amendments made to the EU Parent-Subsidiary Directive, in accordance with which dividends paid by EU-based qualifying subsidiaries are not taxed to the extent that such profits are not deductible by the subsidiary, and are taxed to the extent that such profits are deductible by the subsidiary.

Greece has transposed the provisions of the EU Anti-Tax Avoidance Directive and of EU Directive 2017/952 amending the EU Anti-Tax Avoidance Directive as regards hybrid mismatches with third countries. In accordance, hybrid mismatches are the consequence of differences in the legal characterisation of payments (financial instruments) or entities with a possible effect of a deduction in both states or a deduction of the income in one state without inclusion in the tax base of the other. The rules lay down rules whereby one of the two jurisdictions in a mismatch should deny the deduction of a payment leading to such an outcome.

9.7 Territorial Tax Regime

Greece generally imposes tax on worldwide income, in the sense that it also exercises taxation rights in respect of the foreign-source income earned by Greek tax residents. Foreign tax residents are taxed in Greece under a territorial system, ie, they are only taxed on Greek-source income. It is notable that profits distributed by EU subsidiaries are exempt from corporate income tax in Greece, subject to specific requirements under the rules transposing the Parent-Subsidiary Directive.

Legal persons are exempt under conditions from tax on capital gains arising from the disposal of shares in EU Parent-Subsidiary Directive-qualifying subsidiaries (see **2.7 Capital Gains Taxation**). In such cases, apart from the generally applicable interest deductibility limitations, interest incurred as a result of financing the relevant participations is not deductible. The BEPS-related interest deducibility limitation of up to 30%

of EBITDA operates subject to a de minimis threshold of exceeding borrowing costs set at EUR3 million annually, which makes it likely to affect a smaller number of Greek enterprises.

9.8 CFC Proposals
As mentioned in **9.7 Territorial Tax Regime**, Greece does not have a territorial tax regime, and Greek CFC rules only capture profits of CFCs that fall under certain categories. When it comes to subsidiaries established in EEA member states, Greece does not have sweeper CFC rules: even if such states are low-rate jurisdictions, the relevant subsidiaries and permanent establishments are outside the scope of the CFC rules if such entities carry on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by all relevant facts and circumstances.

9.9 Anti-avoidance Rules
In the context of the MLI, Greece has adopted the principal purpose test (PPT) rule in order to prevent the abuse of benefits derived from its tax treaty network. Greece has explicitly opted out of the Simplified Limitation of Benefits. As detailed in **7.1 Overarching Anti-avoidance Provisions**, Greece incorporated a general anti-abuse rule into domestic law in 2014.

Both inbound and outbound investors may, therefore, be affected by a combination of the domestic law provisions, the anti-avoidance rules to be included in the double taxation treaties, and the EU rules as transposed into domestic law. Consequently, existing and new structures should be carefully reviewed from all of these perspectives.

9.10 Transfer Pricing Changes
Prior to BEPS, the applicable legal framework for transfer pricing in Greece fully endorsed the arm's-length principle as defined in Article 9 of the OECD Model Tax Convention and interpreted by the OECD Transfer Pricing Guidelines; currently, it also follows the revisions introduced as a result of Actions 8–10 of the OECD BEPS project. In general, no radical changes have taken place under the BEPS transfer pricing changes. As regards documentation, the required content of the local transfer pricing files is not yet fully aligned with BEPS Action 13, particularly in relation to value chain analysis.

As mentioned in **9.1 Recommended Changes**, one relevant change is that, in the aftermath of BEPS, Greece has also introduced into domestic legislation the automatic exchange of CbC reports amongst EU Member States, as well as amongst the signatories of the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (concerning multinational enterprises with an annual consolidated turnover exceeding EUR750 million) and the USA, with the first reporting year being the year commencing 1 January 2016. Surrogate reporting and local notification requirements have also been adopted.

Information on the ownership of intangible assets in the group, as well as related-party transactions for the licensing of rights on intangible assets, forms part of the transfer pricing documentation required under domestic law. The role of each related party in the development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangible assets is an element of increasing significance in terms of the scrutiny of related-party transactions between domestic licensees and foreign IP-holding entities.

9.11 Transparency and Country-by-country Reporting
Although transparency, country-by-country reporting and mandatory disclosure of potentially aggressive tax planning arrangements are positive measures in terms of combatting tax avoidance, care should be taken that the relevant implementation rules and their interpretation by the tax authorities lead to the minimum possible compliance burden for enterprises, and where applicable measures should be adopted to ensure that the relevant procedures do not lead to the unnecessary disclosure of commercial information.

9.12 Taxation of Digital Economy Businesses
Greece has not implemented any changes specifically relating to the taxation of transactions effected or profits generated by digital economy businesses operating largely from outside the jurisdiction. At a local direct taxation level, Greece has a legal framework regarding the taxation of short-term rentals in the sharing economy through digital platforms.

In the context of the OECD/G20 Inclusive Framework on BEPS, Greece participates in the OECD Task Force on the Digital Economy, which works towards a consensus-based long-term solution to the broader challenges arising from the digitalisation of the economy.

9.13 Digital Taxation
See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP
Greece imposes withholding tax on royalties paid to offshore owners in exchange for the use of intellectual property. Rates can be reduced or eliminated if payments are made to beneficiaries in income tax treaty jurisdictions. Moreover, payments to persons residing in states deemed as non-co-operative or preferential are not deductible, unless the taxpayer proves that these expenses are incurred for real transactions and do not result in profit-shifting aimed at tax avoidance or evasion.

Zepos & Yannopoulos was established in 1893, and is a leading Greek law firm renowned for its legal acumen and integrity. It offers comprehensive legal and tax services, with a focus on multinational companies and high net worth individuals. The firm's tax and accounting practice is acknowledged as the largest and most specialised of any law firm in Greece, and offers the full range of tax services on both a transactional and ongoing basis, covering the areas of business tax advisory and compliance, finance and capital markets taxation, international tax and taxation of M&A, real estate taxation, tax controversy and litigation, transfer pricing, VAT, indirect tax and customs.

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ZEPOS & YANNOPOULOS

Trends and Developments

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Introduction

Greece ranks 29th overall on the 2020 International Tax Competitiveness Index. Greece's ranking in the Tax Competitiveness Index (the "Index") underlines the need for Greece to improve its position in the Index in order to become more attractive for investments and creating new jobs. The right-wing party that entered into government in July 2019 has begun implementing a flurry of never seen before tax reforms, both for private individuals as well as businesses, that should be able to move Greece in the short term to the 27th and in the long term to the 22nd position in the Index rankings. Below is a brief summary of the trends and developments in taxation in Greece.

Income Tax and Capital Gains

Greece's corporate income tax rate has been on a bit of a bumpy ride over the last several years. After hitting a low point of 20% in 2011, Greece's rate was hiked in two stages until it reached 29% in 2015. Greece brought the corporate income tax rate down from the 28% to 24%, moving Greece closer to the current OECD average of 23.6%. It is in the government's mid-term plans to lower Greece's corporate income tax rate back to 20%.

In addition, the Greek government lowered the income tax rate for dividends even lower from 10% to 5%, making the tax rate one of the lowest.

As of 1 July 2020, Greek companies are exempt from capital gains tax arising from the disposal of "participations" held in legal entities, provided that they hold at least 10% participation for a period of 24 months and the conditions of Directive 2011/96/EU (Parent-Subsidiary Directive) are met. This income is not subject to tax upon distribution or capitalization, whereas any related expenses are not deductible. This reform is revolutionary for Greek corporate Greek income tax as the exemption applied only to dividends arising from "participations" and not

Foreign companies are as of 1 January 2020 exempt from tax on interest they generate from listed corporate bonds. Moreover, tax exemption for interest and royalty payments between associated enterprises in accordance with the provisions of Directive 2003/49/EU (Interest-Royalties Directive) applies equally to payments paid between Greek companies.

Tax Deductibles

It should be noted that Greece has also passed several tax incentives for companies adopting measures that are in favour of corporate social and environmental responsibility as well as companies that wish to make donations to the Greek State.

Greece has also made it easier to write off bad debts (VAT included) up to EUR300 per debtor without obliging the company to file law suits, provided that bad debts written off do not exceed 5% of the total amount of the receivables of the business per tax year. Moreover, bad debts can also be written off in the context of mutual agreement or judicial settlement.

Expenses related to R&D are deducted at the time of their realisation at their full (100%) actual expense (rather than the previous 30%). Even more importantly, the manner in which R&D expenses are certified has also been changed. Now, the certification procedure is effected through an audit report issued by a certified auditor or audit firm and not (as previously done) by the General Secretariat for Research and Technology, which was a slow and ambiguous process. The above is in effect as of 1 September 2020.

Management Tax Co-liability

Radical changes have also introduced in relation to management's co-liability in the event the companies they manage fail to pay taxes and social security contributions. First, the law sets out explicitly the taxes for which management can be held personally liable and which are specifically income tax, withholding taxes, consumption taxes, VAT and annual real estate tax (excluding all other taxes such as stamp duty, special real estate tax, real estate transfer tax, standalone penalties, etc). Second, in order for joint liability to be established, management must be acting at fault in relation to the non-payment of the above-mentioned taxes, as opposed to the previous regime, where liability was established objectively, merely due to the management capacity as such.

Real Estate

In order to boost sales of real estate in Greece, VAT on sales of new buildings (with a construction permit issued as of 1 January 2006) has been suspended up to 31 December 2022, albeit it is questionable whether the this is compatible with the EU VAT Directive. It should be noted that real estate transfer tax is imposed on the sale, whereas the constructor is obliged to settle the corresponding input VAT.

Additional exemptions from the special real estate tax of 15% has been introduced, applicable for institutional and other international investors engaged in the real estate market, indicatively applicable to: real estate mutual funds, venture capital funds, European long-term investment funds, alternative investment funds, UCITS, European venture capital funds and European social entrepreneurship funds.

The minimum taxation (0.75% imposed on the average net asset value of investments) of Greek REICs (real estate investment companies), real estate mutual funds and portfolio investment companies has been abolished, as is the minimum taxation of UCITS. REICs have to pay an annual tax set a rate set at 10% of the ECB intervention rate increased by one point and is calculated on the average of the investments, plus any available funds, at their current value. On the basis of the above, the current annual tax rate is 0.125% slashed from 0.75%.

Exit Tax

Article 58 of Law 4714/20 incorporated the provisions of Article 5 of Directive (EU) 2016/1164, with the addition of Article 66A to the Greek Income Tax Code. The new provisions provide that if a Greek company or permanent establishment (PE) transfers assets, its business or its tax residence out of Greece as of 1 January 2020 onwards, any capital gain (even if not yet realized at the time of exit) is subject to Greek corporate income tax.

In particular, exit taxation is imposed on the following cases:

- transfer of assets from a Greek to a foreign affiliate or PE, subject to Greece not being able to tax the transferred asset;
- transfer of tax residence of a Greek company or PE out of Greece, except for those assets that remain connected with a PE in Greece; and
- transfer of the business carried on by a PE from Greece to a foreign country, subject to Greece not being able to tax the transferred assets due to the transfer.

The tax basis for calculating the capital gain is the difference between the market value at the time of the exit and the value the particular asset or business had for tax purposes.

The exit tax is paid though in one lump sum, exhausting any further income tax liability. Alternatively, the exit tax can be paid in five equal interest-free installments, in the event the assets or the business have been transferred to an EU member state or to a third country that is party to the EEA Agreement.

It should be noted that transfers of assets in particular circumstances may not be subject to exit tax, if the said assets will return to Greece within 12 months.

Hybrid Mismatch

Article 59 of Law 4714/20 incorporated the provisions of Article 9 of Directive (EU) 2016/1164, with the addition of Article 66B to the Greek Income Tax Code, establishing rules for hybrid mismatches ("mismatches"). In particular, mismatches effectively arise when two countries characterise payments differently, often leading to the double deduction of the same payment (as an expense or a loss) or the deduction of a payment in one country without the same payment being taxed in the other country.

It should be noted that the commentaries and examples of the OECD BEPS Action 2 Report can be used in Greece for construction purposes. However, it should be noted that, if the provisions of another Directive resolve any mismatches, these rules do not apply.

Mismatches are applicable only between related companies and PEs within the same group or through a structured arrangement and they do not apply to individuals. In order for the company or a PE to be considered "related" a participation rate of 50% or more is required.

Tax Incentives to Angel Investors

According to the new Article 70A of the Greek Income Tax Code, individuals (not companies) who contribute capital to Greek start-up companies duly registered with the National Registrar of Start Up Companies of the General Secretariat for Research and Innovation of the Ministry of Development and Investments can deduct from their taxable income, an amount equal to 50% of the amount of their contribution, in the tax year in which the contribution was made. This incentive applies to capital contributions via a bank deposit of up to EUR300,000 per tax year, which are invested in up to three start-ups with a maximum investment of EUR100,000 per start-up.

Share Option Plans

The Greek Income Tax Code has introduced, as of 1 January 2020, an exemption from income tax in connection with the receipt of shares received by an employee or a shareholder from a legal person or legal entity within the framework of a share option plan, in which the achievement of specific goals or the occurrence of a specific event, is set as prerequisite in order for the shares to be awarded. The capital gain arising for an employee or shareholder constitutes taxable income if the shares are sold 24 months after acquiring the share options.

Moreover, the capital gain on shares of a company that is a non-listed small enterprise or a very small enterprise is subject to 5% capital gains tax (and not at the standard 15% capital gains tax rate), provided that the following conditions are cumulatively met:

- the above rights are acquired within five years after the establishment of the company;
- the company has not been incorporated through a merger; and
- the shares are transferred after the completion of 36 months from the acquisition of the share option.

Retroactive Effect of Advance Pricing Agreements (APAs)

Under the previous law, APAs were issued only for future cross-border transactions between related parties for a pre-determined period of no more than four years. L.4714/2020 introduced, for the first time in Greece, the possibility of retroactive effect of APAs subject to the fulfillment of the following conditions:

- the facts and circumstances of the previous years are the same as the ones of the year of the application;
- there is no statute of limitation for the Greek State to carry out a tax audit; and
- the applicant has not been notified of a tax audit.

In the case an APA is issued, pursuant to which the Greek company has to submit an amending income tax return, the Company will not pay interest and late payment fines.

E-books and E-invoicing

Law 4701/20 that was passed on 30 June 2020 introduced a new provision in the Greek Income Tax Code (70 f), pursuant to which companies opting for e-invoicing through licensed providers, are granted the following tax incentives:

- reduction of the statute of limitation by two years;
- the cost of the equipment and software purchased for the respective e-invoicing as well as the costs for producing, transmitting, and filing of e-invoices for the first year are deducted in the year of purchase, the deductible cost being increased by 100%; and
- the tax refund timeline is reduced to 45 days (from 90 days).

Out-of-Court Settlement of Disputes

With the aim of quickly resolving pending tax disputes before the tax courts, an Out-of-Court Tax Dispute Resolution Committee has been established for resolving specific issues, which are the following:

- statute of limitation of the State's right to impose taxes or penalties;
- wrong charging of tax or penalty due to an obvious lack of a tax obligation or calculating error;
- retroactive effect of more favorable tax sanctions; and
- reduction of additional taxes, interest, surcharges and penalties.

The application may only apply to pending cases that have not been discussed by 30 October 2020. The Committee verifies the allegations based on the case law and the regular practice of the Tax Administration and may propose the acceptance or rejection of the request in whole or in part, submitting a specific proposal to the applicant in each case. In the event the applications is rejected, a report of the out-of-court settlement is drawn up.

Shared Services Centers

Greek L.89/67 provides for a special tax regime for the establishment of Shared Services Centers in Greece in order to provide specific back office support shared services (advisory services, central accounting support, quality control of production, product process and services, design of studies, projects and contracts, advertising and marketing services, data processing, supply of information, research and development) to related companies.

The main benefits of the regime are that:

- the taxable profits are determined based on the cost-plus method;
- the applicable mark-up is pre-approved by the above-mentioned decision and is reviewed every five years;
- all expenses on which the mark-up applies are tax deductible for corporate income tax purposes (without any conditions); and
- transfer pricing obligations are fulfilled by the receipt of the relevant Ministerial Decision.

Under the new law the range of shared services has been expanded to include the following:

- T software development;
- computer programming and IT support;
- storage and management of records and data;
- management of suppliers, customers and supply chain, excluding transportation by own means;
- HR management and training of employees; and
- computer-based call center and telephone information services.

Moreover, companies that opt for the regime of L.89/1967 may also receive financial support in the form of grants, covering part of the eligible expenses.

The supply of the above shared services does not constitute a place of effective management in Greece by the foreign company established in Greece.

The preconditions set are that the companies develop a new activity, either regarding the nature of the services rendered or the companies to which those services are rendered, which must not have been performed in Greece for the last two years until the date on which the application to receive the grant is submitted, and a minimum number of new jobs is created by the new activity, which are maintained for a minimum specified period.

Greek Stamp Duty on Loans

One of the biggest financing problems faced by companies in Greece the past decades has been the imposition of stamp duty of 2.4% on the capital and interest of non-banking loans and credits issued to or by Greek companies.

However, the above regime came to a halt following Greece's Supreme Administrative Court's (SAC) landmark decisions No 2163-4/2020 and No 2323-5/2020, which ruled that the granting of non-banking loans in exchange for interest by VAT able persons falls within the scope of VAT. Thus, according to Article 63 of the Greek VAT Code such loans and credits are exempt from Greek stamp duty. In particular, the imposition of stamp duty on interest-bearing loans by VATable persons has been abolished since 1987 when VAT was first introduced which explicitly defined that as of the introduction of VAT Law, the stamp duty provisions on cases provided for in the Greek VAT Code (even of exempt) are abolished.

On the basis of the above, the SAC, held that the granting of interest-bearing loans by a VATable person acting in that capacity, constitutes a supply of services in exchange for consideration (ie, interest) and such activity should be subject to VAT (and not stamp duty) thus falling within the general concept of granting of credits.

Conclusion

The trends and developments in the area of tax will be conducive on economic growth and are heading in the right direction to help Greece improve its tax competitiveness, moving down from the 29th position in the Tax Competitiveness Index, aspiring to reach as low as the 22nd position.

Machas & Partners Law Firm is an independent, full-service corporate and commercial law firm with a strong presence in Greece, consisting of five partners and ten associates. The firm has extensive activity in Greek and international corporate tax advisory services, M&A, private client tax and wealth advisory services, and tax diagnostic reviews, audits and litigation. Tax-related areas include research and consultation on the direct and indirect tax treatment of proposed transactions, investments and businesses both in Greece and abroad; interpretation of tax legislation and advising on obligations and tax issues arising therefrom, including assessing tax exposure and risk; cross-border taxation of profits, dividends, royalties and interest, and international tax and customs implications in cross-border transactions; general anti-abuse and anti-avoidance legislation; remuneration policies for executives and employees; and ad hoc corporate and private tax advice.

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GUATEMALA

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses commonly adopt a corporate form. Regardless of the corporate form adopted by the business, each entity is taxed as a separate legal taxpayer from its members, partners or shareholders. The Guatemalan Commercial Code defines five basic types of corporate entity for business purposes, whose key differences may be generally described as falling under one of two categories: separate corporate entities and partnerships. They are as follows:

Separate corporate entities:

- limited liability company (LLC) (*sociedad de responsabilidad limitada*, or SRL); and
- stock corporation (*sociedad anónima*, or SA).

Partnerships:

- general partnership (*sociedad colectiva*);
- limited partnership (*sociedad en comandita simple*); and
- partnership by shares (*sociedad comandita por acciones*).

Businesses may also operate as branches of foreign companies.

The main corporate forms used as business vehicles are the stock company and the limited liability company.

Stock Company

This is the most common corporate form used in Guatemala. It offers the most flexibility, allowing shares to be freely transferred, which is not the case in a limited liability company. The shareholders of an SA are not personally liable for the SA's obligations beyond the amount of capital each shareholder subscribes and pays. An SA's obligations are guaranteed by the company's assets and the shareholders' subscribed and paid capital.

An SA's governance structure includes:

- the shareholders of the company (generally, there are no prohibitions for foreign individuals and/or corporations to be shareholders of an SA);
- the board of directors or a sole administrator; and
- the general manager (CEO) of the company.

Limited Liability Company

Limited liability companies are used less commonly by foreign investors than SAs. It is, however, more difficult to transfer ownership in a limited liability company, as this requires the amendment of the company's articles of association, and to register with the Commercial Registry a certified copy of the deed needed to make the transfer. A limited liability company is often used where a "tick the box" tax arrangement is preferred by US corporations for the purpose of paying taxes only at the level of the parent corporation. Only the limited liability company (up to the value of the available assets belonging to it) is liable for its obligations in Guatemala.

1.2 Transparent Entities

For local purposes, there are no entities considered as transparent. However, the Guatemalan LLC is commonly used for transparency purposes before tax authorities in the USA and other jurisdictions.

1.3 Determining Residence of Incorporated Businesses

Guatemala has no double taxation treaties currently in force. However, Guatemalan tax law sets the minimum standards regarding residence; ie, being incorporated under Guatemalan laws; effective place of management in Guatemala; having its tax or corporate seat, a permanent establishment or the centre of economic interests located in Guatemala.

1.4 Tax Rates

Guatemalan income tax has an applicable rate for different kinds of income. For income derived from the ordinary course of business, there are two types of regimens: (i) the general statutory corporate income tax regimen, with a tax rate of 25% on net income; and (ii) the flat rate regimen, with tax rates of 7% or 5% on gross income, minus exempt income. Under this regimen, the applicable tax rate will depend on the amount of taxable income. When the taxable income is less than (approximately) USD3,870.96, the applicable tax rate is 5%. When the taxable income is equal to or above that amount, the applicable tax rate is 7% on the surplus, plus a fixed amount of USD193.54.

Non-residents without a permanent establishment are subject to a final withholding tax between 5% and 25% on Guatemalan-sourced income.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

As a rule, profits are taxed on an accrual basis and based on accounting profits. However, tax adjustments must be made to comply with legal requirements for determining the taxable base. The most common tax adjustments are limitations set by law on deductibility of expenses actually incurred for generating taxable income.

2.2 Special Incentives for Technology Investments

There are currently no special incentives under Guatemalan law.

2.3 Other Special Incentives

Guatemala grants certain tax incentives to specific activities developed within the country, such as power generation using clean energy technology, manufacture of goods and the provision of telecommunication services (including call centres and business process outsourcing).

Generally, these tax incentives are:

- an income tax exemption for up to ten years;
- an exemption or suspension (as applicable) from customs duties on the importation of machinery and capital goods related to the activity; and
- an exemption or suspension (as applicable) from VAT on the importation of machinery and goods related to the activity.

2.4 Basic Rules on Loss Relief

Losses incurred during a tax year can only be offset against earnings from the same period. Therefore, no carry forward or backward is allowed. However, capital losses may be offset against capital gains only and carried forward for up to two years.

2.5 Imposed Limits on Deduction of Interest

Interest payments are deductible as long as they are incurred in order to generate taxable income and up to a limit of multiplying the applicable interest rate (defined by financial authorities according to the law) by three times the average net assets in one tax year.

2.6 Basic Rules on Consolidated Tax Grouping

Group consolidation is not permitted for tax purposes. All entities are considered separate taxpayers. Companies cannot utilise separate company losses.

2.7 Capital Gains Taxation

Capital gains are taxed at a rate of 10%. The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the sale price. Although there are no exemptions relative to capital gains, it is possible to deduct up to 15% of the transaction value as transaction costs.

2.8 Other Taxes Payable by an Incorporated Business

VAT and Stamp Tax are payable by an incorporated business on a transaction.

2.9 Incorporated Businesses and Notable Taxes

In addition to income tax, Guatemala's tax system also includes the following notable taxes.

- VAT – general rate of 12%. VAT liability is the difference between the total tax debits and the total tax credits generated. Such credit must be related to the taxpayer's course of business in order to be offset against tax debit. There is a reduced rate of 5% for small taxpayers (roughly under USD16,375.00 yearly income).
- Stamp tax – general fixed rate of 3% on certain taxable documents, and specific rates for other documents and acts.
- Alternative minimum tax (*impuesto de solidaridad*, or ISO) – fixed 1% rate on the greater value between a quarter of annual gross income and a quarter of the value of net assets.
- Property (real estate) tax (*impuesto único sobre inmuebles*, or IUSI) – variable rate (0.2%, 0.6% or 0.9%) depending on the declared value of the property.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a non-corporate form.

Although Guatemalan law does not include a formal concept equivalent to closely held corporations, the VAT Law includes a special regime for small businesses (individuals and corporations), as stated in **2.9 Incorporated Businesses and Notable Taxes**.

3.2 Individual Rates and Corporate Rates

Under Guatemalan tax law, individuals may generate income as employees or as independent professionals or technicians.

In regard to labour income, tax-resident employees are liable to pay income tax at 5% or 7%. Employees with an income less than USD40,518.75 are taxed at 5%. Those making that amount or more are taxed at 7% on the surplus, plus a fixed amount of USD2,025.94. Deductions allowed are:

- a cost of living allowance of about USD8,103.75 per year;
- social security contributions and contributions to pension funds; and
- life insurance premiums (that do not provide for rescue value).

The employer must calculate and withhold the monthly tax throughout the year, and a final payment or refund is made at the end of the fiscal year, if more or less than the required tax has been withheld.

Regarding professional or technical services and business income, the same tax regimes are available for both professionals and corporations (see **1.4 Tax Rates**). Thus, the same tax rates would apply in similar circumstances.

Under the gross income tax regime, payment is generally made through withholding.

3.3 Accumulating Earnings for Investment Purposes

There are no statutory provisions preventing closely held corporations from accumulating earnings for investment purposes. However, the partners or shareholders may freely establish provisions on the matter in the by-laws.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividend/profit distributions are subject to a final 5% withholding tax. The disposal of shares or participations in a company is subject to capital gains tax (10% rate). The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the sale price.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividend/profit distributions are subject to a final 5% withholding tax. The disposal of shares or participations in a company is subject to capital gains tax (10% rate). The taxable gain is determined by the difference between the book value or purchase value (as applicable) and the sale price.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The Income Tax Act includes a general provision subjecting non-residents without permanent establishment to final withholding taxes on Guatemalan-sourced income. These are final rates without tax reliefs, and applicable depending on the type of income as described in the law.

The applicable withholding rates for each source are:

- dividends and profit distributions – 5%;
- interest – 10% (not applicable to interest paid to regulated banking and financial institutions); and
- royalties – 15%.

The law grants a wide definition of what are considered interest and royalty payments, which sometimes differ from their usual concept.

4.2 Primary Tax Treaty Countries

Guatemala has no tax treaties in force.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Guatemala has no tax treaties in force.

4.4 Transfer Pricing Issues

Transfer pricing rules are fairly new in Guatemala. The biggest issue that the tax authorities have raised is regarding the import and export value method (sixth method, not OECD). Authorities tend to request the application of this method before one of the five OECD procedures. They have also focused on verifying the filing of the report as a formal obligation.

4.5 Related-Party Limited Risk Distribution Arrangements

The tax authorities, as mentioned above, have focused on the formal obligation of filing the report and application of the sixth method. Limited risk distribution arrangements have not been an issue with the authorities yet. However, any related-party arrangement that does not comply with transfer pricing (TP) rules should be challenged by the tax authorities.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Although Guatemalan income tax law generally follows the five OECD methods, it also includes a sixth method for determining arm's-length transactions (import and export value method).

4.7 International Transfer Pricing Disputes

Guatemala has no tax treaties in force.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Guatemala has no tax treaties in force.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

The law treats local branches of non-local corporations and local subsidiaries of non-local corporations identically.

5.3 Capital Gains of Non-residents

The Guatemalan Income Tax Act does not include a provision levying indirect disposal of Guatemalan companies. However, direct disposal of Guatemalan companies is subject to capital gains tax.

5.4 Change of Control Provisions

There are no change of control provisions.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no formulas used for determining the income of foreign-owned local affiliates.

5.6 Deductions for Payments by Local Affiliates

There are no applicable standards. In order for expenses to be deductible, they must be related to the generation of taxable income.

5.7 Constraints on Related-Party Borrowing

There are thin capitalisation and transfer pricing rules, as well as withholding tax, with regard to related-party borrowing by foreign-owned local affiliates paid to non-local affiliates.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign-sourced income is not subject to taxation, since Guatemala adopts a territorial taxation system.

6.2 Non-deductible Local Expenses

Since foreign-sourced income is not subject to taxation, any expense incurred related to such source is not deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are not taxed.

6.4 Use of Intangibles by Non-local Subsidiaries

Under transfer pricing regulations, intangibles developed by a local company (as its main course of business) cannot be used by non-resident related parties without incurring local corporate tax.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Guatemala does not have controlled foreign corporation (CFC) rules.

6.6 Rules Related to the Substance of Non-local Affiliates

Guatemalan tax law does not establish rules related to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Although gains on the sale of shares in non-local affiliates should be considered as foreign income, and therefore not subject to taxation in Guatemala, there is a risk that the local tax authority may consider such a transaction as a taxable event.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Guatemala does not have general anti-avoidance rules, other than those related to the tax adjustments for determining the taxable base.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Guatemala does not have a regular routine audit cycle.

9. BEPS

9.1 Recommended Changes

Guatemala is not a member of the OECD. Therefore, it has not yet strictly implemented the BEPS recommended changes. However, the new Income Tax Act (issued in 2012) includes some provisions that partly reflect BEPS guidelines, such as transfer pricing regulations that are heavily influenced by Action 13.

9.2 Government Attitudes

The government seeks to comply with most of the OECD guidelines, including BEPS. However, there is no strict policy developed for this purpose.

9.3 Profile of International Tax

Since the Guatemalan taxation system follows the territoriality principle, international taxation does not have a high profile in the jurisdiction.

9.4 Competitive Tax Policy Objective

Guatemala's tax policy is not highly influenced by BEPS.

9.5 Features of the Competitive Tax System
The most important key features of the Guatemalan tax system are its basis on the territoriality principle and its simplicity. They do not conflict with BEPS.

9.6 Proposals for Dealing with Hybrid Instruments
Since Guatemala has not yet implemented BEPS, the proposals for dealing with hybrid instruments do not appear as a relevant issue in the near future.

9.7 Territorial Tax Regime
Strictly speaking, there are no tailor-made provisions for interest deductibility limitations. Guatemala has general provisions such as thin capitalisation rules and all interest payments to non-residents are subject to a 10% withholding. However, the thin capitalisation rule differs from general rules of its kind by subjecting the limit calculation to local thresholds; eg, the interest rate published by the local financial authority must be used in order to determine the ratio.

9.8 CFC Proposals
Guatemala follows a strict territoriality principle and therefore foreign-sourced income is not relevant to local authorities. Since Guatemala does not have CFC rules, the general drift of the proposal should not greatly affect current practice.

9.9 Anti-avoidance Rules
Guatemala does not have double taxation conventions in force.

9.10 Transfer Pricing Changes
Since transfer pricing regulation is a relatively recent matter in the Guatemalan tax system, it already followed OECD guidelines when introduced. Consequently, the authors do not see BEPS implementation as a radical change.

9.11 Transparency and Country-by-country Reporting
As mentioned, some provisions of Guatemalan law partly align with BEPS, including Action 13. The Guatemalan Income Tax Act includes a provision similar to country-by-country reporting but it is only triggered if certain conditions are met. The authors consider this approach reasonable.

9.12 Taxation of Digital Economy Businesses
No changes have been made or are being discussed or proposed in relation to this issue.

9.13 Digital Taxation
Guatemala has not taken any position in relation to this proposal, nor have any been brought forward.

9.14 Taxation of Offshore IP
Guatemala has not introduced any other provisions dealing with this issue, other than withholding taxes on royalty payments.

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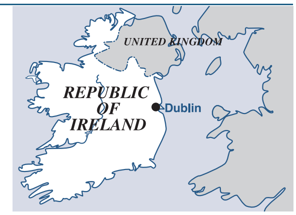

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Ireland tend to incorporate in order to take advantage of the benefits of separate legal entity status and limitation of liability. Ireland enacted amended and consolidated company law legislation in 2014 (the Companies Acts 2014), which provides for the following forms of incorporated entity:

- private company limited by shares (LTD);
- designated activity company (DAC);
- public limited company (PLC);
- company limited by guarantee (CLG);
- unlimited company; and
- investment company.

The limited company has traditionally been the most popular form for incorporated trading business, and is likely to remain so. Companies involved in the issuance of listed debt securities are formed as DACs. Investment funds are incorporated as investment companies or as an Irish Collective Asset Management Vehicle (ICAV).

Entities with separate legal form are taxed separately.

1.2 Transparent Entities

In Ireland, partnerships and limited partnerships are treated as transparent for tax purposes. Partnerships are generally used for investment purposes and also by certain professional services firms (eg, accountants and solicitors). In addition, pension funds may make use of a particular form of tax-transparent investment fund called a common contractual fund (CCF).

1.3 Determining Residence of Incorporated Businesses

A company that has its central management and control in Ireland is considered resident in Ireland, irrespective of where it is incorporated. A company that does not have its central management and control in Ireland but is incorporated in Ireland is considered resident in Ireland, except where the company is regarded as not being resident in Ireland under a double taxation treaty between Ireland and another country.

The term "central management and control" is, in broad terms, directed at the highest level of control of the company. The Irish Revenue Commissioners ("Irish Revenue") and the Irish courts emphasise the location of the meetings of the board of directors.

1.4 Tax Rates

Ireland has two rates of corporation tax:

- a 12.5% rate applies to the trading income of a company that carries on a trade in Ireland (including certain qualifying foreign dividends paid out of trading profits). There is no precise definition of what constitutes trade for this purpose but, broadly, where a company is carrying on an active business in Ireland on a regular or habitual basis and with a view to realising a profit, it should be considered to be trading for tax purposes; and
- a 25% rate applies in respect of passive or investment income, profits arising from a possession outside of Ireland (ie, foreign trade carried on wholly outside of Ireland) and profits of certain trades, such as dealing in or developing land and mineral exploration activities.

A 33% rate applies to capital gains.

The same capital gains rates also apply to gains earned by individuals directly or through transparent entities. Personal income is taxed at rates of up to 55%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporation tax is imposed on the profits of a company (including both income and chargeable gains), wherever they arise, for the fiscal year or "accounting period" of the company. The accounting period cannot exceed 12 months.

The starting point for determining taxable profits is the profit of the company according to its statutory accounts, subject to any adjustments required by law. The following are some of the more important items that are not deductible when calculating the tax-adjusted profits:

- any capital expenses;
- any expenses not wholly or exclusively incurred for the purposes of the trade or profession;
- general provisions for bad debts (specific bad debts and specific bad debt provisions are deductible);
- dividends or other distributions paid or payable by the company; and
- certain specific expenses, including business entertainment costs, interest on late payment of taxes, general provisions for repairs and certain motor leasing expenses.

A tax deduction is not available for accounting depreciation. However, capital allowances are available in relation to qualifying capital expenditure on land and buildings, plant and machinery and certain intellectual property.

Chargeable gains that do not form part of the trading profits are calculated in accordance with capital gains tax rules.

2.2 Special Incentives for Technology Investments

R&D Tax Credit

A 25% tax credit for qualifying research and development expenditure exists for companies engaged in qualifying in-house research and development undertaken within the European Economic Area (EEA). This credit may be set against a company's corporation tax liability. It is available on a group basis in the case of group companies. For accounting periods that commenced prior to 1 January 2015, the amount of qualifying expenditure is restricted to incremental expenditure over expenditure in a base year (2003). The tax credit is calculated separately from the normal deduction of the R&D expenditure in computing the taxable profits of the company.

Qualifying R&D activities must satisfy certain conditions and, in particular, must seek to achieve scientific or technological advancement and involve the resolution of scientific or technological uncertainty.

Where a company has insufficient corporation tax against which to claim the R&D tax credit in a given accounting period, the tax credit may be credited against corporation tax for the preceding period, may be carried forward indefinitely or, if the company is a member of a group, may be allocated to other group members. The R&D credit can also be claimed by the company as a payable credit over a three-year period or surrendered to "key employees" to set off against their income tax liability.

Knowledge Development Box

In 2016, Ireland introduced an OECD-compliant "knowledge development box" for the taxation of certain intellectual property. The amount of expenditure incurred by a company in developing, creating or improving qualifying patents or computer programs ("qualifying expenditure") is divided by the overall expenditure on such assets before being multiplied by the profits arising from such assets (eg, from royalties and net sales). The result is effectively taxed at 6.25%. A potential 30% uplift in the qualifying expenditure is available, capped at the total amount of acquisition costs and group outsourcing costs.

Capital Allowances on Provision or Acquisition of Intangible Assets

Capital allowances (tax depreciation) are available for companies incurring capital expenditure on the provision of intangible assets for the purposes of a trade. The relief applies to a broad range of intangible assets (eg, patents, copyright, trade marks, know-how) that are recognised as such under generally accepted accounting practice, and are listed as "specified intangible assets" in the Irish tax legislation. The relief is granted as a capital allowance for set-off against profits arising from the use of the intangible assets. The write-off is available in line with the depreciation or amortisation charge in the accounts or, alternatively, a company can elect to take the write-off against its taxable income over a 15-year period. Where the intangible asset is acquired prior to 14 October 2020 and held for more than five years, there is no clawback of the allowances on a disposal (unless the asset is sold to a connected company that wishes to claim allowances). If an intangible asset is acquired on or after 14 October 2020, a clawback or "balancing charge" will only arise on the disposal of that asset if the sales proceeds are in excess of the "tax written down value" of the asset. The allowance can be surrendered by way of group relief or carried forward if unused.

2.3 Other Special Incentives

Certain reliefs and incentives may apply for companies involved in shipping, financial services, property development, forestry, farming and mining businesses.

2.4 Basic Rules on Loss Relief

Ireland distinguishes between losses arising from trading income and losses arising from non-trading income. Trading losses are computed in the same manner as trading profits. Trading losses may be offset against non-trading profits, but are adjusted on a "value basis" so that they do not reduce the non-trading income more than they would have reduced the trading income.

Broadly, the following actions apply to trading losses, in the following order:

- trading losses can be set off against other profits of the company (before charges) in the same accounting period;
- trading losses can be set off against profits (before charges) of the previous accounting period of corresponding length, if the company carried on the trade in that period;
- trading losses of one Irish company (or of an Irish branch of an EU company) can be set off against the profits of an Irish resident company or Irish branch of an EU company in the same corporate group as the company that has excess trading losses; and
- trading losses can be carried forward on an indefinite basis and set off against future profits derived from the same trade.

2.5 Imposed Limits on Deduction of Interest

In general, trading companies can only take a deduction for interest incurred wholly and exclusively for the purposes of the trade.

Interest expenses incurred on funds borrowed to purchase, repair or improve rented premises are allowed as a deduction against the related rental income.

Interest incurred by a company on funds borrowed to acquire shares in, or loan money to, certain other companies can be allowable in full against the total profits of the company (as a charge on income), providing specific conditions are met.

While there are no "thin capitalisation" rules that apply in Ireland, it is nonetheless possible in certain limited cases for the interest to be reclassified as a distribution, preventing such interest from being tax-deductible.

The new EU Anti-Tax Avoidance Directive (EU ATAD or ATAD) contains certain restrictions on borrowing costs. It is expected that ATAD-compliant interest limitation rules will be introduced into Irish law with effect from 1 January 2022.

2.6 Basic Rules on Consolidated Tax Grouping

The concept of consolidated tax grouping for corporation tax purposes does not exist in Ireland. Trading losses may be offset on a current-year basis against the taxable profits of another group company.

Both the claimant company and the surrendering company must be within the charge to Irish corporation tax. To form a group for corporation tax purposes, both the claimant company and the surrendering company must be resident in an EU country or an EEA country with which Ireland has a double tax treaty. In addition, one company must be a 75% subsidiary of the other company, or both companies must be 75% subsidiaries of a third company. The 75% group relationship can be traced through companies resident in a "relevant territory" – ie, an EU Member State, an EEA treaty country, or another country with which Ireland has a double tax treaty.

2.7 Capital Gains Taxation

Capital gains other than gains from development land are included in a company's profits for corporation tax purposes and are charged to tax under a formula whose effect is that tax is paid at the prevailing capital gains tax (CGT) rate, currently 33%.

Substantial Shareholder's Relief

Disposals by a company of a substantial shareholding in a subsidiary company that is resident in an EU Member State or a country with which Ireland has concluded a double tax treaty are exempt from CGT if, at the time of the disposal:

- the subsidiary company carries on a trade, or the activities of the disposing company and all of its 5% subsidiaries taken together amount to trading activities; and/or
- the disposing company holds or has held at least 5% of the ordinary share capital and economic interest in the subsidiary company for 12 months, beginning not more than two years before the disposal.

Intra-Group Relief

Relief from CGT is available where both the company disposing of the asset and the company acquiring the asset are within a CGT group. A CGT group consists of a principal company and all its effective 75% subsidiaries. In addition, the shares must be within the charge to corporation tax on capital gains both before and after the transfer.

The effect of the relief is that both the company disposing and the company acquiring the asset are treated as if the shares were acquired for such consideration as would secure that neither a gain nor a loss would accrue to the disposing company (that is, the acquiring company takes the shares at the same base cost as applied to the disposing company).

Paper-for-Paper Reconstructions

Where shares are transferred as part of a bona fide scheme of reconstruction or amalgamation and certain additional conditions are met, no CGT arises for the disposing shareholders, and the acquiring shareholders are deemed to have received the shares on the same date and at the same cost as the old shares. The relief will only apply where the company acquiring the shares has, or as a result of the transaction will have, control of the target company, or where the share-for-share exchange results from a general offer made to the members of the target company.

2.8 Other Taxes Payable by an Incorporated Business

Stamp duty and VAT may be payable by companies on particular transactions.

Stamp Duty

Stamp duty is a tax on certain instruments (primarily written documents). Generally, unless exempted, stamp duty is chargeable on a document if the document is both:

- of a type set out in Schedule 1 to the Stamp Duties Consolidation Act 1999 (SDCA) (this lists the different categories of document to which stamp duty applies, including conveyances or transfers on sale of stocks or marketable securities and property); and
- executed in Ireland or, if executed outside Ireland, relates to something done or to be done in Ireland.

Generally, the purchaser or transferee is liable to pay stamp duty arising on a written instrument, and a return must be filed and stamp duty paid within 44 days of the execution of the instrument.

Stamp duty is broadly charged on either the consideration paid for or the market value of the relevant asset, whichever is higher. The main categories of instrument to which stamp duty applies and the applicable rates of the duty are as follows:

- transfers of shares or marketable securities: 1%;
- transfers of commercial property: 7.5%; and
- transfers of residential property:
  (a) 1% on consideration up to EUR1 million; and
  (b) 2% on the balance of consideration in excess of EUR1 million.

Stamp duty may also be chargeable in connection with certain leases and rent payments.

There are a number of reliefs and exemptions, including:

- group relief on transfers between companies where the transferor and transferee are 90% associates at the time of execution and for two years afterwards; and
- exemptions for transfers of intellectual property, non-Irish shares, land, loan capital, aircraft and ships.

VAT

VAT is an EU transaction-based tax that is chargeable on the supply of goods and services in Ireland by a taxable person in the course or furtherance of a business carried on by him or her. The top rate of VAT is 23% and certain services (such as "financial services") are VAT exempt. VAT is also chargeable on:

- goods imported into Ireland from outside the EU;
- the purchase of certain services from suppliers outside Ireland; and
- the intra-EU acquisition of goods.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses operating in certain industries may be subject to additional taxes, such as relevant contracts tax (RCT) and professional services withholding tax. In addition, incorporated businesses are required to withhold income tax on payments to employees and directors of the company (pay-as-you-earn income tax, or PAYE), and to withhold tax at 20% from payments of interest, dividends and certain royalties (unless exempted). They must also pay social insurance contributions in respect of employees.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

Further detail on close companies is set out in **3.3 Accumulating Earnings for Investment Purposes**. Closely held companies that are professional services companies are liable to a surcharge on both undistributed investment and rental income and professional income. This surcharge is 15% of 50% of the annual undistributed professional income, and 20% of all of the company's undistributed investment and rental income.

In addition, Irish Revenue guidelines note that the mandating, allocating or routing through a firm or company of remuneration arising from an individual having or exercising an office or employment does not mean that the remuneration is taken outside of that individual's income tax rules.

3.3 Accumulating Earnings for Investment Purposes

For Irish tax purposes, a closely held company is a company controlled by five or fewer "participators", or by any number of participators who are directors. A "participator" is a shareholder or a person having an interest in the company's capital or interest.

Closely held companies are subject to a tax surcharge on investment income (including interest and distributions) or rental income that is not distributed within 18 months of the end of the company's accounting period. This surcharge is 20% of the undistributed income and is intended to act as a disincentive to individuals using corporates as personal holding companies and availing themselves of corporation tax rates that are lower than the tax rates applicable to individuals.

Closely held companies that are professional services companies are liable to a surcharge on both undistributed investment and rental income and professional income, as further described in **3.2 Individual Rates and Corporate Rates**.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Irish-resident individuals are liable to income tax at their marginal rate on the gross amount of any dividend received from an Irish company (whether that company is a closely held company or otherwise), with a credit for any dividend withholding tax (DWT) suffered.

Withholding tax at 25% is deducted from payments of dividends by Irish-resident companies to both Irish and non-Irish-resident individuals.

Irish-resident individuals are liable to CGT at a rate of 33% on the sale of shares in an Irish company (whether that company is a close company or otherwise).

Non-Irish-resident individuals are generally only liable to Irish capital gains tax on the sale of unquoted shares in an Irish company if those shares derive the majority of their value from:

- land and buildings in Ireland;
- minerals in Ireland and rights or interests associated with mining for or searching for minerals in Ireland; or
- exploration or exploitation rights in the Irish Continental Shelf.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The treatment set out in **3.4 Sales of Shares by Individuals in Closely Held Corporations** also applies to dividends from quoted companies and gains on the disposal of shares in quoted companies.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

DWT at the standard income tax rate of 25% applies to dividends and distributions made by Irish tax-resident companies.

There are a wide range of exemptions from DWT where the dividend or distribution is paid by an Irish-resident company to certain parties, including:

- another Irish tax-resident company;
- companies resident in an EU Member State (other than Ireland) or a country with which Ireland has concluded a double tax treaty, and which are not controlled by Irish residents;
- companies that are under the control, directly or indirectly, of a person or persons who are resident in an EU Member State or a country with which Ireland has concluded a double tax treaty and are not controlled by persons who are not resident in that country;
- companies whose shares are substantially and regularly traded on a recognised stock exchange in another EU Member State or country with which Ireland has concluded a double tax treaty, or where the recipient company is a 75% subsidiary of such a company or is wholly owned by two or more such companies; and
- a company resident in another EU Member State with at least a 5% holding in the Irish paying company (under Directive 90/435/EEC on the taxation of parent companies and subsidiaries – the Parent-Subsidiary Directive).

Interest Withholding Tax

Irish tax legislation provides that tax at the standard rate of income tax (currently 20%) is required to be withheld from payments of Irish-source interest.

However, a large number of exemptions from the requirement to withhold on payments of interest are available, including for:

- interest paid in Ireland to a bank carrying on a bona fide banking business;
- interest paid by such a bank in the ordinary course of business;
- interest paid to a company that is resident in an EU Member State or a country with which Ireland has signed a double tax treaty, where that territory imposes a tax that generally applies to interest receivable in that territory by companies from outside that territory;
- interest paid to a US corporation that is subject to tax in the US on its worldwide income;
- interest paid in respect of a “quoted Eurobond” (provided certain other conditions are met); and
- interest paid to certain Irish entities, including qualifying companies for the purposes of Section 110 of the Taxes Consolidation Act, 1997 (as amended) (TCA), investment undertakings and certain government bodies.

Withholding Tax on Patent Royalties

Withholding tax at a rate of 20% applies to payments of a royalty or other sum paid for the use of a patent.

Withholding tax will not apply to royalty payments that are made to associated companies resident in another EU Member State nor to royalties paid by a company in the course of a trade or business to a company that is resident in a country with which Ireland has a double tax treaty.

It has been Irish Revenue’s administrative practice since 2010 not to charge withholding tax on royalties payable under a licence agreement executed in a foreign territory that is subject to the law and jurisdiction of a foreign territory (subject to the Irish company obtaining advance approval from Irish Revenue).

4.2 Primary Tax Treaty Countries

Ireland is an open jurisdiction that encourages investment from all countries. No specific countries are preferred for investing in

Ireland. Many US, UK, European, Asian and Gulf Co-operation Council companies invest directly in Irish companies.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Generally, the use of a treaty by a tax-resident beneficial owner should be respected.

4.4 Transfer Pricing Issues

Ireland first introduced transfer pricing in 2011, which only applied to trading transactions involving the supply and acquisition of goods, services, money or intangible assets between associated persons or companies. Updated Irish transfer pricing provisions introduced in January 2020 extend the rules to non-trading income and capital transactions.

The rules require that transactions between associated persons should take place at arm's length, and that the principles contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration must be followed when analysing whether a transaction has been entered into at arm's length. The Finance Act 2019 removes the exclusion from transfer pricing rules that previously applied in respect of small and medium enterprises, but sets out that these enterprises are either fully exempt from transfer pricing documentation requirements or will have significantly reduced transfer pricing documentation requirements.

If Irish Revenue determines that a transaction was not entered into at arm's length and has had the effect of reducing profits or increasing losses, an adjustment will be made by substituting the arm's-length consideration for the actual consideration.

4.5 Related-Party Limited Risk Distribution Arrangements

Ireland should follow OECD norms and guidelines in relation to the application of transfer pricing rules.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Finance Act 2019 introduced new changes to Ireland's transfer pricing rules, in part to bring Ireland's transfer pricing legislation in line with the 2017 OECD Transfer Pricing Guidelines, and has applied since 1 January 2020.

4.7 International Transfer Pricing Disputes

There has been an increasing trend for taxpayers and tax authorities to seek resolutions to transfer pricing disputes through the use of mutual agreement procedures (MAPs). This is evidenced by an increase in Ireland's number of MAP cases in 2018, which rose by over 33% in the 12 months up to January 2019 and again in 2019 as that figure grew by over 50%.

Although the increasing number of MAP cases would indicate that a proliferation of disputes has occurred in recent years, the prevailing view is that the Irish Revenue Commissioners (as the Irish Competent Authority), where provided with comprehensive supporting transfer pricing documentation by the taxpayer, has shown an ability to resolve disputes on a principled basis that reflects the merits of the Irish taxpayers' position.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Irish Revenue allows for compensating adjustments where a MAP request is made and successfully resolved by Irish Revenue and any other relevant competent authorities. No particular difficulties are faced by claimants where double taxation conventions apply, with Irish Revenue seeking to implement best practice in line with the OECD's Manual on Effective Mutual Agreement Procedures.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Non-resident companies that carry on a trade in Ireland through a branch or agency are subject to corporation tax in the same manner as local companies.

5.3 Capital Gains of Non-residents

Non-Irish-tax-resident companies are liable for tax on gains arising from the disposal of certain assets, including:

- land and buildings in Ireland (relief from CGT may be claimed in respect of real estate acquired between 6 December 2011 and 31 December 2014 if it has been held for a period of at least seven years);
- minerals in Ireland and rights or interests associated with mining or searching for minerals in Ireland;
- exploration or exploitation rights in the Irish Continental Shelf;
- unquoted shares or securities deriving their value or the greater part of their value directly or indirectly from the above assets;
- assets situated in Ireland that are used, held or acquired for business carried on in Ireland through a branch or agency; and
- assets of a life assurance company that are situated outside Ireland but held in connection with the life business carried on by the company in Ireland, and that were used or held by or for the purposes of that company's branch or agency in Ireland.

5.4 Change of Control Provisions
Change of control provisions could arise in relation to the indirect disposal by a non-resident of an Irish land-rich company, as explained under **5.3 Capital Gains of Non-residents**.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
OECD standards would be expected to be applied in the determination of the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates
The basic rule for the allowance of deductions for Irish corporation tax purposes is that the expenses must have been incurred wholly and exclusively for the purposes of carrying on the trade or profession. As a general matter, it is difficult to envisage a situation where expenses incurred by a non-local affiliate could be considered to be incurred wholly and exclusively for the purposes of the trade of an Irish company, but there could be exceptions based on specific circumstances.

5.7 Constraints on Related-Party Borrowing
Other than as set out below, Ireland does not operate what would be considered statutory thin capitalisation rules.

In broad terms, an Irish-based borrower should be entitled to a tax deduction for payments of interest to a non-local affiliated lender. However, there are certain restrictions that would need to be considered, including but not limited to the following:

- the interest payments should be an arm's-length amount;
- the interest payments may be subject to withholding tax if the lender does not fall within relevant exemptions (see **4.1 Withholding Taxes** for details of potential exemptions);
- in certain cases, payments to a non-EU 75%-related affiliate may be re-characterised as a distribution subject to dividend withholding tax and disallowed as a deduction; and
- where a company borrows to finance the acquisition of shares, there may be a restriction if the lender is related to the borrower, under Section 247 of the TCA.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Foreign income is not exempt from corporate tax. A company that is tax-resident in Ireland is subject to corporation tax on all its profits, wherever they arise, at either 12.5% or 25%.

6.2 Non-deductible Local Expenses
This question is not applicable in Ireland.

6.3 Taxation on Dividends from Foreign Subsidiaries
Foreign dividends received by Irish companies are generally subject to corporation tax at a rate of 25%. However, dividends received by an Irish company from non-resident subsidiaries are subject to corporation tax at 12.5% if such dividends are paid out of the trading profits of a company that is resident:

- in an EU Member State;
- in a country with which Ireland has a double tax treaty;
- in a country that has ratified the Joint Council of Europe/OECD Convention on Mutual Assistance in Tax Matters; or
- in a non-treaty country, if the company is directly or indirectly owned by a quoted company.

Companies that are portfolio investors (ie, investors holding not more than 5% of the company and having no more than 5% of the voting rights) and that receive dividends from a company resident in an EU Member State or a country with which Ireland has a double tax treaty will be subject to corporation tax on those dividends, at the 12.5% rate.

6.4 Use of Intangibles by Non-local Subsidiaries
If an Irish company licenses intellectual property to a subsidiary, it will be subject to Irish corporation tax on the licence fees (or deemed licence fees if transfer pricing applies) received in respect of the licence. The rate will be 12.5% if licensing is part of the trading activity of the Irish company, or 25% if it is part of non-trading activity.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
Prior to ATAD, Ireland had very limited CFC rules. However, ATAD-compliant CFC rules were introduced in the Finance Act 2018, with the legislation taking effect for accounting periods beginning on or after 1 January 2019. Of the two frameworks available under ATAD, Ireland chose to adopt the "Option B" model.

Option B focuses on CFC income that is diverted from Ireland. Broadly, CFC income is that which arises to a non-Irish-resident company from non-genuine arrangements put in place for the essential purpose of obtaining a tax advantage. CFC income is attributed to the controlling company or a connected company in Ireland where that controlling or connected company has "significant people functions" (SPF) in Ireland. The CFC charge is based on an arm's-length measurement of the undistributed profits of the CFC that are attributable to the SPF.

Whether a CFC charge is imposed on an Irish controlling company will depend on the extent to which the CFC is regarded as having "non-genuine arrangements" in place. A CFC will be regarded as having non-genuine arrangements in the following circumstances:

- where the CFC would not own the assets or would not have borne the risks that generate all, or part of, its undistributed income but for relevant Irish activities or SPF being undertaken in Ireland in relation to those assets and risks; and
- where it would be reasonable to consider that the relevant Irish activities were instrumental in generating that income.

The concept of SPF is not defined in the Irish implementing legislation but must be construed in a manner consistent with the use of that term in the OECD report. If there is no SPF in Ireland to which the management of assets and business risks can be attributed, no tax will arise under the new CFC rules.

The CFC charge applies to the undistributed profits that have been diverted to the low-taxed CFC pursuant to non-genuine arrangements. The rate of Irish tax chargeable will depend on the nature of the income. In Ireland, trading income is taxed at 12.5% and non-trading income is taxed at 25%. A credit is available for any foreign tax paid by the CFC on its undistributed income.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no applicable Irish rules relating to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Irish companies are subject to CGT on the sale of shares in directly held non-local affiliates under the normal CGT rules at a rate of 33%, unless the substantial shareholder's exemption or group reliefs apply (as described in detail under **2.7 Capital Gains Taxation**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Ireland does have general anti-avoidance rules, recently amended, which are intended to negate the effects of transactions that have little or no commercial reality but are primarily intended to avoid or reduce a tax charge, or to artificially create a tax deduction or tax refund. The anti-avoidance rules mean that Irish Revenue may at any time deny or withdraw a tax advantage created through the use of a tax avoidance transaction by making or amending an assessment of that person.

In determining whether a transaction is a tax-avoidance transaction, regard should be had to the form and substance of the transaction, the substance of any other transactions directly or indirectly related to the transaction, and the final outcome of the transaction and any related transactions.

Where a person enters into a tax-avoidance transaction – ie, one that gives rise to a tax advantage contrary to general or specific anti-avoidance provisions – that person shall be liable to pay a 30% surcharge of the amount of the tax advantage. However, no surcharge is payable by a person who has made a valid protective notification. A taxpayer can also avail themselves of a reduced surcharge amount if a "qualifying avoidance disclosure" is made to Irish Revenue.

Article 6 of the EU ATAD also introduces a broad general anti-avoidance provision. However, the existing Irish general anti-avoidance provisions are regarded as being broader than those contained in Article 6, so no further amendment is envisaged at this time.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Ireland does not have a defined audit cycle for tax purposes: companies are subject to audit by the Irish tax authorities at any time. The time limit for enquiry by Irish Revenue into a tax return is four years from the end of the accounting period in which that return was filed.

9. BEPS

9.1 Recommended Changes

In response to the BEPS recommended changes, Ireland has introduced country-by-country reporting and updated its transfer pricing legislation, among other measures.

Other recent reforms include ratification and implementation of the BEPS Multilateral Instrument, introducing the automatic exchange of information between tax authorities, and mandatory disclosure of tax planning. Ireland has also amended its corporate tax residence rules in order to phase out the so-called "double Irish" structure used by certain multinational groups.

9.2 Government Attitudes

The Irish Government is committed to ongoing work on corporate tax reform, and has recently published a Corporate

Tax Roadmap, which lays out the next steps in Ireland's implementation of various commitments made through BEPS, along with other international initiatives. In this regard, Irish legislation concerning tax regulation has significantly increased over the past few years, and this effort is set to continue in the coming years.

With respect to the Irish Government's wider attitude, the Irish Department of Finance has insisted that transparency and substance are key components of the Irish tax regime, and is keen to ensure that Irish tax policy is continually in step with all BEPS proposals.

9.3 Profile of International Tax

The emergence of the double Irish structure, and its subsequent phasing out, along with the EC's recent Apple State Aid decision, has drawn public attention to international taxation. The Irish media also comments frequently on international tax matters, such as BEPS and US tax reform, given its importance to Ireland as an open economy.

Whilst this has not influenced Ireland's implementation of BEPS, the Irish Government has repeated that its commitment to corporate tax reform remains steadfast, and is keen to play a strong role in promoting BEPS in an international context.

9.4 Competitive Tax Policy Objective

Ireland has undertaken to review its corporate tax code regularly to ensure that new standards such as BEPS are met while remaining competitive as the economy continues to grow. Irish officials have made clear, however, that there will be no change to the corporate tax rate, indicating that "the cornerstone of our competitive offering remains the 12.5% corporation tax rate."

For Ireland's tax policymakers, the key balancing task is to ensure that the implementation phase of BEPS would result in the country's tax regime being seen as meeting the standards for substance and transparency while maintaining the country's reputation as an open economy that encourages foreign direct investment and has a low rate of corporation tax.

9.5 Features of the Competitive Tax System

Ireland's headline corporate tax rate of 12.5% has faced some commentary internationally. The Irish Government has reiterated its intention to retain the rate at its current level and has pointed to the fact that, under EU law, the determination of corporate tax rates remains the responsibility of each individual country as a national competence.

In a similar context, the Irish authorities have firmly voiced their opposition to the EC's interim proposal for a "digital economy tax", with the Irish Minister for Finance emphasising the need for unanimity before any EU digital tax proposal can be agreed. Similarly, the Irish Government has urged caution in respect of the proposed EU Common Corporate Tax Base, stating that discussions on harmonising tax across the eurozone are at a relatively early stage, and much more technical analysis and discussion is needed.

9.6 Proposals for Dealing with Hybrid Instruments

Ireland has implemented legislation to address hybrid mismatch arrangements as required by ATAD, with the exception of the anti-reverse hybrid rules, which must be implemented by 1 January 2022. The Irish implementing legislation took effect from 1 January 2020 in respect of all payments made after that date.

One of the purposes of the anti-hybrid rules is to prevent arrangements that exploit differences in the tax treatment of a financial instrument under the tax laws of two or more jurisdictions to generate a tax advantage – ie, a "hybrid" situation.

The rules are highly complex and will need to be considered in any international financing structure, especially where an Irish company is making deductible payments, such as under debt funding.

The rules apply to arrangements between associated enterprises. For this purpose, an entity is associated with another entity if it holds a certain percentage (25% or 50%, depending on the particular provision) of the shares, voting rights or rights to profits in that other entity, or if there is another entity that holds that percentage in both entities. Two entities will also be associated regardless of the percentage association if they are included in the same consolidated financial statements, or if one has significant influence over the management of the other. For this purpose, significant influence means the ability to participate on the board of directors in the financial and operating decisions of an entity.

The rules may also apply to a "structured arrangement" that is not between associated entities, where a mismatch outcome is priced into the terms of an arrangement, or where an arrangement is designed to produce a mismatch outcome.

ATAD sets out a number of specific situations that give rise to a hybrid mismatch, including where the payment under the financial instrument is not chargeable to tax due to differences in the characterisation of the payment in Ireland and another territory – eg, the payment is treated as debt in Ireland but as equity in the other territory.

In such cases, the Irish company may be denied a deduction for a payment made to an associated entity or as part of a structured arrangement to the extent such payment is not taxed in another territory. It is important to note that the rules do not require the denial of a deduction if the reason a payment is not taxed is because the other territory does not impose tax or does not generally impose tax on payments received from outside the territory, or if it exempts the payee from tax that generally applies in the territory.

The rules are of particular relevance for Irish companies used in fund and financing structures. They could apply whenever such companies make payments that give rise to a tax deduction in Ireland, but no other country taxes the associated receipt by reason of hybridity.

9.7 Territorial Tax Regime

Ireland does not have a territorial regime, but rather taxes companies on a worldwide basis. That said, as Ireland is party to a large number of tax treaties, the operation of a foreign tax credit system means that foreign tax paid on income can, in certain cases, be used to offset any Irish tax payable on the same income.

Furthermore, following a review of Ireland's corporate tax code that was commissioned by the Department of Finance in 2017, one of the recommendations was that consideration should be given to moving to a territorial system. Whilst further public consultation is expected to take place before any changes are introduced, this recommendation has generally received support from stakeholders.

Interest limitation rules are already in existence in Irish tax law, although these are different in structure from the rules set to be introduced under ATAD. Broadly, the effect of the Irish rules is that a tax deduction for interest is only available where the relevant borrowings are used for certain limited qualifying purposes.

In a tax strategy paper released on 14 January 2021, the Irish Department of Finance provided more information regarding the transposition of the interest limitation rules, following interaction with the European Commission, and indicated that draft legislation will be published in 2021, with an expected introduction from 1 January 2022.

9.8 CFC Proposals

A sweeper CFC rule would be problematic in that it would lead to an infringement regardless of the substantial activity of the companies in question. If revenues are gained abroad through a foreign subsidiary, then having them subsequently taxed in Ireland primarily on the grounds of the company in question being an offshore subsidiary, and without any reference to substance, would appear to be inappropriate.

9.9 Anti-avoidance Rules

Ireland signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) on 7 June 2017. The MLI came into force in Ireland on 1 May 2019, adopting the principal purpose test (PPT) provisions in its double taxation conventions.

In respect of anti-avoidance rules, Ireland already maintains a long-standing general anti-abuse rule under its tax code. Following a review of the relevant provisions, the Irish tax authorities have indicated that an amendment of the current General Anti-Avoidance Rule will not be necessary. Consequently, the proposed double taxation convention limitation of benefit and anti-avoidance rules are unlikely to have a significant impact on Ireland in respect of inbound and outbound investors.

9.10 Transfer Pricing Changes

As Ireland has had transfer pricing rules since 2011, the proposed changes are not expected to present any major hurdles to the Irish regime. Furthermore, the Finance Act 2019 introduced changes with effect from 1 January 2020 to bring the current regime in line with the new 2017 OECD Transfer Pricing Guidelines, which reflect the outcomes of BEPS Actions 8-10 and 13.

As discussed in **2.2 Special Incentives for Technology Investments**, Ireland has introduced a "knowledge development box". The operation of this regime is in line with similar schemes introduced in neighbouring jurisdictions, such as the UK, and provides for an effective 6.25% tax rate on income from IP and software that was improved, created or developed in Ireland. The introduction of this scheme has generally been welcomed, and has not been the subject of controversy or criticism.

9.11 Transparency and Country-by-country Reporting

Ireland is in favour of the country-by-country reporting proposals. Regulations implementing these rules have applied since 2016 to groups with an Irish presence and turnover exceeding EUR750 million.

More recently, an OECD peer group report confirmed that Ireland has introduced sufficient national laws to implement country-by-country tax reporting measures, and recommended that follow-up action was not necessary. Furthermore, the Finance Act 2019 introduced new rules giving effect to the EU DAC6 Mandatory Disclosure Rules legislation.

Accordingly, no change to the current Irish regime is anticipated.

9.12 Taxation of Digital Economy Businesses

No changes have been discussed or proposed at a domestic level.

9.13 Digital Taxation

In respect of wider international developments, the Irish Government has strongly opposed the EC's interim proposal for a "digital economy tax". Responding to the proposal, the Irish Minister for Finance referenced the OECD reports on digital taxation, hinting at a need for broader international consensus on this issue, rather than EU-focused measures. Moreover, the Irish Government also published a reasoned opinion on 16 May 2018, addressed to the President of the EU Council, questioning the necessity of these measures. In this instance, the Irish preference for building an international consensus based on proposals from the OECD appears to have prevailed, as the Council was unable to reach an agreement on the EU digital services tax on 12 March 2019. Most recently, the EU Council has agreed to further postpone the measure, indicating that if progress is not achieved at the OECD level by July 2021 then the EU will respond with fresh proposals.

9.14 Taxation of Offshore IP

Payments of patent royalties by an Irish resident company are typically subject to withholding tax at 20%. Patent royalties paid to associated companies resident in another EU Member State or paid in the course of a trade or business to a company resident in a country with which Ireland has a double tax treaty are generally exempt from withholding tax. The Revenue Commissioners issued a Statement of Practice in 2010, which effectively extends the relief from withholding tax on certain patent royalties paid to non-treaty countries. To avail of the exemption, certain conditions apply, including the fact that the royalty must be paid in respect of a foreign patent and the payment must be made in the course of the Irish paying company's trade. Prior approval of Irish Revenue will be required.

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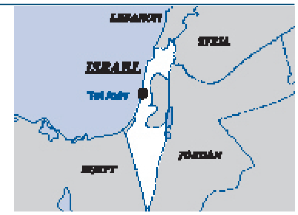

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Most businesses conducting business activities and trade in Israel are incorporated as companies limited by shares, which may be public or private, or as partnerships (for partnerships, please see below). Public company shares are listed on a stock exchange or offered to the public pursuant to a prospectus. A private company is any company other than a public company.

Israeli companies are generally respected as separate entities from their owners. The Israeli corporate tax regime is based on two-tier taxation: first, at the company level and second, upon distribution of dividends to the company's shareholders, at the shareholder level. Dividend income is subject to a lower tax rate than ordinary income (please see below).

1.2 Transparent Entities

Transparent entities commonly used include partnerships, which are treated as pass-through entities for Israeli tax purposes and, thus, are not subject to two-tier taxation. Only the partners in the partnership are subject to tax with respect to its income based on the pro rata rights of the partners to the partnership income. Partnerships are widely used in the case of private equity firms, and venture capital and hedge funds.

In a general partnership, each partner is liable for all the partnership's liabilities, as opposed to a limited partnership, in which the limited partners are liable only to the extent of their contribution to the partnership. Limited partnerships must have a general partner, who has unlimited liability. Only the general partner is allowed to participate in the management of the limited partnership.

Additional entities, which are not subject to two-tier taxation and are treated as transparent for Israeli tax purposes, include house property companies, which are minority companies (controlled by five or fewer persons, which meet several other conditions) whose assets and business are holding buildings. Certain family companies may appoint a "representative assessee" (a tax matters partner), who holds the rights to the highest percentage of the company's profits. The taxable income of the company is attributed to the representative and will not be subject to two-tier taxation.

1.3 Determining Residence of Incorporated Businesses

A company is considered resident of Israel for tax purposes if it is either incorporated in Israel or incorporated abroad, but it is managed and controlled from Israel. According to guidance published by the Israel Tax Authority (ITA), a company is managed and controlled in the place where the business strategy of the company is determined, that is, where the business decisions of the company are made. The location of the board of directors meetings is an important, though not a determinative, factor, especially where the board authorises another organ of the company to manage the company.

In a 2012 Supreme Court decision, the directors of a foreign company acted as an artificial platform for conducting the business of the Israeli company and were not substantially involved in the business management of the foreign company. The Supreme Court ruled that the foreign company was to be regarded as having been managed and controlled from Israel.

Transparent entities are not considered residents of Israel for double tax treaty purposes and are usually eligible to claim treaty benefits based on the residency of the interest holder (that is, the ultimate beneficial owner of the income).

1.4 Tax Rates

The corporate tax rate for incorporated businesses in 2021 is 23%. Permanent establishments of corporations are also subject to the regular corporate tax rate.

Capital gains and losses arising from real estate transactions located in Israel (including real estate associations) are taxed in accordance with the Land Taxation Law 5723-1963, at the applicable corporate income tax rate.

Transparent entities, such as business partnerships, are generally not subject to Israeli taxation at the level of the transparent entity but rather are taxed based on the pro rata rights of the partners to the partnership income. Thus, individuals may be taxed up to a 50% marginal tax rate (which includes a 3% surtax that is applicable to individuals with annual income over a certain threshold), and companies in accordance with the said corporate tax rate.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Israeli companies' income is taxed on a worldwide basis, while foreign companies are only subject to Israeli tax with respect to their Israeli-sourced income.

The company's net income, calculated using Israeli accounting principles and reconciled with the provisions of the Israel Tax Ordinance (the "Ordinance") and regulations, determines the tax base for corporate income tax purposes. In general, the accrual method of accounting is used by Israeli companies to report their income for accounting and tax purposes.

Tax and accounting rules differ in several areas, including accounting income derived from grouping rules that is eliminated for tax purposes, depreciation and amortisation rates and specific categories of expenses that may not be fully deductible, such as overseas travel expenses, vehicle expenses and similar expenses determined by relevant regulations.

2.2 Special Incentives for Technology Investments

In order to encourage start-up investments, Israeli tax law allows the deduction of up to ILS5 million invested in the shares of a company, immediately, or over a three-year period, by an individual or a partnership, provided certain conditions are met. This law was applicable until the end of 2019 and has not yet been extended. The authors anticipate it will be extended, subject to certain modifications, as part of the budget approval following the upcoming elections, with retrospective applicability to capture the 2021 tax year as well.

2.3 Other Special Incentives

Companies deemed "preferred enterprises" are entitled to reduced corporate tax rates with regard to their "preferred income" generated by a "preferred enterprise" within Israel. Depending upon their locations, the tax rate for preferred enterprises is 7.5% or 16%, as of 2021. Dividends distributed from certain preferred income are subject to 20% tax, in accordance with the Law of Encouragement of Capital Investments of 1959 (the "Encouragement Law").

More significant corporate tax reductions apply to large manufacturing companies, as profits of such companies are subject to 5% or 8% corporate income tax (depending upon the location of their manufacturing facilities).

In addition, "technology enterprises" that meet certain conditions are entitled to preferable corporate income tax rates on their preferred income, ranging from 6% to 12%. Subject to meeting certain conditions, including meeting a minimum 90% holding threshold, dividend distributions to foreign resident companies are subject to a 4% tax rate.

Assets and buildings used to produce certain preferred income are entitled to accelerated depreciation. During the first five years of operation, the company may depreciate its assets at 200% of the regular rate of depreciation with regard to equipment and 400% of the regular rate for buildings, with an annual upper limit of 20% of the value of the buildings.

Large manufacturing companies may also be eligible for grants of up to 20%, if certain conditions are met.

Most recently, Income Tax Regulations (Accelerated Depreciation during the Coronavirus Period) (Temporary Provision), 5780-2020 were finalised. These regulations aim to induce economic activity in Israel during the coronavirus crisis, although they are not limited to businesses that suffered losses, and benefits thereunder are available to any business that satisfies the conditions in said regulations.

2.4 Basic Rules on Loss Relief

Losses incurred from a trade or business may be used to offset any other income or gain recognised by the company in the same tax year, including interest, dividends and capital gains. Capital losses may only be offset against capital gains. Specific limitations apply to foreign-source losses. Net operating losses of a company may be carried forward indefinitely, although they may not be carried back. The balance of any unutilised losses in the same tax year may be carried forward indefinitely to be offset against business income and against capital gains from a business, but cannot be offset against income from any other source.

Carry-forward losses generally survive ownership change, although Israeli courts have ruled that, in certain circumstances, when a transaction is carried out for the sole purpose of utilising the carry-forward losses, such losses will not be recognised against the income of the company following the change of control. This is based on the anti-avoidance provision of Section 86 of the Ordinance, discussed further below.

2.5 Imposed Limits on Deduction of Interest

Generally, sums paid on interest or linkage differentials are deductible, provided that the capital was used for the production of the income. In certain cases, such as the receipt of income with special tax rates, or tax-exempt status, the expenses used to obtain such income must be deducted, either proportionately or according to other methods, against preferred income. Thus, in certain circumstances, holding companies may be required to deduct interest payments against exempted or special-rate income and therefore do not fully benefit from this deduction.

2.6 Basic Rules on Consolidated Tax Grouping

In general, Israeli law does not allow for consolidated tax grouping. However, Israeli-resident "industrial" companies (companies that receive 90% or more of their revenues from an industrial entity involved in a manufacturing activity) or a holding company of industrial companies may consolidate tax returns and file a single, consolidated tax return in respect of themselves and their subsidiaries (that are also industrial companies), if the industrial companies included in the consolidated group are part of a single manufacturing process or assembly line. In the event that an industrial holding company has subsidiaries engaged in different assembly lines, it may consolidate its return only with regard to the company or companies with a single assembly line, in which it has the largest capital investment.

2.7 Capital Gains Taxation

Local companies are subject to capital gains tax, according to the corporate income tax rate (23% as of 2021) upon the sale of shares of other companies. However, in the event that the company whose shares were sold is a non-publicly traded company, or is a public company in which the selling company is a substantive shareholder (holds at least 10% of any of the means of control of such company), and has accumulated profits available for distribution, the portion of the selling company's gain attributed to the years prior to 2006 is subject to 10% tax, while the gain attributed to 2006 onwards is tax exempt.

Foreign companies are generally exempt from capital gains tax upon sale of shares in Israel. See below for elaboration.

2.8 Other Taxes Payable by an Incorporated Business

Incorporated businesses are subject to regular capital gains tax upon taxable transactions. In certain transactions, value added tax (VAT) may be imposed, as detailed in **2.9 Incorporated Businesses and Notable Taxes**. In addition, there is no stamp duty in Israel, and transfer tax only applies upon certain transactions that involve purchase of real estate.

2.9 Incorporated Businesses and Notable Taxes

Israel charges VAT on transactions in Israel and on the importation of goods into Israel, the standard rate of which is currently 17%. A transaction that is a sale of goods is deemed to have taken place in Israel if, in the case of a tangible asset, it was delivered in Israel or exported to Israel, and if, in the case of an intangible asset, the seller is an Israeli resident. Certain transactions are subject to a zero-rate tax (mainly exports of goods and services) or exempt (such as certain financial services and specific real estate transactions). Financial institutions are subject to profit tax and a tax on paid salaries (salary tax), both at a rate of 17%, subject to certain adjustments. Businesses are entitled to recover input VAT costs in connection with goods or services used by them to create their taxable (including a zero rate) supply.

Israel imposes customs duties on certain imported goods and sales tax on certain imported and domestic goods. Israel also imposes several duties, such as trade levies and dumping levies, in accordance with the Trade Levy Law.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

It is difficult to ascertain how most closely held businesses operate in practice. However, in the event that they do incorporate, the responses set forth below apply.

3.2 Individual Rates and Corporate Rates

The Israeli corporate tax regime is based on two-tier taxation:

- tax at the company level – the corporate tax rate in 2021 is 23%, and;
- tax at the shareholder level, upon dividend distribution – the dividend tax rate for shareholders is generally 25%, which rate is increased to 30% for shareholders who hold 10% or more of any of the company's means of control ("Substantive Shareholders") at the time of the distribution or at any time during the 12-month period preceding the distribution.

The highest applicable marginal tax rate on ordinary income is 47% (in 2021). Moreover, an additional 3% surtax will apply to any taxable income of an individual that is above ILS651,600.

Although dividend income is subject to a lower tax rate than ordinary income, when taken together with the corporate income tax rate, the total tax paid can be almost equal to the highest marginal tax rate applicable to ordinary income.

Nevertheless, domestic law subjects the income of closely held companies, which stems from the personal exertion income of a Substantive Shareholder, to the marginal income tax rate, provided that several conditions are met. In addition, as discussed further below, in certain circumstances, a portion of the accumulated profits may be deemed notionally distributed.

3.3 Accumulating Earnings for Investment Purposes

As mentioned above, subject to meeting certain conditions, closely held companies are taxed on the income that stems from the personal exertion income of a Substantive Shareholder at marginal income tax rates.

In addition, under certain circumstances, the ITA may deem accumulated profits of a closely held company as distributed to its shareholders if the following conditions are met:

- the closely held company accumulates profits that exceed ILS5 million;

- it has not distributed to its shareholders a dividend of at least 50% of its profits in a tax year, until the end of the five-year period following such tax year;
- the distribution of the dividend does not damage or negatively impact the company; and
- the lack of distribution results in tax avoidance or tax reduction.

The ITA may exercise such authority and deem up to 50% of such accumulated profits distributed as a dividend (subtracting actual dividends paid), provided that the accumulated profits of the company do not fall below ILS3 million.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend, increased to 30% if they are Substantive Shareholders at the time of the distribution or at any time during the 12-month period preceding the distribution. An additional 3% surtax applies on the income portion exceeding ILS651,600.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Generally, individuals are subject to 25% tax upon receipt of a dividend, increased to 30% if they are Substantive Shareholders at the time of the distribution or at any time during the 12-month period preceding the distribution. An additional 3% surtax applies on the income portion exceeding ILS651,600.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of an applicable income tax treaty, the following particular withholding taxes apply to payments to non-Israeli residents.

In general, payments made to non-Israeli individuals are subject to 25% withholding tax, and non-Israeli corporations are subject to withholding tax pursuant to the corporate income tax rate (23% in 2021).

Interest paid to non-resident corporations is generally subject to withholding tax at the corporate income tax rate level (23% in 2021) and up to 47% in the event of a payment to an individual who is a Substantive Shareholder. Certain interest payments to non-resident investors are generally exempt from withholding tax, such as interest on certain traded government bonds and interest on certain deposits by a non-Israeli resident, provided the non-Israeli resident does not conduct business, or practise a profession in Israel.

Dividends distributed to non-Substantive Shareholders are subject to 25% withholding tax, while dividends to Substantive Shareholders (at the time of the distribution or at any time during the 12-month period preceding the distribution) are subject to 30% tax. However, if the Israeli-resident company distributing the dividend is a publicly traded company, and its shares are held by a registration company, then 25% withholding tax will also apply to Substantive Shareholders. In the case of a dividend distribution by a preferred enterprise, a reduced rate of withholding tax of 20% applies; and in the case of a dividend distributed by a technology enterprise, a reduced rate of withholding tax of 4% may apply under certain circumstances.

4.2 Primary Tax Treaty Countries

There are over 50 double tax treaties to which Israel is party and that are in force in Israel. Israel generally follows the Organisation for Economic Co-operation and Development (OECD) Model Convention, with the exception of a number of treaties (such as Norway and Sweden) signed in the 1960s and the 1970s, before the OECD model was widely accepted. Israel signed the Multilateral Instrument (MLI) in June 2017.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

An ITA circular describes the phenomenon of "Treaty Shopping" and lists several methods with which this issue may be confronted, such as:

- examining the residency of the entity, based on the rules determined in the relevant treaty;
- limitation of benefits provisions that allow the contracting states unilaterally or jointly to revoke or disallow benefits, in cases whereby the entity attempts to secure tax benefits unlawfully, or if the activity is deemed to be abuse of the treaty;
- beneficial owner provisions, which determine that only the ultimate beneficiary may be the recipient of treaty benefits;
- interpretation of the treaty based on the Vienna Convention, which calls, among other things, for treaties to be interpreted in good faith; and
- use of domestic anti-avoidance legislation, such as Section 86 of the Ordinance.

4.4 Transfer Pricing Issues

Foreign corporations that conduct business activity in Israel must operate in accordance with accepted transfer pricing standards and, in particular, the arm's-length principal.

In an international transaction where, due to special relationships between the parties, less profit is derived in Israel as compared to the price or conditions been between unrelated parties, the transaction must be reported according to the market conditions and will be taxed accordingly.

Regulations published in 2006 specify certain methods to determine fair market value. The preferred method is to compare the price of the transaction with the price of a similar international transaction between unrelated parties. If this method cannot be implemented, the taxpayer must use one of the methods stipulated in the regulations. If neither of the methods indicated in the regulations can be used, the taxpayer is permitted to use any other suitable method of comparison.

The local affiliate of a non-Israeli entity is not specifically required to prepare an annual transfer pricing study; however, the tax-assessing officer has the authority to demand a transfer pricing study within a 60-day period. Moreover, taxpayers are obligated to describe the terms of any international transaction with a related party in its annual tax return.

4.5 Related-Party Limited Risk Distribution Arrangements

This is an issue that the ITA has been examining. Many audits have been carried out recently by the ITA with respect to limited risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

In general, Israel's local transfer pricing rules follow the relevant OECD standards.

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are not very often resolved through double tax treaties or mutual agreement procedures (MAPs), as most transfer pricing disputes are resolved through settlements with the ITA, with relatively few that reach litigation or resolution through the MAP process. The ITA is generally open to participating in the MAP process.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When a transfer pricing claim is settled, the ITA usually argues for a correlating adjustment. This adjustment may be in the form of a deemed dividend or interest on a loan. Israeli courts have generally approved this position in their decisions.

In a 2018 Supreme Court case, an Israeli company provided research and development (R&D) services to its parent company under a cost-plus arrangement. The Supreme Court ruled that given the price of the services the Israeli company provided to its parent company was higher than the amount reported to the ITA, this created an intercompany debt of the parent company to the Israeli company equal to the additional amount that should have been paid and reported. Due to this debt, the parent company should have been charged with interest and therefore the Israeli company had a corresponding deemed interest income inclusion, which is subject to tax in Israel.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

A branch of a non-Israeli entity is taxed in Israel on the profits the branch derives from its Israeli activities, while a local subsidiary is generally taxed on its worldwide income. The corporate income tax rate in Israel is 23% and thus the taxable profits of the branch allocable to Israel are subject to such tax.

Generally, there is no branch profits tax in Israel and profits may be distributed by the branch to the overseas headquarters without an additional layer of tax.

For dividends paid by an Israeli subsidiary to overseas shareholders, the withholding tax rate is generally 30%, reduced to 25% if the Israeli subsidiary is listed on the Tel Aviv Stock Exchange (TASE). Such rates may be reduced further under an applicable double tax treaty. It is possible to mitigate the tax impact of such distributions by a subsidiary if the profits are distributed only when the subsidiary is liquidated. In such case, the capital gains derived from the liquidation, as well as the distribution of the profits, are tax exempt in Israel. On the other hand, the sale of a branch by a non-local corporation is subject to capital gains tax in Israel.

5.3 Capital Gains of Non-residents

Capital gains of non-Israeli residents on the sale of stock in public companies traded on the TASE are generally tax exempt, provided that the capital gains do not stem from a permanent establishment of such non-Israeli resident in Israel, from investments in certain real estate funds or from the sale of certain short-term bonds or loans.

Capital gains of non-Israeli residents on the sale of stock in private companies acquired on or after 1 January 2009 are also generally tax exempt, provided that they did not arise from a permanent establishment of such non-Israeli resident in Israel, that the stock was not purchased from a related party or restricted due to certain tax-free reorganisations, and that the principal value of the stock does not derive from real property, any asset attached to real property, or the right to benefit from real property situated in Israel, in any form, or rights to use natural resources.

The exemption on capital gains on the sale of stock of private companies also applies upon the sale of the shares of a non-local holding company that owns the stock of a local company, either directly or indirectly.

Certain treaties provide partial or full relief with respect to corporate capital gains taxes on non-Israeli residents, subject to satisfying certain conditions.

5.4 Change of Control Provisions

In general, pursuant to the provisions of the Ordinance, a non-Israeli resident company is exempt from tax on capital gains generated from the sale of securities of an Israeli resident company or the sale of a right in a non-Israeli resident company, the main value of which are rights, either directly or indirectly, in assets located in Israel, including shares of an Israeli subsidiary (subject to certain additional conditions).

As mentioned above, the tax exemption generally applies if the acquisition was made by a non-Israeli resident after 1 January 2009, as opposed to an acquisition made before 1 January 2009, which is generally subject to capital gains tax in Israel (although certain other domestic law exemptions may still be applicable).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The taxable profits of a local branch of a non-Israeli company are generally calculated by reference to the income and deductions attributable to the branch under the assumption it operates as an independent business unit and in accordance with transfer pricing rules. The income tax regulations stipulate that if the transaction cannot be compared to a similar transaction, the value of the transaction should be determined based on the profit rate of the transaction, compared to similar international transactions, or carry out a profit split based on the contributions and risks of each party to the transaction. If none of the above-mentioned methods are applicable, then the most appropriate method must be applied on a case-by-case basis.

The Ordinance, however, does not include specific rules regarding the taxation of a branch or the allocation of income and expenses to a branch in Israel.

5.6 Deductions for Payments by Local Affiliates

There is no specific standard applied. The deduction must be carried out in accordance with the fair market value of such services.

5.7 Constraints on Related-Party Borrowing

Israel does not impose thin capitalisation rules and therefore it is theoretically possible to finance a company with 100% debt. However, this type of debt arrangement is subject to transfer pricing rules and must bear interest in accordance with fair market interest rates.

In addition, it is possible to provide an interest-free capital note, provided the recipient of the loan is controlled by the provider of the loan, the loan is not linked to any index and does not carry interest or yield, the loan must not be repaid prior to a five-year period and its repayment must be subordinate to all other obligations of the company.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of local companies is subject to corporate income tax, as, in general, local companies are taxed on their worldwide income at the corporate income tax rate (23% in 2021), as opposed to non-Israeli companies, which are only subject to Israeli tax with respect to their Israeli-sourced income.

6.2 Non-deductible Local Expenses

As noted above, foreign income is subject to taxation at the regular corporate income tax rates.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local companies are subject to regular corporate income tax rates (23% in 2021). However, tax credits are available in such cases.

The Israeli local company may claim foreign taxes paid with respect to the distribution as credit pursuant to one of the following methods:

- direct credit, where the Israeli company may claim credits with respect to foreign withholding taxes paid on the dividend distribution, in which case, the dividend distribution will be subject to a 23% rate in Israel (as of 2021); and
- indirect credit, where the Israeli company may claim credits with respect to its allocable share of the foreign taxes paid by the distributing company on its foreign-source income and the foreign withholding taxes paid on the dividend distribution, in which case, the dividend distribution will be subject to the regular corporate income tax rate in Israel (also 23% as of 2021).

6.4 Use of Intangibles by Non-local Subsidiaries

In general, in order for non-Israeli subsidiaries to use intangibles developed by local companies, the intangibles must be either sold to such subsidiaries or the local company may license the intangibles to non-local subsidiaries, providing them with rights to use the intangibles in return for proper consideration. All the above is subject to compliance with transfer pricing rules.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Non-local subsidiaries may be subject to controlled foreign corporation (CFC) rules, provided that they meet several conditions.

A controlling shareholder of the CFC is an Israeli resident (individual or corporation) that owns 10% or more of any of the means of control of the CFC. The controlling shareholder's proportionate amount of the CFC's passive income is deemed a dividend distribution to the controlling shareholder.

A CFC is a foreign company that is a non-Israeli tax resident, not listed on an exchange (or, if listed, less than 30% of the interests of which have been offered to the public), not including shares held by controlling shareholders. In addition, most of the company's income must stem from passive sources and such passive income is subject to a 15% or less tax rate in the foreign jurisdiction. Moreover, the foreign company must be controlled by Israeli residents (ie, Israeli residents hold over 50% of the interests in the foreign company, or over 40% of the interests in the foreign company and together with the holdings of related parties hold over 50%, or if an Israeli resident has veto power over major company decisions).

On the other hand, non-local branches of local corporations are deemed to be Israeli tax residents and are therefore subject to corporate income tax on their worldwide income, whether from Israel or abroad. However, tax credits may be available in such cases.

6.6 Rules Related to the Substance of Non-local Affiliates

As mentioned above, a company is deemed to be a resident of Israel if it was incorporated in Israel, or if it was incorporated abroad and is managed and controlled in Israel.

Non-local subsidiaries of Israeli resident companies are subject to a management and control test, according to which, a company is managed and controlled in the place where the business strategy of the company is determined; ie, where the principal and substantive business decisions of the company are made. The location of the board of directors' meetings is important, although not determinative, especially in a case where the board authorises a different organ of the company to manage the company. Israeli case law determines a foreign company to be managed and controlled from Israel whereby the managers of the foreign company are not substantially involved in the foreign company's business management and merely act as an artificial platform for conducting the business of the Israeli company.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Local companies are taxed on gain on the sale of shares in non-local affiliates according to the regular corporate income tax rate (23% in 2021).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

The Ordinance includes a general anti-avoidance provision in Section 86, according to which, a tax-assessing officer may ignore transactions that are deemed to be artificial or fictitious, or if one of the main motivations of such a transaction is tax avoidance. In addition, the "substance over form" doctrine is a generally accepted principle of local case law.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Generally, tax audits are carried out randomly and not all taxpayers and tax returns are examined.

In addition, within four years (and in certain circumstances five years) from the end of tax year in which a tax return was filed, the assessing officer may audit a company's tax return. The assessment of the officer may be appealed to another officer within the same local office. The decision of the second officer is subject to appeal to the District Court. The decision of the district court may be appealed to the Supreme Court.

9. BEPS

9.1 Recommended Changes

Israel has already begun to implement certain BEPS recommendations and the authors expect this process to continue gradually. So far, implementation has mostly occurred through changes in the interpretation of existing law and tax treaties, rather than through changes in legislation.

In 2016, following BEPS Action 1, which focuses on the digital economy, the ITA published a circular addressing the taxation of income applicable to non-Israeli internet companies selling goods or providing services to the Israeli market through the internet, as well as the VAT liability of internet services companies. The circular extends to the VAT registration obligation of non-Israeli companies active in the Israeli market and, in addition, provides new, broader interpretations with regard to the definitions of a permanent establishment conducted through dependent agents and fixed places of business.

Following BEPS Action 5, which addresses harmful tax practices and consistent with the OECD's so-called nexus approach relating to preferential tax regimes for intellectual property, the Israeli government recently enacted legislation granting preferential tax rates to technology and hi-tech companies with respect to income derived from intellectual property development activities carried out in Israel. The new legislation determines a new IP regime in Israel by granting preferential tax rates to technology and hi-tech companies developing their intellectual property in Israel. In order to be entitled to these preferential rates, the new legislation sets out certain complex conditions to ensure that the benefits are only provided when the IP is actually developed in Israel. These tax benefits are part of a significant reform under the Encouragement Law, in light of the recommendations of the OECD BEPS Project.

Proposed legislation to implement the BEPS Action 13 recommendation regarding transfer pricing documentation (including a "country-by-country" report and master and local filings) has already been published. The proposed legislation enacts a new reporting regime for taxpayers of a multinational entity that has engaged in an international transaction. In this regard, the taxpayer may be required to provide the ITA with the complete documentation regarding the international transaction, including documents regarding the method used for the price calculation, as well as forms and information regarding the multinational enterprise itself.

In addition, the ITA has recently established a committee for a reform in the Israeli international tax regime. This committee is expected to recommend many changes in light of the BEPS recommendations. The authors expect the committee's recommendations to be enacted into law during 2021.

9.2 Government Attitudes

The ITA has indicated that it intends to follow and implement the OECD's recommendations in the BEPS reports and, accordingly, the authors expect to see amendments to domestic legislation, the enactment of regulations and the publication of guidance papers by the ITA, which will indicate the ITA's position. In addition, discussions with Israel's treaty partners are anticipated, and the OECD's recommendations implemented. Israel is also a signatory to, and has ratified, the MLI.

9.3 Profile of International Tax

International tax has significant media exposure and hence a high public profile in Israel, especially with respect to the taxation of non-Israeli internet companies, which has given rise to public protest. The protesters claim that these non-Israeli internet companies do not pay sufficient tax on their activity in Israel. The authors expect that the media focus on this issue, together with the high public profile, will increase Israel's motivation to implement the BEPS recommendations.

9.4 Competitive Tax Policy Objective

Although the government is trying to encourage investments in the Israeli economy, the authors expect the competitive tax policy to be restricted as a result of the BEPS recommendations, which will surpass other considerations.

An example of this can be seen in the recently enacted amendments to the Encouragement Law, which provides for preferential tax rates to be granted to technology and hi-tech companies, but only with respect to income derived from intellectual property developed in Israel. This law was revised in accordance with BEPS Action 5. In this regard, the Israeli regulations have adopted the principle proposed in the BEPS rules (the "nexus approach") for calculating the qualifying income and the benefitted capital gain, in order for it not to be considered a harmful tax regime.

9.5 Features of the Competitive Tax System

As part of the Encouragement Law, Israel grants extensive tax benefits to Israeli manufacturers. In certain cases, this contradicts BEPS Action 5 and the nexus approach, which limits the ability to grant benefits where the intellectual property has not been developed in Israel.

9.6 Proposals for Dealing with Hybrid Instruments

Israel has not yet implemented these changes and there is no draft legislation proposing implementation. However, as stated above, the Israeli government is committed to implementing the BEPS recommendations and, as such, the authors expect the legislation to be published in the near future.

9.7 Territorial Tax Regime

Israel has a territorial tax regime (combined with a personal tax regime). However, there are no interest-deductibility restrictions or thin capitalisation rules. The authors are not aware of any intention on the part of the ITA to enact such rules.

9.8 CFC Proposals

Israel has a very sophisticated CFC regime, ratified almost 15 years ago. The main features of the Israeli regime are very similar to the BEPS recommendations regarding the CFC rules.

Accordingly, the authors do not expect any significant change to the Israeli CFC regime as a result of the BEPS legislation.

9.9 Anti-avoidance Rules

Israel maintains a conservative approach with respect to granting treaty benefits, and such benefits are granted subject to the existence of substance in the treaty country.

There are limitation on benefits clauses only in a minority of the Israeli treaties (though one exists in the Israel–US treaty). However, there is a court ruling determining that Israel is entitled to implement anti-avoidance doctrines from its domestic legislation when interpreting tax treaty provisions. For example, the establishment of a foreign company in a treaty country may be considered artificial where the purpose is to avoid the payment of tax.

In addition, Israel has ratified the MLI.

Israel complies with, and encompasses most of, the BEPS proposals with respect to the DTC limitation. Accordingly, the authors do not expect significant impact on inbound or outbound investors.

9.10 Transfer Pricing Changes

In 2018, the ITA published two circulars concerning transfer pricing.

The first circular provides guidance, which is based on the OECD transfer pricing guidelines, for identifying and analysing intercompany activity and the most appropriate transfer pricing method for determining the activity's part in the global business activity. In accordance with the BEPS recommendation, the circular suggests that the analysis should first begin by reviewing the contractual arrangements, followed by examining the parties' conduct in order to ascertain if it is consistent with the contractual arrangements.

The second circular, also based on the OECD transfer pricing guidelines, presents the ITA's position with respect to a number of transactions, while reducing the burden of the documentation and reporting requirements, by way of the safe harbour principle. The circular sets a safe harbour for the following transactions:

- low value-adding services, having an operating profitability of net cost plus margin of 5%;
- marketing services, having an operating profitability of net cost plus margin between 10% and 12%; and
- low-risk distribution services, having an operating profitability of sales as turnover of between 3% and 4%.

The circular mentions that the margins will be revised from time to time.

9.11 Transparency and Country-by-country Reporting

The authors believe that the BEPS proposal for transparency and country-by-country reporting will improve enforcement and that, overall, the proposal is proportionate, as it only applies to large entities and will not impose unreasonable compliance costs on small entities. As noted above, there is proposed legislation in Israel to implement this recommendation.

9.12 Taxation of Digital Economy Businesses

As noted above, the ITA has published a circular that is focused on the taxation of income by non-Israeli internet companies selling goods or providing services to the Israeli market through the internet, as well as the VAT liability of internet services companies. The circular generally provides new, broader interpretations of the definitions of a permanent establishment conducted through dependent agents and fixed places of business, and expands the VAT registration obligation of non-Israeli companies active in the Israeli market.

9.13 Digital Taxation

Israel has not yet enacted laws addressing digital economy taxation rights. As noted above, the ITA has published a circular that takes a somewhat aggressive position. For treaty-partner countries, the circular expands the interpretation of a permanent establishment (PE) through a "fixed place of business" or a "dependent agent" in such tax treaties in the context of the digital economy.

For a fixed place of business PE, the circular states that a PE may exist even where there is no internet server located in Israel, and notes that certain activities of representatives and employees of an Israeli affiliate of a non-resident company in Israel – such as identifying potential clients, marketing activities and client relationship management – when conducted with assistance from, or through, a place of business in Israel may create a PE. In effect, the ITA's position is equivalent to attributing the activities of an Israeli affiliate of a multinational group to a non-Israeli affiliate within the group.

With respect to creating a PE through a "dependent agent", the circular adopts the "principal role" approach, pursuant to which, increased involvement of the agent in Israel in negotiations on behalf of, and decisions that bind, a non-Israeli company reinforce the conclusion that the dependent agent will be treated as a PE of such company. Under this approach, if employees of an Israeli affiliate of a multinational group perform substantive activities that lead to binding contracts, a PE in Israel may be established (by essentially deeming such employees as dependent agents of a non-Israeli affiliate within the multinational group).

For companies' resident in non-treaty jurisdictions, the circular notes that the ITA will acquire taxing rights over a non-Israeli taxpayer based on domestic law principles (namely, business activity conducted in Israel, which generally requires a lower threshold than the PE treaty standard). One of the examples that the circular cites as meeting this standard is the existence of "significant digital presence" even without a physical presence in Israel. Indications of the existence of a digital presence in Israel include a significant number of contracts signed with Israeli residents via the internet, a significant number of customers in Israel that consume the services provided by such company, and the services over the internet have been adapted to suit Israeli customers, such as a website in Hebrew, using local currency and local credit card clearance.

9.14 Taxation of Offshore IP

There is no specific legislation that addresses taxation of offshore intellectual property. Payments to non-Israeli corporate owners of intellectual property by Israeli residents for use or licence rights of such intellectual property are generally subject to withholding at the corporate income tax rate (23% in 2021), unless otherwise reduced by a double tax treaty.

Herzog Fox & Neeman is one of Israel's premier law firms, with a reputation as a market leader, through its involvement in major developments that shaped the Israeli economy. Its teams have experience in cross-border and domestic matters, which enables it to address clients' legal needs across all industries. Herzog Fox & Neeman has one of the largest and most broadly experienced and diversified tax departments in Israel. The department is comprised of approximately 45 fee earners (including 16 partners) and provides an exceptionally wide range of services; ranging from corporate tax, indirect tax and transfer pricing to tax litigation and disputes with the Israel Tax Authority, private clients, investment funds and more. The Tax Department has a hugely diversified client-base, comprised of multinational companies that operate in Israel (such as Facebook, Google, Microsoft and Salesforce), investment funds, ultra high net worth individuals, Israeli companies (such as the Israel Electric Corporation and Mellanox Technologies Ltd) as well as non-profit organisations.

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Trends and Developments

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Redemption of Shares – Income Tax Implications

In recent years, the income tax aspects of redemption of shares in Israel pursuant to the Israeli Income Tax Ordinance [New Version] 5721-1961 (the "Ordinance") were examined by the Israeli courts and were referred to by the Israel Tax Authority (ITA) in several official publications. This chapter will review the different references to the income tax aspects of redemption of shares, including the tax implications for the remaining shareholders in a company following the shares redemption.

Redemption of shares under the Israeli Companies Law

The Israeli Companies Law 5759-1999 (the "Companies Law") provides that a company may distribute its earnings and profits. Distribution is defined in the Companies Law as the grant of cash or an undertaking to grant cash, directly or indirectly, as well as a purchase of shares. A purchase includes the purchase or the granting of funding for a purchase, directly or indirectly, by a company or by its subsidiary, or by any other corporate body controlled by it, of its shares.

In contrast to the Companies Law, the Ordinance does not define the term "dividend" or does not directly refer to a redemption of shares.

Redemption of shares – the ITA's position

In 2001, the ITA published Income Tax Circular 10/01, titled "The Effects of the New Israeli Companies Law on Tax Laws" ("Circular 10/01"). With respect to the shareholders whose shares are being purchased by the company, the ITA held, in Circular 10/01, that in the case of a pro rata redemption, the redemption of shares would be considered as a dividend distribution to the redeemed shareholders. However, in the case of a non-pro rata redemption, the redemption of shares would be considered to be a sale of shares by the redeemed shareholders. However, Circular 10/01 did not include any discussion regarding shareholders whose shares were not redeemed. The same approach in regard to the redemption of shares was included in a tax circular that was published concerning the redemption of shares by a real estate property company pursuant to the Israeli Real Estate Tax Law (Tax Circular 9/2003).

On 11 January 2018, following the below-mentioned Tel Aviv District Court rulings, the ITA published Income Tax Circular 2/2018, titled "Share Redemption Pursuant to the Companies Law" ("Circular 2/2018"). In Circular 2/2018, the ITA changed its position, and stated that the consideration to be paid to shareholders to purchase the redeemed shares should be considered as a dividend distribution to the non-redeemed shareholders, regardless of whether the redemption of shares is pro rata or non-pro rata. This position of the ITA was based on the premise that the increase in the ownership of the remaining shareholders in the company should be considered a taxable event comparable to a dividend. In regard to the taxable event deemed to occur in a non-pro rata share redemption, Circular 2/2018 provides two approaches. Pursuant to each of such approaches, the ITA's position was that a deemed dividend is attributed to the non-redeeming shareholders.

It should be noted that the ITA's position in Circular 2/2018 adopted the same logic of Reportable Position No 42/2017. Also, the ITA has published tax decisions that adopted the position of Circular 2/2018 (see Tax Decision 0699/18).

Prior court rulings

During 2014, the Tel Aviv District Court ruled in the cases of Baranowski (Tax Appeal 21268-06-11) and Bar Nir (Tax Appeal 1100-06). Both cases were heard by the same judge. It should be noted that in both cases the relevant tax assessment office claimed that the redemption of shares was an "artificial transaction" pursuant to Section 86 of the Ordinance, because the redemption of shares did not serve the interests of the company but only the interests of the remaining shareholders of the company. The ITA relied on the Tel Aviv District Court rulings in Circular 2/2018. However, the Haifa District Court further held in the case of Beit Hossen Ltd. that not every redemption of shares is an "artificial transaction".

The case of Beit Hossen

On 1 November 2020, the Haifa District Court ruled in the case of Beit Hossen Ltd. (Tax Appeal 71455-12-18+54505-04-19) and accepted the taxpayer's appeal and rejected the previously published position of the ITA regarding certain income tax aspects of redemption of shares in Israel pursuant to the Ordinance. In the case of Beit Hossen Ltd., the Haifa District Court accepted the taxpayer's appeal and did not accept the ITA's position as was published in Circular 2/2018, and held that a non-pro rata redemption of shares in a company should be considered as capital gain income to the redeeming shareholders and should not be considered as a deemed dividend to the remaining shareholders.

The Haifa District Court based its ruling on the following legal general tax principles.

The realisation principle; ie, that a taxpayer should be subject to tax only upon the realisation of a gain with respect to his or her property. In the event that a gain is not yet realised, a taxpayer should not be subject to tax, other than in exceptional cases as may be determined by the legislature. The Haifa District Court held that in the case of a redemption of shares, no realisation event has occurred with respect to the non-redeemed shareholders.

The enrichment principle; ie, that a taxpayer should generally be subject to tax when his personal wealth has increased and was also realised. In that regard, the Haifa District Court held that although the ownership percentage of non-redeemed shareholders in the company was increased due to the redemption of shares, the non-redeemed shareholders were not enriched. The Court explained that, in fact, the actual economic value of the shares was not increased due to the funds expended to purchase the shares from the redeeming shareholder.

Redemption of shares as a transaction with an economic purpose. The Haifa District Court also held that a share redemption may also serve the interests of the company; for example, in the event that a disagreement between the shareholders has a negative influence on the company's operations. Thus, not every redemption of shares is an "artificial transaction" pursuant to Section 86 of the Ordinance.

The ITA appealed the ruling of the Haifa District Court to the Israeli Supreme Court (Civil Appeal 9308/20). The Supreme Court has not yet ruled in this appeal. However, pursuant to the Haifa District Court ruling, a transaction of non-pro rata redemption of shares that was made for the interests of the company should not be considered as a taxable event (ie, deemed dividend distribution) by the non-redeemed shareholders.

Investment Funds

The Ordinance does not provide any special rules regarding investment funds – such as venture capital (VC) or private equity funds – and such investment funds operate in Israel pursuant to tax rulings that are issued to them by the ITA pursuant to Section 16A of the Ordinance. Such tax rulings, subject to their terms, provide certain benefits and tax reliefs to foreign investors investing in funds.

Background

Pursuant to the capital gains sourcing rule in Section 89 of the Ordinance, a foreign resident is generally subject to tax in Israel on capital gains from a sale of securities in an Israeli company. The Israeli government has recognised the significant weight of tax considerations in the decision of foreign investors as to whether to invest in Israel, and the ITA started to issue tax rulings under Section 16A of the Ordinance in the early 1990s to incentivise foreign investors and investment into the then young hi-tech industry.

Section 16A of the Ordinance generally authorises the Israeli Minister of Finance to refund taxes to foreign investors if the tax paid in Israel is not creditable in the investor's home jurisdiction. These tax rulings were initially issued with respect to VC funds and provided reduced tax rates to foreign investors, with a full exemption from Israeli tax to foreign investors that were tax exempt in their home jurisdiction. In 2005, the first tax ruling was issued to a private equity fund, which granted a tax exemption for capital gains, but not for interest and dividends.

It should be noted that in 2003, as part of a reform of the tax system, a new subsection was added to Section 97 of the Ordinance providing for an exemption from capital gains tax for foreign investors in R&D companies. However, this exemption was replaced in 2009 with a provision exempting foreign investors in Israel from tax under Section 97 of the Ordinance, unless their gain is "attributable to a permanent establishment". While tax rulings granted to investment funds have always required the funds to agree that their local presence in Israel constituted a permanent establishment, the tax exemption from capital gains regarding the sale of securities of Israeli companies was still provided to foreign investors in a fund.

The 2018 income tax circulars

In recent years, the ITA has published income tax circulars on these matters (Income Tax Circulars 24/01 and 14/04). However, following a review of its policy, on 14 March 2018, the ITA issued two official income tax circulars regarding the terms for the issuance of tax rulings to VC and private equity funds (Income Tax Circulars 9/2018 and 10/2018) (the "Circulars"). The purpose of the Circulars was to provide the terms and conditions for an investment fund to apply for and receive a tax ruling and to outline the tax arrangement that will apply to any such tax ruling. The Circulars provide a number of terms and conditions for the issuance of a tax ruling to a fund, including with respect to the minimum number of investors in a fund and the diversity of the investor base, minimum capital commitments, and the number, type of and minimum investments to be made by a fund. In particular, the following two conditions were added in the Circulars.

Diversification of foreign investors

Pursuant to the Circulars, a fund is required to have at least ten unrelated investors, of whom none are connected to the general partner of the fund. However, the Circulars added a new requirement for obtaining a ruling, under which, at least 30% of the commitments to the fund must be made by foreign investors. In the past, if the percentage of Israeli investors exceeded 70% of the fund, certain tax consequences would apply regarding the tax rate applicable to carried interest income received by the general partner in a fund. Currently, the ITA will not issue a tax ruling if this condition regarding foreign investors in a fund has not been met. It is not clear why this is required, as a ruling would apply only to foreign investors and the tax rate applicable to the Israeli investors' general partner should be irrelevant. Also, this assumption is unrealistic and disproportionate, as raising 30% of commitments from foreign investors in a fund with total capital commitments of USD100 million is not the same as raising said rate in a fund of USD400 million.

The type of investments

The Circulars mandate certain rules regarding the focus of a fund's investments in order to receive a ruling and providing a tax exemption to foreign investors in a fund. The Circulars provide that certain minimum amounts and a percentage of commitments of the VC or private equity funds should be invested in "Qualified Investments" (for a VC fund, the term "VC Investment" includes a reference to "Qualified Investments"). A Qualified Investment is defined as an investment in an Israeli company or Israeli-related company whose business is in various types of activities (such as water, energy, production, transporting, media and communication, software, or medicine), which owns its own intellectual property. Also, a fund's total investment in a single company cannot exceed 25% of the fund's total commitments.

In this regard, the Circulars provide a new rule that a foreign investor is exempt from tax on the capital gain of the fund from Qualified Investments (in the case of private equity funds) and VC Investments (in the case of VC funds). In other words, if a fund does not invest in specific activities, a foreign investor will not be exempt from tax from capital gain. It is not clear why, as a policy matter, the ITA would differentiate between these types of investments rather than encouraging funds to invest in all sectors in the Israeli economy. It is also not clear if the ITA has the authority to create this distinction in a publication without the imprimatur of the legislature.

Recently, the ITA has begun drafting a tax amendment to the Ordinance in regard to the tax regime to be applied to investment funds. The authors hope that any such future tax regime will reduce the importance of raising foreign capital and the nature of the fund's specific investment activity in the decision of whether to raise funds from non-Israeli investors.

The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting

On 7 June 2017, Israel, together with the delegates of 75 additional countries and jurisdictions, signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, also referred to as the Multilateral Instrument (MLI). The MLI was designed with the intention of swiftly implementing a series of tax treaty measures, updating international tax rules and reducing the opportunity for tax avoidance by multinational enterprises, and was signed pursuant to the recommendations of Article 15 of the Organisation for Economic Co-operation and Development's Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

The MLI includes measures that may assist with issues such as the abuse of tax treaties, the tax treatment of disregarded entities, the tax residency of entities, permanent establishment-related issues and transfer pricing regarding cross-border transactions. Israel ratified the MLI on 13 September 2018, and the MLI entered into force in Israel as of 1 January 2019. As of 11 February 2021, the list of parties to the MLI consists of 95 countries and jurisdictions.

Application of a Zero VAT Rate under Section 30(a)(5) of the Value Added Tax Law

Israeli value added tax - general

Value added tax (VAT) is generally imposed at a rate of 17% on the sale of goods and provision of services under the Israeli Value Added Tax Law 5736-1975 (the "VAT Law") and the applicable regulations. However, there are a few exceptions that enable local businesses to qualify for a zero VAT rate under certain circumstances, including the provision of services to foreign residents. Section 30(a)(5) of the VAT Law provides that the provision of services by an Israeli service provider to a foreign resident will be taxed at a zero VAT rate (except for certain excluded services, as specified in the relevant regulations). However, Section 30(a)(5) of the VAT Law should not apply if the provision of services is in regard to an Israeli asset or is to an Israeli resident. This exception is relevant to global corporations with an Israeli subsidiary or office that provides services to a foreign related entity, as it might be regarded as providing services to an Israeli resident.

It should be noted that the application of this section was challenged by the VAT Authority in a number of court cases. It should also be noted that following the Supreme Court ruling in the case of Casuto (Civil Appeal 41/96, dated 18 March 1999), under which a zero VAT rate was applied, even though there was a secondary Israeli beneficiary to the provision of services, the Israeli legislature amended the section in 2002. Based on this amendment, Israeli courts held that Section 30(a)(5) will not apply even if a secondary Israeli beneficiary also benefits from the provision of services.

Rothschild Group ruling

In the past two years, Israeli courts have issued rulings on the application of Section 30(a)(5) of the VAT Law, including the Tel Aviv District Court in the case of Rothschild (Tax Appeal 9136-04-18) on 26 November 2019. The question before the Tel Aviv District Court was the application of a zero VAT rate to certain marketing services provided by an Israeli subsidiary to the Rothschild Group abroad. The Israeli subsidiary was an Israeli resident company that provided marketing services on behalf of the Rothschild Group funds to Israeli institutional investors, as well as marketing services for private banking services to Israeli individuals. The Israeli subsidiary claimed that it provided services to the Rothschild Group funds abroad and if any services were provided to Israeli residents, such services were negligible or auxiliary to the actual services provided to the foreign company. Note that the Israeli subsidiary did not provide any investment management services.

The Tel Aviv District Court rejected the arguments of the Israeli subsidiary and held that the services provided to Israeli residents were not negligible or auxiliary from the point of view of the Israeli clients. In practice, the Tel Aviv District Court found that tasks performed by the Israeli subsidiary for Israeli clients of the foreign Rothschild Group had a substantial value, with an independent and separate economic value that rose to the level of the actual provision of services to Israeli clients. Thus, following an examination of the intercompany agreements between the Israeli subsidiary and the foreign Rothschild Group, including the profit-sharing profit mechanism, the Tel Aviv District Court held that the services provided by the Israeli subsidiary were intended to fulfil the interests of the Rothschild Group abroad and the direct and actual interests of the Israeli clients. Therefore, a zero VAT rate should not be applied to the consideration received by the Israeli subsidiary.

I.S.P Financial Management ruling

On 30 March 2020, the Lod District Court also ruled on the applicability of a zero VAT rate in the case of I.S.P Financial Management Ltd. (Tax Appeal 15195-04-18). The appellant, an Israeli company and indirect subsidiary of the I.S.P group, had only two clients, both Swiss subsidiaries of the I.S.P group. One Swiss subsidiary (the "Swiss Subsidiary") represented and provided marketing services to foreign fund managers such as UBS and Pictet, including regarding Israeli institutional investors, via the appellant. The appellant was entitled to compensation based on a cost-plus basis. The appellant provided services by an Israeli company, which was wholly owned by an Israeli resident and was prominent in the market (the "Representative"). The Representative's compensation was based on 20% of the Swiss Subsidiary's income from the Israeli investors' investments in the foreign funds. Neither the appellant nor the Representative had the authority or a licence to provide investment services to Israeli clients.

The Lod District Court examined the services that were provided and ruled that the services were not negligible or auxiliary to the services provided to the foreign funds managers and had actual separate value. It was mentioned that the appellant (via the Representative) did not only create an initial relationship between the foreign fund managers and the Israeli investors, but also had, and maintained, a significant and ongoing relationship, which included assisting Israeli investors in accessing and presenting information.

It should also be emphasised that the Lod District Court mentioned that the impression was that the Representative has a significant role in establishing and maintaining the relationship between Israeli institutional clients and the foreign fund managers. It was a personal activity, based on the trust of Israeli investors, and carried out systematically.

Therefore, the Lod District Court held that the appellant's services also met the needs of Israeli institutional clients, and a zero VAT rate should not apply to the consideration received by the appellant.

Applause App Quality Inc. ruling

Moreover, on 7 September 2020, the Lod District Court opined further on the issue in the case of Applause (Tax Appeal 15802-02-18). The appellant was an Israeli wholly owned subsidiary of Applause App Quality Inc., a foreign company and the owner of a digital platform for testing software for applications and websites. As mentioned above, a zero VAT rate should not apply if the provision of services is also provided to an Israeli resident or in relation to an Israeli asset. An exception to this rule is in a case in which the service includes the value of the goods that are imported into Israel, if certain conditions are met. In the case of Applause, the appellant provided marketing and sales services as well as support services in relation to the digital platform, in connection with the parent company's Israeli clients. The main legal question in the case was if said exception applies if the consideration for the service is part of the value of imported services or if it only applies regarding imported goods.

The Lod District Court ruled that, as the legislation is silent on this question, Section 30(a)(5) of the VAT Law should be interpreted as extending the application of the exception to imported services.

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Raveh Haber & Co. is the only boutique law firm in Israel specialising in private equity and taxation. The legal team of the firm's tax department has an exceptional reputation and extensive experience, developed over years of practice both in Israel and in the USA. The firm's tax department specialises in a wide array of local and international tax matters: provision of tax advice to investment funds, their managers and portfolio companies; complex tax solutions for high net worth families with both Israeli and foreign members; income tax and VAT matters; diverse procedures before the Israel Tax Authority; tax assessment procedures; litigation; obtaining different types of rulings; and providing professional guidance and assistance in drafting and submitting tax reports and disclosures. Among the department's clients are private individuals, leading directors and entrepreneurs, private equity and investment firms, hedge funds, hi-tech companies from both Israel and abroad, public and major private companies, and different types of financial institutions.

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Italian businesses frequently carry out their activity through corporate structures.

A corporate entity may adopt one of the following forms:

- a joint-stock company (*società per azioni* – SpA);
- a limited liability company (*società a responsabilità limitata* – Srl); or
- a partnership limited by shares (*società in accomandita per azioni* – Sapa).

Other corporate entities are co-operative companies and *Societas Europeae* (SE).

The first two corporate forms generally grant shareholders' limited liability up to the value of the shares or quotas held in the company's capital.

The incorporation as an SpA is required in order to carry out certain business activities (such as banking) and is generally selected to carry out businesses of medium-large size, while an Srl is typically preferred for small and medium-sized enterprises. Both the Srl and SpA can have a single share/quota-holder.

A Sapa is characterised by the presence of two classes of shareholders:

- general partners (*soci accomandatari*), who are jointly and unlimitedly liable for the company's obligations and act as directors; and
- limited partners (*soci accomandanti*), who are liable for the company obligations up to the amounts of their contributions and cannot be directors.

Other business forms may include individual enterprises and tax transparent partnerships (see **1.2 Transparent Entities**).

Corporate entities (SpA, Srl, Sapa, *società cooperative* and SE) are separate legal entities for tax purposes and are subject to corporate income tax (IRES) and regional tax on business activity (IRAP).

However, subject to certain conditions, corporate entities may opt for a special regime whereby they are treated as transparent for tax purposes (*regime di trasparenza volontaria*).

1.2 Transparent Entities

The most common transparent entities are the general partnership (*società in nome collettivo* – Snc) and the limited partnership (*società in accomandita semplice* – Sas), which are both entitled to carry out business activities.

A third type of partnership, the simple partnership (*società semplice*), is mainly used as a passive holding vehicle and for succession planning purposes, given the flexible rules applicable to its governance. However, Italian law does not allow it to be used for business activities.

The Snc is characterised by the unlimited liability of all of its partners, while the Sas has two classes of shareholders (ie, general partners and limited partners) with different degrees of liability.

From a private law perspective, partnerships are regarded as separate legal entities, whereas, from a tax standpoint, they are treated as transparent for income tax purposes.

Partnerships are not subject to IRES, but they are subject to IRAP. In accordance with tax transparency rules, the income of the partnership is computed at the partnership's level and then attributed to each partner for income tax purposes, regardless of distributions made and in proportion to their share in the partnership's profit. As a general rule, subsequent profit distributions are not taxed in the hands of the partners.

1.3 Determining Residence of Incorporated Businesses

Corporations and partnerships are regarded as being tax resident in Italy if they have one or more of the following connecting ties within the Italian territory, for the majority of their tax year:

- their legal seat;
- their place of management; or
- their main business purpose.

The legal seat is where the entity's registered office is situated, according to the deed of incorporation.

The place of management is generally intended as the place where the management and control functions of the company are actually carried out (the criterion is regarded by Italian case law as being akin to the place of effective management test under the 2014 OECD Model Tax Convention).

The main business purpose is the main activity (including day-to-day operations) carried out by the entity.

Since Italian law does not envisage the possibility to split the tax period for tax residence purposes, whenever one of the above criteria is satisfied for most part of the tax period, the company/partnership is regarded as being tax resident in Italy for the whole tax period. On the other hand, if none of the criteria is met for the majority of the tax period, the company/partnership is regarded as a non-resident person for the whole period.

Any determination on tax residence in accordance with double tax treaties would prevail over the determination for domestic tax rules.

Resident companies are taxable in Italy on their worldwide income, while non-resident companies are subject to IRES and IRAP only on their Italian-sourced income.

With regard to partnerships, residence comes into play as a connecting factor in order to establish the source of the partnership's income. Thus, the income of resident partnerships is regarded as being Italian sourced for the partners, while the income of non-resident partnerships is not.

1.4 Tax Rates

Resident corporate entities are subject to 24% IRES on their worldwide income; they are also subject to IRAP, which is generally levied at a basic rate of 3.9% (such rate may vary, depending on the Region and the business sectors). Certain surcharges and increased rates apply to companies operating in specific industries (eg, the banking sector) for the purposes of both IRES and IRAP.

Individuals carrying out a business activity directly (ie, individual entrepreneurs), or carrying out a business through a transparent entity, are subject to individual income tax (IRPEF) levied at the ordinary progressive tax rates, which range from 23% up to 43% on income exceeding EUR75,000. Local surcharges apply. Individual entrepreneurs and partnerships (and not their partners) are subject to IRAP.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits for IRES purposes are computed on the basis of accounting profits and on an accrual basis (with certain exceptions, such as dividends or directors' fees, which are tax-relevant on a cash basis).

The tax base is determined by applying certain downward and upward adjustments to accounting profits, based on specific rules provided for by Italian tax law. Such adjustments include the non-deductibility of expenses that do not pertain to the business activity and of other expenses exceeding certain thresholds (eg, entertainment and accommodation costs). Further adjustments may arise from differences between depreciation/amortisation rates allowed for tax purposes and those used for accounting purposes.

For instance, trade marks and good will can be amortised up to one eighteenth of their cost for each tax period, while patents and other IP can be amortised up to one half of their cost.

Furthermore, tax law provides specific limitations for the deduction of bad debts. For instance, in any given tax year, the unsecured bad commercial debts of companies – other than banks, financial institutions and insurance companies – are tax deductible only up to 0.5% of the total receivables gross value, up to a maximum provision of 5% of the gross value of the receivables as of the end of the tax year.

IRAP is levied on the "net value of production", which is computed differently depending on the type of taxpayer and activity carried out (eg, there are different rules for companies, banks and financial institutions, insurance companies, partnerships, etc).

2.2 Special Incentives for Technology Investments

Income from the exploitation of certain qualifying intangibles (eg, software and patents; trade marks were originally included, but were removed in 2017) may benefit from a patent box regime. A company may opt for the regime if it carries out R&D activities (directly or indirectly, by outsourcing to non-related companies, universities or other research institutions). In general terms, the regime grants a 50% exemption on the portion of the corporate income attributable to the economic contribution of the intangible, multiplied by the ratio between qualifying R&D expenditures and the total cost for the development of the intangibles. The value of qualifying R&D expenditures may be increased up to 30% by including the acquisition costs and R&D costs from outsourcing to related companies. The determination of the economic contribution of the intangible can be defined in a ruling with the tax authorities. Under certain conditions, the patent box regime also applies to capital gains on the sale of the relevant intangibles.

A tax credit is available for certain qualifying R&D expenses. In order to benefit from the tax credit, the eligible companies shall also meet certain record-keeping requirements (ie, tracing and tracking system and certification by a qualified auditor).

2.3 Other Special Incentives

Innovative start-ups are companies that satisfy specific requirements, such as having an R&D expenditure that amounts to at least a certain amount established by law. Companies investing in an innovative start-up company and holding the investment for at least three consecutive tax years are allowed to deduct from their taxable income 30% of the amount actually invested, with a maximum yearly deduction of EUR540,000; the amount in excess may be carried forward in the subsequent three fiscal years.

Under certain conditions, a tax credit is granted for investments in new tangible and intangible assets intended to be used for production facilities located in the Italian territory.

An optional tonnage tax regime provides for a deemed computation for income tax purposes of the taxable income stemming from the operation of ships. To be eligible for such regime, the entity must operate ships that:

- have a net tonnage greater than 100 tons;
- are used to transport goods or passengers, or to perform certain other qualifying activities on the high seas; and
- are enrolled in the Italian international ships register.

Specific limitations apply for chartered ships (also on a bare boat basis). The regime allows for the determination of a deemed income based on the net tonnage of the ships, apportioned to the effective shipping days (in lieu of the determination on the basis of the profits stemming from the financial statements). Once the option is exercised, it is irrevocable for ten tax years and is deemed to be renewed at the end of such period, unless expressly revoked.

Shipping companies qualifying for the tonnage tax regime are not subject to IRAP. Furthermore, companies opting for the tonnage tax regime cannot be included in the consolidation regime (see **2.6 Basic Rules on Consolidated Tax Grouping**).

If a resident company receives assets (including good will) as a consequence of a merger, a demerger and/or the contribution of a going concern, it may benefit from a tax-free step-up of the tax basis of such assets for corporate tax and IRAP purposes, for a value up to EUR5 million. The regime is applicable only in relation to transactions taking place between 1 May 2019 and 31 December 2022. Moreover, the regime applies on the condition that the companies that are parties to the transaction are unrelated and have been active from an economic standpoint in the last two fiscal years preceding the transaction. The benefits from the above regime are clawed back if, in the four years following the year of the transaction, the company sells the assets that benefitted from the free step-up or is party to a merger, demerger and/or contribution of a going concern (such claw-back can be avoided, under certain circumstances, by obtaining a specific ruling from the Revenue Agency).

An optional step-up of the tax basis of business assets resulting from the financial statements concerning the financial year current at the date 31 December 2019 was introduced by article 110 of Decree Law No 104/2020 of 14 August 2020. This provision, as modified by the Budget Law for 2021 (Law No 178 of 30 December 2020), allows companies to step-up the book value of their business assets to reflect their higher fair value and to recognise this step-up also for tax purposes by paying a 3% substitute tax. Under certain conditions, the tax value of business assets may be stepped-up to the higher book value thereof.

In order to encourage the increase of the share capital in small and medium companies, Article 26 of Law Decree No 34/2020, as modified by the Budget Law for 2021, provides a tax credit for small and medium companies receiving capital contributions before 30 June 2021, where certain stringent requirements are met.

Finally, with the aim to mitigate the effects of the COVID-19 pandemic, some additional tax incentives have been granted to support enterprises. Such measures include a tax credit for the expenses incurred for the rental of buildings for non-residential use and business leases, and a tax credit for the expenses incurred in 2020 for sanitising working environments and acquiring certain protective equipment.

2.4 Basic Rules on Loss Relief

Losses may be carried forward without time limitation to offset the corporate tax base in subsequent tax years; no carry back is allowed. In particular, losses incurred in a tax year can offset the corporate tax base of subsequent tax years up to 80% of the latter amount. This limitation does not apply to losses incurred by a company during the first three years of activity. In both cases, no time limitation applies.

However, the right of the company to carry forward losses is excluded in certain circumstances, such as:

- where there is a change in the persons controlling the company, in the range of two tax periods preceding or following the change of control, or there is a change in the activity of the company and the company did not satisfy certain substance requirements (number of employees, revenues, employment costs, etc) in the one/two tax years preceding the transfer; or
- where there is a merger or demerger and, in addition, the tax losses exceed the qualifying net equity of the company

and the company with losses carried forward did not satisfy certain substance requirements (revenues and employment costs) in the tax year preceding the merger/demerger.

The above loss carry-forward exclusions may be avoided by obtaining a specific ruling confirming the absence of any abuse of law.

2.5 Imposed Limits on Deduction of Interest

Subject to certain minor exceptions, the deductibility of interest – whether relating to intercompany financing or not – is subject to a specific deduction barrier. In particular, interest payable in excess of interest receivable is deductible up to 30% of the company's tax-relevant EBITDA.

Interest expenses that exceed such barrier in a tax year may be carried forward and deducted in subsequent tax years (up to the amount of the 30% tax-relevant EBITDA that exceeds the net interest expenses of those subsequent years), or, if the company is part of a fiscal unity, used by other entities of the fiscal unity. Any excess of the 30% EBITDA over net interest expenses may be carried forward in the following five tax years or, if the company is part of a fiscal unity, may be used by other companies of the fiscal unity. Moreover, interest income that exceeds interest expenses in a tax year may be carried forward to offset the interest expenses of subsequent tax periods.

Certain companies involved in the financial sector are not subject to the interest limitation rule described above and can deduct up to 96% of their interest payable (under certain conditions, interest payable to companies of the same fiscal unity is not subject to this limitation).

2.6 Basic Rules on Consolidated Tax Grouping

Under the Italian domestic tax consolidation regime, companies belonging to a group may opt for the determination of an overall taxable base (fiscal unity). The tax return of the fiscal unity must be filed by the controlling company, or, in certain cases, by a controlled company designated by the non-resident controlling company (the company filing the tax return of the fiscal unity is generally known as the "consolidating entity").

The regime is available to:

- Italian resident companies controlled by an Italian resident parent;
- Italian resident companies controlled by a non-resident parent with an Italian permanent establishment, provided that the parent is a tax resident of a jurisdiction that has concluded a treaty enabling the exchange of information with Italy; and
- Italian resident companies controlled by a parent that is a tax resident of an EU or EEA member state.

In addition, non-resident companies with an Italian permanent establishment can be included in the fiscal unity as a consolidated entity (if resident in an EU/EEA member state).

The consolidating entity must own, from the beginning of the relevant tax period, a participation in the consolidated entities representing more than 50% of the share capital and more than 50% of the rights to the profits (shares without voting rights are not taken into account).

All entities included in the fiscal unity must have tax years ending on the same date.

The perimeter of the tax consolidation may be freely devised by the taxpayers (ie, some companies may be kept out).

In the fiscal unity, the overall tax base is computed as the sum of the taxable bases (with some adjustments) of all participating entities. The taxable bases of the group entities are taken into account for their whole amount, irrespective of the percentage of the participation held by the controlling company.

Once the election for the fiscal unity is made, the option is irrevocable for three years, unless the conditions for the options cease to be met (interruption events).

Furthermore, under certain conditions, a worldwide consolidation tax regime is available, in which case the fiscal unity must include all foreign controlled companies.

2.7 Capital Gains Taxation

Capital gains are generally treated as ordinary income, subject to corporate income tax levied at 24%.

However, under a specific participation exemption regime, capital gains realised by companies on the disposal of participations in other companies are exempt for 95% of their amount (while capital losses are wholly non-deductible) if the following conditions are met:

- the participations have been held uninterruptedly since the first day of the 12th month preceding the sale (using a last-in, first-out method);
- the participations have been booked as fixed financial assets in the first financial statements after their acquisition;
- the participated company has been carrying out a business activity in the last three tax periods or, if later, since incorporation; and

- the participated company has not been resident of a low-tax jurisdiction for all the five tax years prior to the year of sale if the buyer is a non-related party, or for the entire holding period if the buyer is a related company. Such condition is waived if it is demonstrated that the ownership of the participation did not – for the same period – have the effect of shifting the income to a low-tax jurisdiction.

With regard to the third bullet point, companies in which the value of assets is mainly represented by real estate not used in the course of a business activity are deemed to not carry out a business activity. This condition does not apply, however, in respect of participations in companies whose shares are listed on a stock exchange.

If the participation exemption regime does not apply, the taxpayer may still opt to spread the capital gain tax base over five tax years if the participation has been booked as fixed financial assets in the last three financial statements or, for other assets, if the capital asset has been held for at least three years.

2.8 Other Taxes Payable by an Incorporated Business

VAT

VAT is a general tax on consumption in Italy. As an EU member state, Italian VAT provisions are in line with the EU VAT Directives.

Where the conditions are met, VAT is levied at a general rate of 22% on transfers of goods and supplies of services. Reduced rates (4%, 5% and 10%) may apply to certain types of transactions.

In general, VAT taxable persons are entrepreneurs, artists and professionals.

Among the most common transactions, the following are subject to Italian VAT:

- the supply of goods and services in Italy by a VAT taxable person;
- the intra-EU acquisition of goods in Italy by a VAT taxable person; and
- the import of goods from outside the EU into Italy by any person (including a non-VAT taxable person).

Exports and intra-EU sales of goods are VAT zero-rated.

Registration Tax, Mortgage and Cadastral Taxes

Registration tax is generally due on deeds (including contracts) executed in Italy. In certain cases (such as transfers of real estate or of a business located in Italy), registration tax is due even if the deed of transfer is executed abroad.

The deed of transfer may be subject to registration tax either at the fixed amount (EUR200) or at a proportional rate, depending on the nature of the deed. If the deed of transfer is within the scope of VAT (even if exempt or zero rated), registration tax applies at the fixed amount (EUR200).

Mortgage and cadastral taxes generally apply to deeds of transfer or mortgages on Italian real estate. These taxes may also apply to the sale of a business if real estate is included. In transfers of real estate assets subject to VAT, a EUR200 mortgage tax and EUR200 cadastral tax are also levied, with certain exceptions (for instance, in the sale of business real estate, a 3% mortgage tax and 1% cadastral tax apply).

Loans guaranteed by a mortgage on real estate are subject to mortgage tax at the rate of 2% of the guaranteed amount (a 0.5% charge may apply on the cancellation of the mortgage), on top of registration tax, which applies at the rate of 0.5% of the guaranteed amount (guarantees granted by the same debtor are subject to registration tax at the fixed amount of EUR200).

However, certain financing transactions and bonds executed in Italy with a medium-long term maturity and granted by qualifying lenders (including resident banks) are not subject to the above-mentioned registration, cadastral and mortgage taxes (as well as other duties) but to an overall 0.25% substitute tax.

Financial Transaction Tax

A financial transaction tax (FTT) is levied on transfers of shares and certain participating financial instruments issued by companies that have their registered office in Italy, regardless of the place of residence of the parties and of where the contract is executed.

The standard tax rate is 0.20% on the transaction value. A reduced tax rate (0.10%) applies to transactions executed on regulated stock markets or in multilateral trading facilities.

2.9 Incorporated Businesses and Notable Taxes

The ownership of real estate located in Italy is subject to municipal real estate tax (IMU), levied at the basic rate of 0.76%, subject to local variations.

Other local taxes connected to the ownership of real estate apply.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses generally operate in the form of Srls or partnerships.

3.2 Individual Rates and Corporate Rates

Even if the corporate rates are lower than individual rates, the total effective tax rate applicable to an individual receiving the profits from an incorporated business (by means of profits distribution) is substantially similar to that deriving from the realisation of income from the carrying out of business activities as an individual entrepreneur. In fact, dividends distributed to individual shareholders are subject to a 26% substitute tax, so that the total effective tax rate is in the range of 44% (while the top progressive tax rate for individuals is 43%).

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules aimed at preventing closely held corporations from accumulating earnings for investment purposes. As a general rule, retained earnings of corporations are taxed in the hands of the shareholders only upon distribution.

On the other hand, there are certain rules that apply with a view to stimulating the re-investment of corporate profits.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Under current rules, dividends from and gains on the sale of shares in closely held corporations are taxed in the hand of individual shareholders, at the rate of 26%.

This regime does not apply to dividends that are paid out of profits earned before 31 December 2017 and whose distribution is declared between 1 January 2018 and 31 December 2022. For such dividends, the previous regime provided for varying tax regimes, depending on the percentage of participation held by the shareholder.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no special rules for the taxation of dividends from and gains on the sale of shares in publicly traded corporations. The tax regime is the same as described in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Dividends paid to non-residents in respect of participations that are not connected with Italian permanent establishments are generally subject to a 26% withholding tax, which may be reduced by applicable double tax treaties. Non-resident recipients may benefit from a potential refund of the foreign tax paid on dividends up to 11/26 of the Italian withholding tax if they prove that a similar tax has already been paid abroad on a final basis on the same dividends.

A reduced 1.2% withholding tax is levied on dividends that are paid out of profits accrued in fiscal years starting on or after 1 January 2008 if the beneficial owner is a company resident and subject to corporate income tax in another EEA member state that allows an adequate exchange of information with Italy.

Dividends paid from 1 January 2021 are not subject to tax if they are paid to collective investment vehicles that are established in EU member states or EEA member states and that are either compliant with Directive 2009/65/EC or whose managers are subject to surveillance in the States in which they are established, pursuant to Directive 2011/61/EU.

Dividends paid to EU and EEA pension funds are generally subject to 11% tax, which may be reduced to zero if certain conditions are met.

There is no withholding tax where the EU Parent-Subsidiary Directive applies.

Interest payments made to non-residents in respect of loans or instruments that are not connected with Italian permanent establishments are generally subject to a 26% withholding tax, which may be reduced by an applicable double tax treaty or eliminated if the EU Interest and Royalties Directive applies. A reduced withholding tax rate (12.5%) is granted to interest arising from government bonds and similar instruments. Some exemptions from withholding tax apply, under specific conditions. For example, no withholding tax is levied on interest from certain bonds paid to residents of jurisdictions with an effective exchange of information with Italy, interest on Italian bank accounts and deposits, and interest payments made in relation to medium-long term financing granted by qualifying lenders.

Royalties paid to non-residents in respect of loans or instruments that are not connected with Italian permanent establishments are generally subject to a withholding tax rate levied at 30%, with the possibility, under certain conditions, to reduce the taxable base by 25%. The royalty withholding tax may be reduced by an applicable double tax treaty or eliminated if the EU Interest and Royalties Directive applies.

4.2 Primary Tax Treaty Countries

When deciding in which jurisdiction to set up a holding company that will hold participations in Italian resident companies, foreign investors tend to prefer countries that have treaties with Italy granting full tax relief on the capital gains from the disposal of such participations.

For example, treaty residents of Luxembourg, the Netherlands and the United Kingdom are not subject to tax in Italy on gains from the disposal of participations in Italian companies. Other treaties, in certain circumstances, do not provide tax relief on gains from the disposal of similar participations (for example, the treaty with France does not provide relief from Italian tax in the case of disposal of a participation in an Italian company granting the holder the right to receive at least 25% of the profits of the company).

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Italian tax authorities often challenge the applicability of double tax treaties and/or EU Directives based on the argument that the recipient is not the beneficial owner of the relevant income or is an artificial arrangement (ie, with no sufficient substance).

In Circular letter No 6 of 30 March 2016, the Italian tax authorities held the view that treaty benefits can be disallowed when a non-resident company lacks economic substance, based on a case-by-case analysis of all relevant facts and circumstances. The tax authorities held that, when treaty benefits are so denied to a non-resident company, the ultimate investors of such company could (subject to the relevant conditions) claim the application of the tax treaties signed between Italy and their state of residence (if any).

Furthermore, domestic tax authorities can challenge abusive practices on the basis of Article 10 bis of Law 212, dated 27 July 2000, which contains a general anti-abuse rule that empowers domestic tax authorities to counteract tax advantages arising from abusive transactions, including treaty-shopping arrangements.

Finally, it is worth mentioning that, with specific regard to the right for the tax administration to counter abusive tax practices, the Italian Supreme Court has recently endorsed (decision No 14756 of 2020) the principles affirmed by the Court of Justice of the European Union in joined cases N Luxembourg 1 (c-115/16), X Denmark A/S (c-118/16), C Danmark I (c-119/16) and Z Denmark ApS (c-299/16), dealing with the application of the Interest and Royalties Directive.

4.4 Transfer Pricing Issues

Intercompany cross-border transactions have to be priced under arm's-length conditions.

Tax authorities frequently challenge the arm's-length value of transactions, having regard to the choice of the set of relevant comparables, the transfer pricing methodologies chosen, the relevant values to be taken into account and the time window of the comparability analysis.

Other aspects of intra-group cross-border transactions that are subject to the scrutiny of Italian tax authorities include:

- a challenge of the functional profile of the parties to the transactions in light of all facts and circumstances emerging during a tax audit; and
- a re-characterisation of the nature of certain transactions – for example, tax authorities may re-characterise a shareholder's loan as a capital contribution.

4.5 Related-Party Limited Risk Distribution Arrangements

Limited risk distribution arrangements are often used by foreign companies to determine the arm's-length remuneration of Italian distributors of the group. In principle, such arrangements are treated as being in line with the arm's-length principle. However, as pointed out in **4.4 Transfer Pricing Issues**, the Italian tax authorities may challenge the functional profile of the Italian distributor if the functions actually performed by the latter are not consistent with the arrangement.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Italian transfer pricing rules are essentially patterned on the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).

In that regard, Article 110(7) of the Italian Income Tax Code, containing the primary legislation dealing with transfer pricing, is generally aligned with the OECD Guidelines and includes an express reference to the arm's-length principle.

4.7 International Transfer Pricing Disputes

Over the past few years, the use of mutual agreement procedures – based on either the double tax treaties or the EU Arbitration Convention (90/436/EEC) – has increased as an alternative, or in concurrence with, domestic litigation.

Recourse to the mutual agreement procedures is expected to increase in the future following the recent implementation in Italy of EU Directive 2017/1852 of 10 October 2017, overcoming some critical issues with particular regard to the access, duration and effective conclusion of the procedure.

The Italian tax authorities that take part in the mutual agreement procedures generally discuss the cases with the foreign competent authorities to achieve a resolution that is in line with the arm's-length standard.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed under Italian tax law and practice.

On the one hand, it is generally accepted in Italy that the contracts regulating transactions between group companies provide for year-end adjustments, based on the actual financial data, to be carried out before the financial statements are realised and the tax returns filed. Although this practice does not represent a proper instance of compensating adjustment (as it does not lead to a departure of the tax figures from the accounting figures), it offers the taxpayer the possibility to correct – also for tax purposes – the prices initially applied in the relevant transactions in order to take into account facts that became known only thereafter.

On the other hand, proper compensating adjustments (ie, adjustments in which the taxpayer reports a transfer price for tax purposes that differs from the amount actually charged between the associated enterprises) are also accepted in Italy.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

There are no significant differences between the taxation of Italian permanent establishments of non-resident companies and resident companies.

5.3 Capital Gains of Non-residents

Capital gains realised by non-residents upon the transfer of shares or other participations in Italian companies are regarded as Italian-sourced and, therefore, are subject to tax in Italy. The applicable rate is generally 26%. There are certain exceptions, such as the following:

- capital gains on non-substantial shareholdings traded in regulated markets are not subject to tax;
- capital gains on non-substantial shareholdings are exempt if the non-resident person is tax resident in a State that allows for an adequate exchange of information with Italy, or if such person qualifies as an "institutional investor" established in a State that allows for an adequate exchange of information with Italy; and
- starting on 1 January 2021, capital gains are not subject to tax if they are realised by collective investment vehicles that are established in EU member states or EEA member states and are either compliant with Directive 2009/65/EC or whose managers are subject to surveillance in the States in which they are established, pursuant to Directive 2011/61/EU.

A person is regarded as selling a non-substantial shareholding if the amount of participation sold during a 12-month period does not exceed 20% (or 2% in the case of a listed company) of the voting rights or 25% (or 5% in the case of a listed company) of the stated capital. Such threshold should be computed by taking into account all disposals occurring in any 12-month period.

The above taxation could be prevented in case of application of double tax treaties.

There are no provisions explicitly addressing the taxation of indirect disposals of shareholdings in Italian resident companies (ie, disposals of shareholdings in a non-resident company that owns an interest in a resident company).

5.4 Change of Control Provisions

In a change of control, the following consequences may arise:

- interruption of any fiscal unit regime (see **2.6 Basic Rules on Consolidated Tax Grouping**); and
- forfeiture of tax losses (see **2.4 Basic Rules on Loss Relief**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

In general terms, the Italian tax authorities tend to follow the guidance laid down by the OECD Guidelines and, therefore, do not make use of predetermined formulas to determine the income of resident subsidiaries or Italian permanent establishments.

Article 152(2) of the Income Tax Code explicitly states that the permanent establishment is treated as if it was a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, the risks assumed and the assets held. The "free capital" of the permanent establishment (*fondo di dotazione*) is determined based on the OECD principles, taking into account the functions performed, the risks assumed and the assets held.

5.6 Deductions for Payments by Local Affiliates

In general terms, the Italian tax authorities follow the OECD Guidelines and allow the deduction of management and administrative expenses incurred by a non-resident related company on the conditions that the expenses do not qualify as shareholder's costs, the services have been effectively rendered to the Italian resident company, the services are provided for the benefit of the Italian company and the value of the consideration is at arm's length. Proper documentation providing evidence that these conditions are met should be kept by the Italian company.

5.7 Constraints on Related-Party Borrowing

In general terms, interest payments made to non-resident related parties are subject to transfer pricing legislation. In addition, the deductibility of interest expenses is subject to the interest limitation rule explained in **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Resident companies are subject to corporate income tax on their worldwide profits. If such profits include foreign-source income or gains that are also subject to tax in the State of source, the Italian resident company is granted a foreign tax credit.

Resident companies that have permanent establishments abroad may also apply an optional branch exemption regime, instead of the tax credit method. The option must be exercised in the tax return relevant to the year in which the permanent establishment has been set up.

If the option is exercised, it is irrevocable and the regime will apply to all the foreign permanent establishments of the resident company.

The profits attributable to the foreign permanent establishment shall be determined pursuant to the Authorised OECD Approach (AOA). If the foreign jurisdiction does not apply the AOA, the company may apply for a ruling asking for the application for Italian tax purposes of the method used in the foreign jurisdiction to determine the profits attributable to the permanent establishment.

6.2 Non-deductible Local Expenses

As foreign-source income and foreign-source gains are usually subject to tax in the hands of a resident company, the related expenses are deductible under the same rules applicable to the deduction of domestic-source income and gains. In relation to the income from (and losses of) permanent establishments under the branch exemption regime, see **6.1 Foreign Income of Local Corporations**.

6.3 Taxation on Dividends from Foreign Subsidiaries

Inbound dividends paid by non-resident companies are subject to the same rules as apply to dividends paid by resident companies and are, therefore, 95% exempt in the hands of the recipient (a few tax treaties provide for full exemption of qualified intercompany dividends).

As a general rule, this regime applies on the condition that the payment is fully profit-contingent (ie, the amount distributed has been determined in light of the economic performance of the payer) and the payment is fully non-deductible in the country of the payer. If the payment is partly deductible and the conditions for the application of the Parent Subsidiary Directive (Directive 2011/96/EU) are met, the 95% exemption applies to the part of the dividend payment that is non-deductible.

As an exception to the above, dividends from low-tax jurisdictions are fully taxable.

EU and EEA member states are never considered as low-tax jurisdictions. The applicable criteria to determine if a non-EU/EEA jurisdiction is low tax are as follows:

- if the resident company has a non-controlling shareholding in the non-resident company, the jurisdiction is low tax if the nominal tax rate in the foreign jurisdiction – taking into account any special regime applicable therein – is lower than 50% of the tax rate applicable in Italy; and
- if the resident company has a controlling shareholding, the jurisdiction is low tax if the effective tax rate in the foreign jurisdiction is lower than 50% of the effective income tax rate applicable in Italy.

The full taxation of dividends applies:

- if the dividends are paid directly by a company resident in a low-tax jurisdiction; or
- if the Italian resident company has a controlling holding in a foreign company that, in turn, has a shareholding in a company resident in a low-tax jurisdiction (to the extent of dividends deriving from the company resident in the low-tax jurisdiction).

Dividends from low-tax jurisdictions can benefit from the 95% exemption under certain conditions. Essentially, pursuant to the current practice of the tax authorities, the shareholder should demonstrate that the profits of the company resident in the low-tax jurisdiction have been subject to an "appropriate tax burden" since the time the shareholding was acquired.

Where such conditions are not met, but the resident company provides evidence that the foreign entity carries out an effective business activity through personnel, equipment, assets and premises, then only 50% of the dividends is taxed. Moreover, in such a case, if the recipient controls the foreign entity, it is also granted a credit for 50% of the corporate tax paid by the foreign entity.

The rules on the taxation of dividends from low-tax jurisdictions also apply to profits repatriated from permanent establishments under the branch exemption regime, under the same conditions explained above.

6.4 Use of Intangibles by Non-local Subsidiaries

If an Italian resident company has developed an intangible that is used by a foreign related company, such dealing is generally subject to transfer pricing legislation. Income from the use of intangibles may benefit from the patent box regime described in **2.2 Special Incentives for Technology Investments**.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

CFC legislation applies if:

- the Italian taxpayer (a resident company or Italian permanent establishment of a non-resident company) has a controlling holding in the foreign entity;
- the foreign entity is subject to an effective tax rate lower than 50% of the Italian effective income tax rate; and
- more than one third of the revenue of the foreign entity is represented by certain tainted income (such as dividends, royalties or interest, revenues from banking, insurance and financial activities, revenues from financial leasing, gains from the sale of shareholdings, or revenues from certain low-value-adding intercompany transactions).

If CFC legislation applies, the profits of the foreign entity shall be computed pursuant to Italian tax legislation and attributed for tax purposes to the Italian taxpayer in proportion to its rights to the entity's profits. The CFC income is taxed separately in the hands of the Italian taxpayer (ie, with no possibility to be offset against the losses of the latter). A credit for the taxes paid by the CFC (and any withholding tax paid on the distribution of the CFC profits) may be deducted from the Italian tax due on the CFC income.

An exemption from the CFC legislation is granted if the resident company provides evidence that the foreign entity carries out an effective business activity through personnel, equipment, assets and premises. It is possible to apply for a ruling in order to obtain confirmation from the tax authorities that this condition is met.

Foreign permanent establishments whose income is exempted under the branch exemption regime (see **6.1 Foreign Income of Local Corporations**) are subject to CFC legislation if they are located in a jurisdiction that qualifies as low tax, according to the above criteria.

6.6 Rules Related to the Substance of Non-local Affiliates

The economic substance of foreign related entities is often looked at by the tax authorities and may trigger challenges.

A common tax challenge concerns the case where the tax authorities tackle the foreign tax residence of a foreign entity with little substance, claiming that such entity should be regarded as a tax resident of Italy because it is actually managed by its Italian parent.

Alternatively, tax authorities may altogether disregard the foreign entity so that all its income and gains will be attributed to the Italian parent as if realised directly by the latter. In the recent practice of the tax authorities, some foreign subsidiaries of Italian parents have been re-characterised as foreign permanent establishments, due to the lack of managerial independence.

The lack of substance of a non-resident company may also lead to a charge denying treaty benefits to the latter.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains made by resident companies on the sale of shareholdings in non-resident companies can be eligible for the 95% participation exemption (see **2.7 Capital Gains Taxation**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

A general anti-avoidance rule empowers the tax authorities to challenge an arrangement or a series of arrangements that do not have economic substance and, although formally compliant with the wording of the law, have been put in place with the main purpose or one of the main purposes of obtaining an undue tax advantage, having regard to all relevant facts and circumstances.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

If a company's turnover exceeds certain thresholds, tax audits are carried out by the competent regional directorate of the Revenue Agency and the company is monitored more strictly and more frequently.

9. BEPS

9.1 Recommended Changes

Several measures recommended within the BEPS project were already part of the Italian tax system before 2015. Others have been added, particularly by the implementation of the ATAD I and II Directives. For example:

- Italy amended the domestic definition of "permanent establishment", aligning it – to a large extent – to the recommendations included in the Final Report on BEPS Action 7;
- even though a number of anti-hybrid provisions have been in place since 2004, in 2018 Italy introduced additional anti-hybrid provisions upon the implementation of ATAD I and II; and
- CFC and interest deduction rules were aligned with the ATAD principles (see **2.5 Imposed Limits on Deduction of Interest** and **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**).

Italy is a signatory to the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS of November 2016. Such convention has not yet been ratified.

9.2 Government Attitudes

The Italian Government actively participated in the BEPS project (see **9.1 Recommended Changes**).

9.3 Profile of International Tax

Issues concerning the fair taxation of multinationals in Italy are often within the domain of public discussion and under the media spotlight.

9.4 Competitive Tax Policy Objective

In the last few years, Italy has introduced a number of favourable regimes meant to incentivise certain investments and behaviours of taxpayers, such as:

- a Notional Interest Deduction regime, meant to incentivise the capitalisation of resident companies and Italian permanent establishments. Under such provision, a special allowance is granted for IRES purposes on certain qualifying equity increases, subject to a number of reductions. The deductible amount is equal to 1.3% of the net equity increases. The application of the Notional Interest Deduction benefit is subject to a number of conditions, including the requirement that the funds that constituted the net equity increases do not derive from investors that are located in States that do not adequately exchange information with Italy, or by investors that are controlled, also indirectly, by Italian resident companies (in order to eliminate any duplication of the benefit). The Notional Interest Deduction base is capped at the amount of the net equity of the company;
- the patent box regime (see **2.2 Special Incentives for Technology Investments**) originally introduced also with respect to trade marks (then carved out in compliance with BEPS recommendations);
- the branch exemption regime (see **6.1 Foreign Income of Local Corporations**), to boost the competitiveness of resident companies operating directly in foreign jurisdictions;
- the tonnage tax regime (see **2.3 Other Special Incentives**) for companies operating ships;
- the tax credits meant to mitigate the effects of the COVID-19 pandemic (see **2.3 Other Special Incentives**); and
- the regime allowing for the step-up of the tax basis of certain business assets (see **2.3 Other Special Incentives**).

Such regimes are not expected to be (further) amended in light of BEPS recommendations (as noted, the patent box regime has been already made compliant with BEPS recommendations).

9.5 Features of the Competitive Tax System

See **9.4 Competitive Tax Policy Objective**.

9.6 Proposals for Dealing with Hybrid Instruments

As mentioned at **9.1 Recommended Changes**, Italy introduced limited anti-hybrid legislation effective from 2004, which was meant to counteract the use of certain hybrid instruments. Fully-fledged anti-hybrid legislation was introduced in 2018, in compliance with ATAD I and II.

9.7 Territorial Tax Regime

There are no territorial tax regimes except for the optional application of the branch exemption regime described in **6.1 Foreign Income of Local Corporations**.

Italian interest limitation rules apply in general to all interest expenses of resident companies and Italian permanent establishments, regardless of whether the payee of the interest payments is Italian or foreign and related or not. The regime applicable to interest deduction is in line with Article 4 of ATAD I.

9.8 CFC Proposals

Italian law has featured CFC legislation since 2000; see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules** for an illustration of the currently applicable rules. A change of the current CFC regime could possibly derive from the decision to implement any measure stemming from the future wide convergence, at the international level, on the proposal recently put forward by the OECD in the context of Pillar Two of the Programme of Work for Addressing the Tax Challenges of the Digitalisation of the Economy agreed upon by the Inclusive Framework.

9.9 Anti-avoidance Rules

Pursuant to an established practice, Italian tax authorities apply Italian domestic anti-avoidance rules and principles to deny treaty benefits. The case law of the Supreme Court upholds this practice. Therefore, the recommendation of a treaty general anti-avoidance rule of Action 6 is not expected have an impact on this practice.

Italian treaties do not generally include a limitation on benefits provision (the notable exception being the treaty with the United States). Furthermore, Italy did not opt to apply the Simplified Limitation on Benefits rule included in the MLI and, therefore, such rule should not be included in any of Italy's Covered Tax Agreements (obviously, this conclusion should be further checked when Italy ratifies the MLI and deposits the final list of notifications).

9.10 Transfer Pricing Changes

The changes to the OECD Transfer Pricing Guidelines made pursuant to BEPS Actions 8 to 10 have not resulted in any dramatic change in the Italian regime. Indeed, the approach of the Italian tax authorities within tax audits was already essentially based on the arm's-length principle.

Transfer pricing was and continues to be an area carefully and often scrutinised by the tax authorities during audits of companies of multinational groups.

9.11 Transparency and Country-by-country Reporting

As an EU member state, Italy complies with the obligations on the exchange of information laid down by the Directive on the exchange of information (under Directive 2011/16/EU – DAC). Such exchange of information includes, inter alia, the mandatory exchange of tax rulings and CRS with other member states.

In 2015, Italy introduced Country-by-Country reporting obligations in line with BEPS Action 13 recommendations and in line with the DAC in relation to information concerning tax years that began on or after 1 January 2016.

Moreover, Italy implemented the provisions of the DAC concerning the automatic exchange of information on certain reportable cross-border arrangements (generally known as DAC 6 provisions).

9.12 Taxation of Digital Economy Businesses

See **9.13 Digital Taxation**.

9.13 Digital Taxation

In 2017, the domestic law definition of permanent establishment was amended to provide that a non-resident company shall be regarded as having a permanent establishment if it has "a significant and continuous economic presence in the Italian territory that has been arranged in such a way that does not give rise to a physical presence therein." The provision seems loosely inspired by BEPS Action 1 Report. However, the exact scope of the provision and its relation with existing tax treaties (which do not include such a provision in their definition of a permanent establishment) is currently unclear.

In December 2019, Italy introduced a Digital Services Tax (DST), patterned after the European Commission Proposal of March 2018. The DST entered into force on 1 January 2020. Taxable persons shall make the first payment of the DST by 16 March 2021 on the taxable revenues that they realised during 2020, and shall submit the relevant tax return by 30 April 2021.

The DST is a tax on revenues stemming from the provisions of three types of services:

- the placing on a digital interface of advertising targeted at users of that interface;
- the making available to users of a multi-sided digital interface which allows users to find other users and to interact with them, and which may also facilitate the provision of underlying supplies of goods or services directly between users; and
- the transmission of data collected about users and generated from users' activities on digital interfaces.

The DST is levied at the rate of 3% on the gross revenues (net of VAT) for the provision of such services that are to be regarded as realised in Italy according to specific territoriality rules based on the location of the users of the services and regardless of the location of the payers.

Like the European Commission's proposal, the DST should not apply to the provision of certain services and the supply of certain goods such as, in particular, the provision of digital contents and e-commerce transactions.

The DST applies to both resident and non-resident entities, with or without an Italian permanent establishment, that meet these two dimensional thresholds in the calendar year preceding the one in which the DST should apply, either on a standalone basis or at the group level:

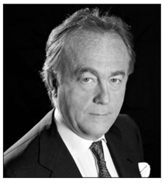
- the total amount of worldwide revenue reported during the calendar year is not lower than EUR750 million; and
- the total amount of revenue from the provision of the DST taxable services from Italian sources realised during the calendar year is not lower than EUR5.5 million.

9.14 Taxation of Offshore IP

There are no specific provisions dealing with the taxation of offshore intellectual property.

Maisto e Associati was established in 1991 and is an independent Italian law firm, specialising in tax law, with offices in Milan, Rome and London. Over the years, the firm has grown consistently in size and reputation, and now has more than 60 professionals, including 12 partners and two of counsels, with consolidated experience in managing complex domestic and multi-jurisdictional cases. Most of the firm's work has an international dimension. Clients include national and international financial institutions, venture capital, private equity and real estate players, large corporations and multinationals, high net worth individuals and wealthy families. Most of the firm's professionals participate in advisory bodies and study groups, are frequent speakers at congresses and contribute to numerous publications and the most prestigious tax journals. Several firm members have substantial experience in international taxation issues, having worked in the Netherlands, the USA and the UK.

Author



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MAISTO E ASSOCIATI

Trends and Developments

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Foreword: COVID-19 Measures

A description of the latest trends and developments in the Italian corporate tax system must begin with the measures introduced in 2020 to alleviate the effects of the COVID-19 pandemic, which in Italy, as in the rest of the world, severely impacted the business environment.

Besides a wide range of financial subsidies, tax and social security breaks/deferrals and suspensions of the tax audit/assessment activities, a couple of tax provisions that are having great success among Italian corporate taxpayers should briefly be mentioned.

The first is aimed at encouraging the disposal of distressed receivables via the conversion of certain deferred tax assets into immediately spendable tax credits. In more detail, a tax credit equal to 20% of the nominal value of the receivables sold is granted, provided the seller shows an equal amount of tax loss carry forwards or excess of notional interest deductions. As a consequence of the disposal of the receivables, the seller improves its financial position and at the same time gets a tax credit that can be immediately utilised to offset tax and social security payments (without any cap), or, alternatively, can be disposed of or asked to be refunded.

With the same aim, the 2021 Italian Budget Law introduced a similar provision for mergers, demergers and business contributions. In a nutshell, the new provision provides that the entity resulting from the said "extraordinary" transactions is entitled to convert deferred tax assets related to tax loss carry forwards and excess of notional interest deductions into a tax credit, by paying a commission fee equal to 25% of the deferred tax assets converted.

The second tax relief is aimed at increasing the financial stability of companies and consists of the possibility to step-up the value of business assets (the 2021 Budget Law extended this relief to goodwill and other non-patented intangible assets). In more detail, the taxpayer can choose to step-up the value of the assets:

- from a purely accounting standpoint;
- both from an accounting and a tax point of view; or
- from a tax standpoint only (where a difference between the accounting value and tax value already exists), in the latter two cases by paying 3% of the increased value.

As a consequence of the step-up, the company obtains an increased equity value, which could be of essence to cover losses incurred in FY 2020, and, on the other hand, a taxable asset that reduces its present and future taxable base for corporate income tax (IRES - 24%) and regional tax on productive activities (IRAP - generally 3.9%).

Most Recent Trends and Developments in Tax Law and Tax Practice

During the last few years, the Italian tax system has been progressively moving towards a friendlier environment, with the aim of becoming more attractive for foreign capital and people.

Having this *leitmotiv* in mind, the Italian government and the Italian parliament have shaped a range of provisions aimed at granting a greater level of tax certainty and a number of tax incentives to attract foreign (and of course stabilise Italian) investments and qualified people.

Unfortunately, this legislative trend is not always followed by an equal sensitivity in "real life" by certain tax "stakeholders": tax authorities are still adopting quite aggressive approaches and tax courts remain very inefficient in terms of the timing and quality of decisions rendered. This, together with the recent implementation in Italy of the DAC 6 Directive and the extension of the criminal responsibility of companies set by Legislative Decree No 231/01 to certain tax crimes, requires a high level of attention from the taxpayers and suggest an advanced co-operative attitude with the tax authorities.

As part of an international trend, it is worth mentioning that, starting from January 2020, Italy has its own Digital Service Tax in force. The tax consists of a 3% rate levied on the gross revenues deriving from the supply of certain digital services by taxpayers having EUR750 million or more global revenues worldwide and EUR5.5 million or more digital-sourced revenues in Italy. Despite the fact that, in January 2021, the Italian Tax Authority issued its official regulations, there are still many areas of uncertainty regarding the application of the tax.

Tax Certainty

Advance tax rulings

As with any other developed country, Italy has a wide range of tax ruling opportunities.

Starting with domestic situations, one should appreciate the increased number of matters covered, including anti-abuse rules, and the more efficient functioning of the relevant procedures. The publication of an increased number of answers on the revenue agency's website now allows a higher level of certainty, consistency and transparency to be reached to the benefit of taxpayers.

Moving to cross-border situations, multinational companies may access several types of advance ruling agreements with the revenue agency and obtain, for a five-year period or more, certainty about complicated matters such as, by way of example, transfer pricing, permanent establishments (existence and profit allocation), treaty regime of inbound or outbound flow of income. The 2021 Italian Budget Law allows, under certain conditions, the retrospective application of advance ruling agreements to all fiscal years open to assessment.

Advance tax ruling on new investments

In addition to the standard ruling procedures, Italy gives the possibility to foreign (and national) investors to go through an "inclusive" and very flexible form of ruling, the so-called advance ruling on new investments. This ruling can cover, in one single procedure, all the tax aspects (interpretation of tax provisions, anti-abuse) of a new investment in the Italian territory, provided the investment equals or exceeds EUR20 million and triggers an employment increase, and gives access to the co-operative compliance programme.

Co-operative compliance programme

In the same spirit as for tax rulings, following the path designed by the OECD, a specific co-operative compliance programme, ie, a mechanism of enhanced co-operation between the Italian revenue agency and taxpayers – was enacted a few years ago and is steadily gaining increasing importance in the Italian tax system.

This regime, initially limited to taxpayers with a turnover of EUR10 billion or more, was extended to taxpayers with a turnover of EUR5 billion or more, and, hopefully soon, should be accessible to all taxpayers with a turnover of EUR100 million or more, provided that a tax control framework is adopted.

Further to the possibility to have a continuous and amicable exchange of views with dedicated auditors of the revenue agency, companies that enter into this regime gain benefits including, among others, half terms for the answer to ruling requests, exemption from bank guarantees for refunds, and reduced penalties in case of assessment.

Alternative dispute resolution mechanisms

For cases where tax certainty, for any reason, cannot be gained in advance, settlement procedures and MAPs have been enhanced in the last few years to offer dispute resolution mechanisms that work more efficiently compared to ordinary court litigation proceedings (which still have a very long duration, up to ten years or more).

Lastly, in 2020, Italy implemented the EU Arbitration Directive (2017/1852), for the resolution of EU cross-border disputes related to any form of double taxation covered by tax treaties, including transfer pricing, which should further boost the above process by reasons, in particular, of the arbitration phase and the consequent obligation to resolve the double taxation cases in a binding manner.

Tax Incentives

Tax credit for R&D and new investments

The 2021 Budget Law, following a path started back in 2015, reinforced the tax credit measures encouraging investments in research and development activities, innovation technologies and design. A similar form of incentive is also granted to taxpayers that purchase 4.0 tangible assets.

Patent box regime

Since 2015, Italy has had its own patent box regime, which grants a 50% tax deduction of the (deemed) income deriving from the exploitation of "qualifying" intangible assets.

In 2020, the above-mentioned regime was boosted, allowing taxpayers to self-assess the portion of income to be exempted, also in case of "internal use" of the intangible assets, without going through a mandatory advance tax ruling procedure. The adoption of a set of explanatory documentation, along the lines of what has already been in force for transfer pricing for several years now, can grant a penalty protection regime in case of assessment.

The full legitimacy of the patent box regime, approved (also due to the recent exclusion of trade marks) by the OECD in line with the BEPS Action No 5, together with the new mechanisms described above, is expected to confirm the patent box regime as one of the most interesting incentives of the Italian tax system.

Tax step-up of the moving-in companies

Another key measure for the incentivisation of foreign investments is the recognition of the fair market value of the assets (and liabilities) owned by foreign companies moving to Italy for tax purposes.

Regardless of any possible exit tax paid in the country of origin, the value of the assets (and liabilities) are computed at fair market value for Italian tax purposes, with no tax payable at the entry. An advance ruling procedure is available to agree such values with the Italian tax authorities.

Exemption from withholding taxes

The incentivisation of foreign investments could gain a further, substantial, boost from the recent reform of the tax regime applicable to EU investment funds.

The Budget Law for 2021 introduced an exemption from withholding taxes on dividends paid by (and capital gain realised from the disposal of) Italian corporate entities to (by) UCITS funds and non-UCITS funds subject to regulatory supervision under the AIFMD in their country of incorporation (EU member states or white-listed EEA countries).

This measure represents a ground breaking evolution of the Italian system which, accompanied by some recent Supreme Court decisions on the concept of the "beneficial owner" and on the anti-abuse rules, should provide greater certainty to foreign investors. An extension (at a legislative or interpretative level) of the same measure to non-EU funds, which is not expected at present, would make the Italian system fully compliant with the EU Law principles.

Workers repatriation rules

The attractive corporate tax environment described above is accompanied, at individual tax level, by a set of rules incentivising the immigration to Italy of workers and high-net-worth individuals.

In a nutshell, workers (employed and self-employed) who move their tax residence to Italy can benefit from an exemption up to 70% of their salary for a five-year period (extendable, under certain conditions, for an additional five years at 50%) provided that, among others, they spend at least two years in Italy.

High-net-worth individuals who move their tax residence to Italy may benefit, under certain conditions, to a EUR100,000 flat tax on their overall foreign (ie, non-Italian sourced) income, being also exempted from any reporting obligations and any inheritance tax on their foreign assets.

Tax Practice and Case Law

Moving from the legal framework to "real life", a couple of trends and developments should briefly be mentioned.

The Italian Constitutional Court recently issued an important decision (No 158/2020), which should hopefully put an end to a wide and long-lasting debate between the Italian authorities and taxpayers on a registration tax matter. In essence, the Constitutional Court blessed the recent legislative reform that, via an interpretative rule (as such applicable also to past situations), stated that registration tax must be applied separately on each single deed that is actually executed; therefore, tax authorities cannot combine two or more deeds and recharacterise them as a single transaction subject to a higher registration tax levy (eg, the contribution of a business into a corporate entity followed by the disposal of the relevant shares – both subject to a EUR200 registration tax – was systematically requalified into a direct sale of that business from the contributor to the purchaser of the shares, subject to a 3% tax).

In terms of trends currently being experienced by corporate taxpayers in tax audits and assessments, one can say, in relation to multinational groups, that the Italian tax authorities are mainly focusing on international matters, looking for possible cross-border base erosion schemes as per the EU and OECD guidelines (duly transposed into the Italian legislation).

In addition to the "ever green" tax residency and permanent establishment matters, a couple of topics that are frequently recurring in the spotlight of the Italian authorities are those of transfer pricing and beneficial ownership.

With reference to transfer pricing, tax authorities are getting more and more sophisticated and have started focusing also on the financial sector as well as on restructuring schemes.

Beneficial ownership

Beneficial ownership, which has been a "hot" topic for many years already, is now producing a second wave of assessments, which touch new sectors (eg, private equity) and often goes beyond the principles stated by the CJEU (in the well-known "Danish cases") and the Italian Supreme Court (ie, pure holding companies can also have their own, proportional, substance and should be respected as beneficial owners). In other words, leveraging on the abuse of law principle, the Italian authorities are challenging the EU platforms of non-EU (mostly US) investors, claiming that the limited substance in terms of personnel and premises as well as the short retention of the flows of income in the EU country of residence (in most of the cases Luxembourg and the Netherlands) would prevent the application of EU Directives and tax treaty benefits, with the consequence that dividends, interest and capital gains would be fully taxable in Italy. On the other hand, a full "look through" approach, recognising the tax regime applicable to the "ultimate beneficial owner", is becoming a commonly accepted basis for a settlement discussion with the authorities.

Tremonti Romagnoli Piccardi e Associati is a leading Italian tax law firm, with a team of 40 highly skilled professionals working out of its two offices based in Milan and Rome. The firm provides a wide range of consultancy and tax advisory services both to domestic and international clients, specialising in international and transfer pricing operations, corporate and group taxation, M&A and group reorganisations, private equity, securitisation, structured finance and debt restructuring, management of non-performing loans, real estate investment and VAT. The firm has a strong track record in the field of pre-litigation and litigation proceedings, and international tax dispute resolution. Among others, in 2020 the firm advised Intesa Sanpaolo (the largest Italian bank) on the agreement with Nexi (Italian leader in the electronic payments sector) for the transfer of its "merchant acquiring" business unit (worth EUR1 billion) as part of a strategic and long-lasting partnership between the two groups.

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JAPAN

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form, either a joint-stock company (*Kabushiki-Kaisha* – KK) or a limited liability company (*Godo-Kaisha* – GK). The KK is intended for a business with a number of shareholders and subject to certain disclosure obligations, although it is used for a closed business as well, while the GK is only for a closed business with limited disclosure. Corporate forms of businesses (including KK and GK) are taxed as separate legal entities.

1.2 Transparent Entities

Civil Partnerships (*Nin-i Kumiai*) and Investment Business Limited Partnerships (*Toshi-jigyo Yugen Sekinin Kumiai*) are commonly used for the purposes of various funds since they are transparent for Japanese tax purposes. Investment Business Limited Partnerships are used in particular as they afford limited liability protection for investors. A silent partnership (*Tokumei Kumiai* - TK) arrangement can achieve an effect similar to a transparent treatment.

1.3 Determining Residence of Incorporated Businesses

The test for the residence of incorporated businesses is the "location of head or principal office" test. Under Japanese domestic tax law, a corporation is treated as a Japanese corporation (having a corporate residence in Japan) if it has its head office or principal office in Japan, regardless of the place of effective management. For transparent entities, the residence of each partner must be determined for Japanese tax purposes; if a partner is an individual, the residence is determined to exist at the place of the centre of his/her life, while if a partner is a corporation, it is subject to the location of head or principal office test. Please note that foreign limited partners must satisfy certain conditions in order to be exempt from the potential permanent establishment taxation due to attribution by Japanese resident partners.

1.4 Tax Rates

The nominal rate of national corporation tax (combined with local corporation tax) is approximately 26%, and the effective corporation tax rate – relevant national and local taxes combined – for companies operating in Tokyo for the fiscal year beginning on or after 1 April 2020 is as follows:

- approximately 31% for large companies (ie, companies with a stated capital of more than JPY100 million); and
- approximately 35% with a certain favourable rate for up to the first JPY8 million for small and medium-sized companies (ie, companies with a stated capital of JPY100 million or less).

Businesses owned by individuals or through transparent entities are subject to a progressive individual tax rate, with a maximum of 55.945% (national and local taxes combined).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The tax base for corporation tax is the net taxable income, which is calculated based on the results reflected in the taxpayer company's profit and loss statements, prepared in accordance with Japanese generally accepted accounting principles. The main differences between the tax accounting and the financial accounting include, but are not limited to, the treatment of donations and entertainment expenses. Donations, including any kind of economic benefit granted for no or unreasonably low consideration, are generally deductible only up to a certain limited amount. The deductibility of entertainment expenses is subject to certain qualifications and a certain ceiling.

Profits are generally taxed on an accrual basis, with certain exceptions for significantly small businesses.

2.2 Special Incentives for Technology Investments

Japan does not adopt a patent box, but Japanese tax law does provide for special tax credits and deductions on certain research and development expenses.

2.3 Other Special Incentives

A number of special incentives apply to capital expenditures in terms of special depreciation or tax credits. There are other special taxation measures aimed at increasing wages and improving productivity.

2.4 Basic Rules on Loss Relief

In general, the tax losses of past fiscal years can be carried forward to offset (by deduction) the taxable income of the current fiscal year, with such deduction being limited to a maximum of 50% (for a fiscal year beginning on or after 1 April 2018) of the before-tax-loss-deduction taxable income. Losses survive for ten years (for losses accrued in a fiscal year beginning on or after 1 April 2018). Please note that these limitations are not applicable (thus, a deduction of losses of up to 100% of the income is available) to the small and medium-sized companies that are stipulated under Japanese tax law – ie, that have a stated capital of JPY100 million or less and are not a wholly-owned subsidiary of a company (Japanese or non-Japanese) with a stated capital of JPY500 million or more.

The tax loss of the current year can be carried back to offset (by deduction) the taxable income of the previous year for the above-stated small and medium-sized companies. For taxable years ending between 1 February 2020 and 31 January 2022, the carry-back is extended to companies that have a stated capital of more than JPY100 million and no more than JPY1 billion (with certain exceptions), as a special relief against COVID-19.

Income losses can be offset against capital gain and vice versa.

2.5 Imposed Limits on Deduction of Interest

Thin Capitalisation Rules

The payor company of interest may be denied a deduction of the interest paid to a non-resident recipient for its own corporation tax purposes, due to the application of the "thin capitalisation" rules under Japanese domestic tax law. Such rules deny the deductibility of interest expenses paid to the payor company's foreign affiliates upon the portion of the debt exceeding three times the shareholder's equity when such company's annual average ratio of debt to equity exceeds 3:1, subject to an exemption available based on separate criteria.

Earnings Stripping Rules

Japan has earnings stripping rules, under which a deduction for "net interest payments" (as defined in such rules) in excess of 20% (or 50% before 1 April 2020) of an "adjusted taxable income" (as defined in such rules) will be disallowed, and the disallowed amounts may be carried forward for seven ensuing business years. If the disallowed interest amount under the earnings stripping rules is smaller than the amount disallowed for deduction under the thin capitalisation rules, then deduction is disallowed to the extent of the larger of the two disallowed amounts.

The old 50% (of an adjusted taxable income) threshold was less rigorous than the standard recommended by BEPS Action 4 Report, "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments" (ie, 10% to 30%). Accordingly, in 2019 the Japanese government tightened its earnings stripping rules by lowering the threshold from 50% to 20% and widening the scope of the rules (subjecting interest on third party loans to the rules, and excluding dividends from an adjusted taxable income), in line with the OECD recommendations and suggestions.

Even if deductibility is denied under the earnings stripping rules, the relief under a treaty (ie, the reduced withholding tax rate) available to the non-resident recipient of such interest would nevertheless not be restricted.

Transfer Pricing Rules

Japanese transfer pricing rules apply to interest that is paid by a Japanese corporation to its foreign related parties, where the interest that is deemed to be in excess of an arm's-length interest is not deductible.

2.6 Basic Rules on Consolidated Tax Grouping

There are two categories of tax grouping rules under Japanese tax law:

- the consolidated tax return rules; and
- the group taxation rules.

A group of Japanese companies in which a Japanese parent company owns – directly or indirectly through other Japanese companies – no less than 100% of other Japanese subsidiaries can elect to file a consolidated tax return. The consolidated tax is calculated on the basis of the aggregate net taxable income of the parent company and all consolidated subsidiaries. With certain exceptions, when a company participates in the consolidated tax return group from outside, the participating company's carry-forward losses will be lost and cannot be used to offset the income of the existing companies in the consolidated tax return group. The consolidated tax return rules were significantly amended in 2020 and the new rules will be applicable to taxable years beginning on or after 1 April 2022, under which restrictions on the carry-forward of losses will be more stringent.

Separate from these consolidated tax return rules, there are special rules for intra-group transactions (the "Group Taxation Rules"), which apply to group companies in a "100% group" (ie, companies that have a direct or indirect 100% shareholding relationship), even if they do not elect to file a consolidated tax return. The Group Taxation Rules apply to Japanese companies that are wholly owned by a foreign or Japanese company or an individual (to which certain family members' ownership is attributed). The Group Taxation Rules include the following rules, among others:

- deferral of capital gains/losses from the transfer of certain assets between Japanese companies in a 100% group; and
- denial of deduction and exclusion of income on donations between Japanese companies in a 100% group.

Under the Group Taxation Rules, the losses of one company are not allowed to be used to offset income of other group companies.

In Japan, neither the consolidation rules nor the Group Taxation Rules allow for relief for losses of overseas subsidiaries.

2.7 Capital Gains Taxation
For purposes of income taxes imposed on a company in Japan (not an individual), generally all of the taxable income of a company is aggregated, regardless of whether such income is classified as capital gains or ordinary/business profits.

2.8 Other Taxes Payable by an Incorporated Business
Consumption Tax
Japan applies Consumption Tax, which is a Japanese version of Value Added Tax. The current tax rate is 10%. No rate reduction has yet been implemented, announced or planned by the Japanese government in response to COVID-19.

Withholding Tax
Certain enumerated items of revenue derived by Japanese residents (either individuals or corporations) are subject to income tax withheld at the source by the payer. Items payable by an incorporated business that are subject to withholding tax include payments of interest and dividends, and payments of salary and remuneration to employees. See **4.1 Withholding Taxes** regarding withholding tax for income payable by non-Japanese individual residents and foreign corporations.

Transactional Taxes
There are some transaction taxes in Japan, including Stamp Duty, Registration and Licence Tax, Real Property Acquisition Tax and Automobile Acquisition Tax, among others.

Customs Duties
Customs duties and import consumption taxes are imposed on dutiable or taxable goods when they are imported into Japan. The rates of the customs duty for imported items are listed in the tariff schedule. The rate of the import consumption tax is 10%.

2.9 Incorporated Businesses and Notable Taxes
Local enterprise tax is imposed by local governments on enterprises located in their jurisdictions. In addition, among local taxes, Prefectural Inhabitant Tax per capita levy, Municipal Inhabitant Tax per capita levy, Fixed Assets Tax and Automobile Tax are of general application to the business operations of incorporated businesses in Japan.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses
Most closely held local businesses operate in corporate form, as either a joint-stock company (KK) or a limited liability company (GK).

3.2 Individual Rates and Corporate Rates
In Japan, generally speaking, corporate rates (approximately 31% or 35% depending on the amount of the stated capital) would be lower than individual rates for individuals who earn sufficiently large income (a maximum of 55.945%). No specific avoidance rules apply to a corporation that consists effectively of an individual's income, which are intended to prevent high-income earners from earning income at corporate rates. However, the Japanese tax authority may attempt to attribute a corporation's income to an individual, and hold him/her personally liable for the income purported to have been earned by a corporation.

3.3 Accumulating Earnings for Investment Purposes
Japanese corporation tax is generally imposed at the same rate upon all corporate taxable profits, regardless of whether such profits are distributed or retained. As an exception, a certain additional surtax (at the rate of 10%, 15% or 20%) may be imposed on certain portions of retained earnings of certain types of so-called family companies, unless such family company is a small and medium-sized company as stipulated under Japanese tax law (ie, a company with a stated capital of JPY100 million or less that is not a wholly owned subsidiary of a company (Japanese or non-Japanese) with a stated capital of JPY500 million or more).

3.4 Sales of Shares by Individuals in Closely Held Corporations
Japanese resident individuals are taxed on dividends from closely held corporations at progressive rates up to approximately 50% after dividend credits. They are taxed on the gain on the sale of shares in closely held corporations at 20.315%, which is an efficient manner for the exit of an investment in closed held corporations. For taxation on sales of shares by non-resident individuals, see **5.3 Capital Gains of Non-residents**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations
Japanese resident individuals are taxed on dividends from publicly traded corporations at 20.315%. They are taxed on the gain on the sale of shares in publicly traded corporation at 20.315%. For taxation on sales of shares by non-resident individuals, see **5.3 Capital Gains of Non-residents**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Under Japanese domestic tax law, generally, a non-resident (either a company or individual) is subject to Japanese

withholding tax with respect to interest on loans, dividends and royalties at the rate of 20.42%, and with respect to interest on government and corporate bonds and bank deposits at 15.315%, in the absence of income tax treaties.

However, most of the income tax treaties currently in force in Japan generally provide that the reduced treaty rate in the source country shall be 15% or 10% for portfolio investors and 10% or 5% for parent and other certain major shareholders. Furthermore, under the Japan/US Treaty and a certain limited number of other modernised tax treaties recently executed by Japan (including those with Australia, France, the Netherlands, Sweden, Switzerland and the United Kingdom), the withholding tax rate is reduced to 10% for portfolio investors and 5% or 0% for parent and other certain major shareholders.

If real property (land or any right on land or any building or auxiliary facility or structure), commercial or otherwise, that is located within Japan is alienated by a non-resident (either a individual or company), the gross amount of the consideration received by such non-resident for such alienation is subject to Japanese withholding tax at the rate of 10.21%, with certain exceptions (including no withholding tax for an alienation to an individual for use as a personal or family residence for a consideration of JPY100 million or less).

4.2 Primary Tax Treaty Countries

As of 1 November 2020, there are 66 income tax treaties (including an agreement between private associations of Japan and Taiwan) applicable to 75 jurisdictions currently in force in Japan, including OECD countries and non-OECD countries.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The Japanese tax authorities may challenge the use of an entity that is a resident of a country that has a tax treaty with Japan, if such entity is effectively owned or controlled by a non-treaty country resident. Legal bases for denial of benefits include the following:

- the limitation of benefits clause or the "beneficiary owner" clause included in the applicable treaty;
- the "principal purpose test" under the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) as incorporated in the applicable treaty; or
- domestic tax law provisions regarding the "substantial (beneficial) owner".

4.4 Transfer Pricing Issues

Japanese transfer pricing rules are applicable to inbound investors operating through a local corporation, and by and large follow the OECD Transfer Pricing Guidelines. Generally speaking, a local corporation controlled by a non-Japan shareholder is often afforded only a limited function, such as limited risk distribution. For such a limited function entity, the most appropriate transfer pricing method would be the transactional net margin method (TNMM). If the TNMM applies, a party that performs simple or routine functions is deemed a contractor who does not assume business risk, and is often viewed to be compensated with the same operating margin as comparable companies in the same industry and business. The Japanese tax authorities may challenge the comparable companies selected by a taxpayer, arguing that the arm's-length price should have been lower or higher.

4.5 Related-Party Limited Risk Distribution Arrangements

The Japanese tax authorities may challenge the use of related-party limited risk distribution arrangements for the sale of goods, and recharacterise it as a reseller. In fact, in the Adobe case, the Japanese tax authorities viewed a limited risk marketing subsidiary as a reseller and applied a transfer pricing rule accordingly. However, the Tokyo High Court rejected such recharacterisation in its judgment dated 30 October 2008, and nullified the tax authorities' adjustment. Still, the Japanese tax authorities may attempt to challenge the use of such arrangements on various legal bases.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Japanese transfer pricing rules by and large follow the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

Generally speaking, in a transaction involving a country where competent authority relief is effective, taxpayers tend to seek such relief. The Japanese tax authorities have received a number of requests for competent authority relief, including mutual agreement procedures (MAPs) and advance pricing agreements (APAs), with OECD member countries. With Australia, Germany, Korea, the United Kingdom and the United States in particular, most of the requests have been successfully resolved by agreements between the relevant governments. In addition, the Japanese government has had MAPs and APAs with non-OECD member countries, including China, Hong Kong, India, Indonesia, Singapore, Taiwan, Thailand, Malaysia and Vietnam; however, with respect to competent authority relief with non-OECD member countries, precedents are relatively few.

The Japanese tax authorities are generally positive in negotiating and resolving issues, although they may be reluctant when the case involves countries where there are no or few MAP or APA precedents.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When transfer pricing claims are settled through MAPs, compensating adjustments are allowed/made.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

If a foreign parent forms a Japanese subsidiary that is a corporation, such Japanese subsidiary will be treated as a Japanese taxpayer and will be subject to Japanese corporation tax on its worldwide income in the same manner as any other domestic Japanese corporation, subject to the exclusion of 95% of dividends from certain foreign subsidiaries. A branch of a non-resident corporation, by contrast, is generally only subject to Japanese corporation tax on the profits attributable to its permanent establishment in Japan. There is no branch profits tax or other similar tax that is applicable to a branch of a non-resident company, but not a subsidiary.

5.3 Capital Gains of Non-residents

With respect to capital gains on the sale of stock in a Japanese company, when a non-resident shareholder (either a company or individual) that has no permanent establishment in Japan alienates its shares in a Japanese company, such shareholder is not subject to any Japanese taxation, with certain exceptions, including the following.

First, where such shareholder owns 25% or more of the issued shares of a Japanese company in a three-year period and sells 5% or more of the issued shares in aggregate in a single fiscal year, such non-resident alienator is required to file a tax return in Japan and is subject to Japanese personal income tax or corporation tax (but not withholding tax), as the case may be, on a net income basis with respect to any capital gains.

Second, the special rules for a Real Property Related Company (defined below) apply when a non-resident individual or a non-resident company and his/her/its special related parties, in aggregate, hold more than 2% (5% if listed) of the shares issued by a company, the value of whose assets are 50% or more attributable directly or indirectly to real property (land or any right on land or any building or auxiliary facility or structure), commercial or otherwise, that is located within Japan ("Real Property Related Company"), or shares of other Real Property Related Companies.

If the special rules for a Real Property Related Company are applicable, such non-resident company or individual is required to file a tax return in Japan and is subject to Japanese personal income tax or corporation tax (but not withholding tax), as the case may be, on a net income basis with respect to any capital gains.

When either of the aforementioned exceptions applies, the capital gains are taxed at the general national corporation tax rate on a non-resident company or at 15.315% on a non-resident individual. Treaty relief may be available, depending on the jurisdiction of the non-resident shareholder.

5.4 Change of Control Provisions

Generally speaking, the disposal of an indirect holding in a Japanese corporation by a non-Japanese group will not trigger any tax or tax charges in Japan. However, there are a few exceptions where a change of control of non-Japanese shareholders in a Japanese corporation will trigger Japanese taxation, (see **5.3 Capital Gains of Non-residents**).

A change of control does not generally restrict a corporation from utilising its accumulated tax losses incurred in prior years. However, under certain specified events that take place within five years of the date of the change of control (measured, in principle, by more than 50% of the issued and outstanding shares), the utilisation of the tax losses of the company may be restricted. The restriction applies in the following circumstances, for example:

- when a company was dormant before the change of control and begins its business after the change of control; or
- when a company ceases its original business after the change of control and receives loans or capital contributions, the amount of which exceeds five times the previous business scale.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No specific formulas are used to determine the taxable income of foreign-owned Japanese corporations selling goods or providing services to third parties. In many cases, for Japanese transfer pricing purposes, the TNMM would be the most appropriate method to produce the arm's-length price for a Japanese entity selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

There is no established standard applied in allowing a deduction for payments by a Japanese corporation for management and administrative expenses incurred by it. Whether payments for management and administrative expenses are deductible is determined according to their substance – ie, if the management or administrative services are so valuable in terms of benefits the corporation receives, compared to payments to be made to an independent service provider under similar circumstances.

5.7 Constraints on Related-Party Borrowing
See **2.5 Imposed Limits on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
The foreign income of local corporations is not exempt from Japanese corporate tax, except for dividends from certain foreign subsidiaries. See **6.3 Taxation on Dividends from Foreign Subsidiaries**.

6.2 Non-deductible Local Expenses
There are limitations on deductibility on certain local expenses, including but not limited to donations and entertainment expenses. Donations, including any kind of economic benefit granted for no or unreasonably low consideration, are generally deductible only up to a certain limited amount. The deductibility of entertainment expenses is subject to certain qualifications and a certain ceiling.

6.3 Taxation on Dividends from Foreign Subsidiaries
With respect to dividends paid to a Japanese company by its foreign subsidiary, a participation exemption from Japanese income taxation is granted for 95% of such dividends if the Japanese company owns at least 25% of such foreign subsidiary's issued and outstanding shares or voting shares for at least six months. The 25% threshold requirement may be altered if a tax treaty explicitly so provides, or if a particular taxpayer is eligible for treaty benefits under an applicable tax treaty in which a lower threshold is required for a treaty-based indirect foreign tax credit eligibility (for example, a 10% shareholding threshold is provided under Article 23(1)(b) of the Japan/US Treaty).

6.4 Use of Intangibles by Non-local Subsidiaries
When the intangibles developed by a Japanese corporation are used by non-Japanese subsidiaries, the Japanese corporation should be entitled to a royalty payment as a licensor from licensee non-Japanese subsidiaries. Accordingly, even if the non-Japanese subsidiaries do not pay a royalty, for the purpose of Japanese transfer pricing rules, the Japanese corporation would be deemed to receive an arm's-length royalty from the non-Japanese subsidiaries, and would be taxed accordingly.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
Japan has its own CFC rules. If such CFC rules are applied to any particular overseas subsidiary, the net profits (but not the net losses) of such subsidiary shall be deemed to constitute the Japanese shareholder's taxable income in proportion to its shareholding percentage, regardless of whether or not such profits are distributed to the Japanese shareholder. These rules apply to Japanese tax payers that own 10% or more of the shares in a certain overseas subsidiary that is more than 50% owned, in aggregate, by Japanese resident individuals or companies directly or indirectly.

The Japanese CFC rules were overhauled in 2017 in line with BEPS Action 3, "Designing Effective Controlled Foreign Company Rules", and the new rules became applicable for the relevant subsidiaries' fiscal years beginning on or after 1 April 2018. Under the new rules, the following applies:

- profits of foreign subsidiaries that are either a "paper company", a "cash box company" or a "company located in black-list jurisdictions" will be included in the taxable income of the Japanese parent, unless the effective tax rate for the relevant subsidiaries is 30% or higher;
- profits of foreign subsidiaries that do not fall under the foregoing categories and do not satisfy the "Economic Activity Test" (ie, the test to see whether the subsidiary is engaged in active business by examining the subsidiary's category of business, fixed facility, management and volume of unrelated sales/purchases or manufacturing) will be included in the taxable income of the Japanese parent, unless the effective tax rate for the relevant subsidiaries is 20% or higher; and
- even if the foreign subsidiaries satisfy the "Economic Activity Test", their "passive income" will be included in the taxable income of the Japanese parent, unless the effective tax rate for the relevant subsidiaries is 20% or higher.

6.6 Rules Related to the Substance of Non-local Affiliates
See **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates
Japanese corporations are taxed on the gain on the sale of shares in non-Japanese affiliates, and subject to the general Japanese corporate income taxation. There is no participation exemption for the gain on the sale of shares in non-Japanese affiliates.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions
Japanese tax law does not have a general anti-avoidance rule, but it does include a so-called "specific" anti-avoidance rule for a family company (ie, a company where more than 50% of the shares are held by three or fewer shareholders and certain related persons). Japanese tax law also has specific anti-avoidance

rules that involve corporate reorganisation transactions and consolidated tax return filings.

In addition, there is an anti-avoidance rule for transactions regarding income attributable to a permanent establishment of overseas corporations, which is applicable to internal and other dealings between a non-Japanese company and its Japanese branch.

Under these specific anti-avoidance rules, transactions that are viewed as "unjust" can be recharacterised and reconstructed to a "normal" or "natural" form of transactions, with different tax implications (presumably higher tax burdens).

The Japanese tax authorities invoke specific anti-avoidance rules against corporate reorganisation transactions utilising intra-group losses, sometimes successfully in cases such as the Yahoo Japan case (the Supreme Court case dated 29 February 2016) and sometimes unsuccessfully in cases such as the IBM case (the Tokyo High Court judgment dated 25 March 2015).

8. Audit Cycles

8.1 Regular Routine Audit Cycle

General

There are no statutory or regulatory rules setting forth a regular routine audit cycle in Japan; the Japanese tax authorities are free to choose when they audit a certain taxpayer. However, significantly large corporations commonly go through audits every three to five years.

Compliance Programme

The Japanese tax authorities encourage corporations to co-operate with them and to voluntarily disclose certain information for compliance purposes. As an incentive, if the authorities acknowledge that a certain taxpayer is in compliance with tax laws, they may refrain from auditing that taxpayer for one year in addition to the period customarily taken to audit that taxpayer in the past. However, this is up to the discretion of the authorities, and a voluntary disclosure will not necessarily entail the exemption or relaxation of any tax audit or other procedural requirements, nor will it reduce any tax.

9. BEPS

9.1 Recommended Changes

Japan has implemented a majority of the OECD's recommendations on the BEPS project, as summarised in the following sections.

9.2 Government Attitudes

The Japanese government is proactive in leading the BEPS initiative and has implemented a majority of its actions.

9.3 Profile of International Tax

No specific legislation has yet been created to capture digital presence, although the Japanese tax authorities appear to be eager to capture digital presence in enforcement. For example, in 2009, it was reported that the Japanese tax authorities made adjustments on a certain Japanese affiliate of Amazon.com because such affiliate was viewed as a permanent establishment of Amazon, based on the finding that Amazon US's computers were used in Japan, Japanese employees were instructed by Amazon US and the Japanese affiliate functioned in more than just a logistical capacity. Amazon sought relief from a MAP with competent authorities, and the US and Japanese tax authorities reached an agreement in 2010 that resulted in no significant tax expense for Amazon. If the OECD makes specific recommendations for taxing digital activities, the Japanese government may move to enforce or take legislative actions in line with them.

Certain cross-border digital services rendered by foreign enterprises are now subject to Japanese Consumption Tax.

9.4 Competitive Tax Policy Objective

The Japanese government has not adopted any aggressively competitive tax regime in order to attract foreign investments, although the recent administration abolished an entrenched high corporate tax rate, reducing the effective corporate tax rate to approximately 30%. However, this is in line with the global standard, or not competitive with it. The Japanese governmental competitive tax policy objective is not against the BEPS project.

9.5 Features of the Competitive Tax System

The Japanese tax system does not appear to be more vulnerable to aggressive tax avoidance schemes than other jurisdictions, since Japan has not adopted significantly competitive tax systems such as patent boxes or harmful tax rulings.

9.6 Proposals for Dealing with Hybrid Instruments

Japan introduced legislation in response to BEPS Action 2 Report, "Neutralising the Effects of Hybrid Mismatch Arrangements", which denies exclusion for dividends received from 25%-owned non-Japanese companies (see **6.3 Taxation on Dividends from Foreign Subsidiaries**), as long as they are deductible in the payer country, including dividends on MRPS issued in Australia and dividends from a Brazilian company.

9.7 Territorial Tax Regime

Japan has a worldwide income taxation regime, where Japanese affiliates of a foreign group are subject to Japanese corporation tax on their worldwide income in the same manner as any other domestic Japanese corporations, subject to the exclusion of 95% of dividends from certain foreign subsidiaries. See **6.3 Taxation on Dividends from Foreign Subsidiaries**.

9.8 CFC Proposals

While Japan has adopted a worldwide income taxation system in general, it also has comprehensive CFC rules that combine an entity approach and an income approach, and are perceived as being sufficiently broad to capture movable income shifted to low-tax jurisdictions. The exemption from CFC taxation afforded to a company with substance is an important element of the current Japanese CFC rules. A sweeper CFC rule may make offshore subsidiaries of Japanese corporations whose profits are taxed at a "low rate" vulnerable to CFC apportionment, as those doing active business have been exempt under the current Japanese CFC rules. Please see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**.

9.9 Anti-avoidance Rules

The double taxation convention limitations and anti-avoidance rules that were introduced under BEPS projects are unlikely to have a significant impact on inbound and outbound investors, as Japan has already adopted the limitation on benefits clauses and the "beneficial owner" provisions in many of the existing double tax conventions.

On the other hand, the impact of the "principal purpose test" that was introduced by the MLI is uncertain since the language of the test (ie, a benefit under the treaty shall not be granted "if it is reasonable to conclude... that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit") is vague and no clear interpretation is established.

9.10 Transfer Pricing Changes

The transfer pricing changes proposed by the BEPS projects were mostly introduced into the Japanese transfer pricing rules, including three-tiered documentation rules and the rules for evaluating hard-to-value intangibles. As the exchange of country-by-country reports has begun between a number of countries, it is expected that the tax authorities will use them to identify potential targets for audit. Corporations are required to be more careful against potential tax audits from multiple tax authorities.

Even though the rules for hard-to-value intangibles have been introduced, it is still hard to measure the value of intangibles in practice. The taxation of profits from intellectual property is and will be a particular source of controversy in Japan as well as in other jurisdictions.

9.11 Transparency and Country-by-country Reporting

In response to BEPS Action 13, "Guidance on Transfer Pricing Documentation and Country-by-Country Reporting", the Japanese government introduced transfer pricing legislation to adopt the three-tiered documentation approach consisting of a country-by-country report, a master file and a local file. Against moves of certain European countries, the Japanese government is reluctant to make information available to the public or to the countries that may make information public. According to the Japanese tax authorities, they have provided country-by-country reporting information filed by Japanese taxpayers only to the jurisdictions that satisfied the standards set by the OECD, including those for confidentiality and appropriate use of such information. Under such policy, Japan provided country-by-country reporting information to 52 jurisdictions for 844 multinational enterprise groups, and received such information from 44 jurisdictions for 1,751 multinational enterprise groups in 2019.

9.12 Taxation of Digital Economy Businesses

See **9.3 Profile of International Tax**.

9.13 Digital Taxation

Although the Japanese government has not officially announced its position, it appears to favour a unified form of the "Pillar One" options that are proposed by the OECD. Apparently, the Japanese government is wary of supporting a revenue-based digital service tax (such as that adopted by France and other countries).

9.14 Taxation of Offshore IP

Japan has not introduced any other provisions than stated herein dealing with the taxation of offshore intellectual property.

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Trends and Developments

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2021 Tax Reform

On 26 January 2021, the government presented the 2021 Tax Reform proposals to the Japanese Parliament (the "Diet"). The reform is expected to be passed into law by the end of March. The proposals aim to establish Japan as an international financial hub, by attracting fund managers and other high-skilled human resources.

Capital gain treatment to be allowed for carried interest for individuals

Where a fund in the form of a (limited) partnership invests in shares and earns capital gains from the sale of such shares, the fund managers, as general partners, are entitled to certain returns in excess of their capital contribution based on their investment performance under the terms and conditions of the fund (the so-called "carried interest").

Under Japanese tax law, it is uncertain whether the carried interest paid to the Japanese resident individual fund manager (directly or through a partnership) is taxed as a capital gain on shares (at 20.315%) or as ordinary income for the rendering of personal services (at a maximum of 55.945%).

Under the 2021 Tax Reform proposal, the carried interest paid to a resident (individual) of Japan will be treated as stock capital gain (taxed at 20.42%) as opposed to ordinary income (taxed at a maximum of 55.945%), on the promulgated conditions, including the requirement that the distribution ratio is economically reasonable and that certain documentation is filed.

Deduction of performance-linked remuneration paid to unlisted asset management companies operating in Japan

Currently, performance-linked remuneration paid to directors of a Japanese company is deductible only if the calculation thereof is disclosed in the Annual Securities Report, thereby effectively limiting its availability to listed companies only. Under the 2021 Tax Reform proposal, the scope of deduction will cover certain unlisted asset management companies that make certain filings under the Financial Instruments and Exchange Act (FIEA), unless such companies are certain family-owned companies. The rationale is to encourage the payment of performance-linked remuneration to non-listed companies, thereby attracting talented fund managers, in circumstances where tailor-made remuneration for fund managers' interests is not expected.

The eligible asset management companies must earn 75% or more of their revenue from the following businesses:

- asset management businesses under the FIEA;
- certain specified businesses undertaken by qualified institutional investors;
- certain specified businesses undertaken by foreign investors; or
- certain specified transitional businesses.

Deductions are subject to transparency requirements, including the following:

- the calculation method of the relevant performance-linked remuneration is set forth in the limited partnership agreements, or approved by investors in their meetings; and
- the relevant performance-linked remuneration is objectively calculated based on the profits derived from funds under management of the relevant asset manager companies.

Extended scope of exemption from permanent establishment taxation for foreign limited partners

In general, when non-Japanese residents (individuals or corporations) invest in Japan as limited partners of either a Japanese or non-Japanese limited partnership, they can be taxed on any allocated income from the limited partnership that is attributable to a permanent establishment (PE) in Japan where a general partner is a Japanese resident. As an exception, a non-Japanese resident limited partner is exempt from the PE taxation if it holds less than 25% of the investment, subject to certain filing requirements.

Regarding application of the 25% test above, where the foreign partner invests in the relevant limited partnership ("Master Fund") through another upper-layer partnership ("Feeder Fund"), the 25% test is only applied by requiring the investment of all foreign investors in the Feeder Fund to be aggregated. For example, if a Feeder Fund, composed of independent non-Japanese investors A (24%), B (24%), C (24%) and D (24%) and a Japanese general partner, has 50% of the investment in the Master Fund, they do not qualify for the exemption as A, B, C and D has 48% (=50% x (24+24+24+24)%) in the Master fund in total.

The 2021 Tax Reform proposal is intended to relax the requirements for the 25% investment test. Specifically, the 25%

test will be applicable to the investment ratio at the level of the Feeder Fund, effectively widening the scope of exemption from PE taxation to the foreign investors investing through the Feeder Fund. In the example above, the non-Japanese investors A, B, C and D will each be viewed as holding 12% investment, below 25% in the Master Fund (= 50% x 24%), thereby qualifying for the exemption.

Relaxed inheritance tax for foreign nationals

In the past, when a foreign national and non-Japanese resident (heir) inherits assets from a foreign national and non-Japanese resident (the deceased), Japanese inheritance tax was imposed (at a maximum of 55%) on the inheritance asset located outside Japan if the deceased had stayed in Japan for more than ten years.

This taxation was criticised as being an obstacle to attracting foreign management candidates, skilled employees, and professionals, who are afraid that their assets outside Japan would be subject to Japanese inheritance tax (at the maximum 55%) if they are a resident in Japan for more than ten years.

Under the 2018 Tax Reform, limitations were introduced on the scope of Japanese inheritance taxation, so that inheritance tax is not imposed on assets located outside Japan with respect to the foreign national and non-Japanese resident who inherits said assets from a foreign national and non-Japanese resident (the deceased), regardless of the term of the deceased's past residency in Japan. Under this reform, when a foreign national had stayed in Japan for work and left Japan, later to become a non-Japanese resident, their assets located outside Japan will not be subject to Japanese inheritance tax even if they had stayed in Japan for more than ten years.

The 2021 Tax Reform will introduce further limitations on the scope of inheritance taxation, so that inheritance tax will not be imposed on the assets located outside Japan inherited by the foreign national and non-Japanese resident heir, or the foreign national and Japanese resident heir who stays in Japan under certain visas (including a working visa), from even the Japanese-resident foreign national (the deceased) staying in Japan under certain visas, regardless of the term of the deceased's residency in Japan. Under the new law, when a foreign national who is now staying in Japan under a working visa, their assets located outside Japan will not be subject to Japanese inheritance tax even if they stay in Japan for more than ten years. This reform is expected to attract high-skilled human resources to Japan.

Court Cases

Shionogi case – tax-free reorganisation in the transfer of shares of a foreign partnership

The treatment of a foreign partnership under Japanese tax law has been unclear for a number of years. In particular, the scope of tax-free reorganisation involving a foreign partnership is ambiguous, creating uncertainty for taxpayers contemplating cross-border restructurings.

Last year, a case involving a Japanese pharmaceutical corporation set an important precedent. In such case, Shionogi & Co., Ltd. (the Taxpayer) formed a joint venture in 2001 with GlaxoSmithKline (GSK) in order to develop drugs for HIV treatment. The legal form of the joint venture was a Cayman Islands Special Limited Liability Partnership (CILP), with the Taxpayer and GSK each owning 50% evenly. After such initial formation, it was decided that Pfizer would join the joint venture, and therefore, the joint venture was reorganised, including the subject transaction. For the reorganisation, the Taxpayer contributed its share of the CILP interest (foreign partnership interest) into its UK subsidiary in exchange for its corporate shares, thereby converting its holding structure into one through a UK subsidiary.

The Taxpayer intended the contribution to be tax-free, which the Japanese tax authority disputed, viewing the contribution as a transfer of assets from inside Japan to outside Japan since the partnership interest had originally belonged to the Taxpayer, which was a Japanese corporation. From this perspective, the contribution resulted in a revenue loss for the Japanese government on the built-in gain of domestic assets. Based on this finding, the Japanese tax authority made an adjustment on the alleged realised capital gain in the amount of approximately USD500 million.

The issue here is whether the contributed assets (ie, the Taxpayer's share of the foreign partnership interest) are viewed as having been located outside Japan. If so viewed, it would qualify for tax-free reorganisation under Japanese tax law because the transaction took place completely outside Japan. The Japanese tax authority regarded the contributed assets (the foreign partnership interest) as having existed inside Japan because the foreign partnership interest was registered in the Taxpayer's books and under the administration of the Taxpayer's headquarters.

In its judgment dated 11 March 2020, the Tokyo District Court rejected the tax authority's findings and nullified the adjustment. The court held the Taxpayer's share of the foreign interest to be an "integral/inseparable combination of (i) a share of the partnership assets, and (ii) contractual status as a (limited) partner." The court stated that the origin of value of the share of the foreign partnership lies in the partnership assets, as opposed to the contractual status and, accordingly, the location of the contributed asset – the share of the foreign partnership – corresponds to where the primary partnership assets are located (ie, where the data relating to the clinical tests and other intangible assets are stored). The court held that such data and other valuable intangible assets were located outside Japan (ie, in the office of the US affiliate of GSK), so the transfer of the foreign partnership interest qualified for tax-free treatment. Based on such judgment, it would appear the court believes that the capital gain had not accrued in Japan since the value principally lay in the assets (located outside Japan) and not the contractual status embodied in the partnership interest.

At present, cross-border joint ventures organised as foreign partnerships have become prevalent, and reorganisation is common in order to keep up with rapid changes in today's economic environment.

The above case has been appealed and is currently pending before the Tokyo High Court.

Thin capitalisation rules

In a rare application of the Japanese thin capitalisation rules, the Tokyo District court approved, in a judgment dated 3 September 2020, the Japanese tax authority's adjustment based on denial of a deduction of interest on a loan borrowed by a Japanese company from its quasi-foreign controlling shareholder.

The case concerned a Japanese company that borrowed a total of JPY16.4 billion from a well-known fund manager and activist at an interest rate of 14.5% per annum, which had been deducted by the borrower Japanese company for its corporate income tax return. The Japanese tax authority invoked the Japanese thin capitalisation rules based on the finding that the fund manager, a Japanese national yet not a resident of Japan, was a legislative equivalent to a "foreign controlling shareholder".

Japan has the type of thin capitalisation rules where the payor Japanese company of interest may be denied a deduction of the interest paid to a non-resident related recipient for the company's corporation income tax purposes. The rationale of the rules is to prevent income tax base erosion utilising interest payment deductions. Such rules deny the deductibility of interest expenses paid to the payor company's foreign controlling shareholder when such company's annual average ratio of debt to equity exceeds 3:1, subject to an exemption available based on separate criteria. The subject payments are principally those made from the Japanese company to its controlling shareholders. However, the rules extend coverage to someone who is able to determine the direction of the company, and subject such person to the same treatment as a "foreign controlling shareholder".

According to the news report, the amount of the loan from the fund manager accounted for 59.1% and 75.24%, respectively, of the total assets of the company for the relevant years and, therefore, the court found that the company raised a substantial portion of its funds for its business activities through borrowing from the fund manager. The court held that the fund manager exercised significant influence on the company's businesses given that the company's borrowing from the fund manager accounted for an extremely large portion of the raised funds of the company.

This case suggests that the Japanese tax authority is paying attention to the base erosion through Japanese companies' interest payments to non-residents which are made not only to its controlling shareholders, but also to someone who has an effective influence without any formal controlling relationship.

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JORDAN

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

All commercial activities in Jordan can be conducted only after registration with the Ministry of Industry and Trade's Company Controller Department. Registration can be as individuals; as incorporated companies limited by shares, which may be public or private; or as partnerships. Public company shares are listed on a stock exchange, while a private company is any company other than a public company.

The types of companies allowed under Jordanian law are general partnership, limited partnership, limited partnership in shares, limited liability company, private shareholding company and public shareholding company.

The Jordanian corporate tax regime is not a two-tier taxation: company income is taxed at the company level; however, dividend income distributed by companies to shareholders or partners is not subject to income tax.

1.2 Transparent Entities

Transparent entities commonly used in Jordan include partnerships, which, like incorporated entities, are not subject to two-tier taxation. In a general partnership, partners are jointly and severally liable. A creditor of the general partnership may sue the company and partners therein for all the partnership's liabilities, as opposed to a limited partnership, in which the limited partners contribute to the capital of the partnership without having the right to manage the company or to realise its operations, and the liability of each one of them towards the company debts and liabilities is limited to their share in the capital of the company.

Limited partnerships must have a general partner who manages the partnership and realises its operations, and is jointly and severally liable for all the partnership's debts and liabilities with unlimited liability.

1.3 Determining Residence of Incorporated Businesses

A company is considered resident in Jordan if it was incorporated in Jordan; or if registered as an operating foreign company, then the Jordanian branch of that foreign company is considered a Jordanian entity.

1.4 Tax Rates

The corporate tax rate for incorporated businesses in 2021 is 20%, except for entities that work in the telecommunications, electricity generation and distribution, mining, insurance and reinsurance, and brokerage sectors, which have a corporate tax rate of 24%. The corporate tax rate for banks is 35%. In addition to those corporate tax rates, certain sectors are required to provide a contribution to the National Fund as follows based on taxable income:

- 3% for banks, and electricity generation and distribution;
- 7% for mining companies;
- 4% for brokerage and leasing companies;
- 2% for telecommunications, and insurance and reinsurance companies; and
- 1% for all other corporate entities.

Capital gains and losses arising from real estate transactions located in Jordan (including real estate associations) are not taxed, unless they are realised by an entity that engages in the sale of real estate as part of its corporate objectives.

Transparent entities, such as business partnerships, are subject to taxation in Jordan at the partnership level. Dividends distributed to partners are not taxable as such. Dividends from publicly listed companies are not taxable; however, there is a flat tax of 0.08% on buy-sell orders for stock exchange transactions.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Jordanian companies' income is taxed on a worldwide basis, based on a flat rate of 10% of the net income declared in the financial statements of the foreign branch. Also, any foreign income realised using funds or deposits generated from any activity in Jordan and then used to invest outside Jordan is subject to a flat rate of 10% of the net income generated from such investment. Similarly, foreign companies are only subject to Jordanian tax with respect to their Jordan-sourced income.

The company's net income is calculated according to the International Financial Reporting Standards (IFRS), which, once reconciled with the provisions of the Jordanian Tax Code and its regulations, determines the tax base for corporate tax purposes. In general, the accrual method of accounting is used by Jordanian companies to report their income for accounting and tax purposes.

2.2 Special Incentives for Technology Investments

In order to encourage start-up investments in the information technology sector, Jordanian tax law allows IT companies that create, process or store data, as well as companies working in programming, to exempt from corporate taxation all capital gains generated from the sale of company shares. This exemption is valid for the first-time sale of shares within 15 years from the date of company incorporation, and may be extended by a Cabinet decision.

2.3 Other Special Incentives

Corporations engaged in industrial activities are entitled in 2021 to a 20% reduction of their corporate tax rate. Similarly, corporations in the drug and garment industries are entitled in 2021 to a 30% reduction of their corporate tax rate. Additionally, entities registered as venture capital companies are exempt from corporate income tax.

Accelerated depreciation, up to 300% of the regular rate of depreciation, is allowed regardless of the industry type provided that the accelerated deprecation rate selected is maintained for the remainder of the asset life. This does not apply to buildings, which normally have a fixed depreciation rate of 2% for non-industrial buildings, a 10% depreciation rate for temporary buildings, and 4% for buildings housing industrial equipment and machines.

Additionally, Jordan has established within its territory free zones in which there is reduced or no income tax. Specifically, the Aqaba Special Economic Zone (ASEZ) allows enterprises registered with the Aqaba Special Economic Zone Authority (ASEZA) to enjoy a 5% income tax on income generated from activities inside the ASEZ or outside Jordan except for banking, insurance and land transport services. Additionally, there are several free zone areas in Jordan that allow enterprises registered within them to enjoy exemption from income tax on all income generated from dealings outside Jordan; ie, transit commerce out of the free zone.

2.4 Basic Rules on Loss Relief

Operating losses incurred from a branch of the business or trade may be used to offset any other operating income or gain recognised by the company in the same tax year. Capital losses can only be offset against capital gains. Net operating losses of a company may be carried forward for five years, although they may not be carried back and cannot be carried forward for losses incurred from exporting goods and services.

Carry-forward loss generally survives ownership change.

2.5 Imposed Limits on Deduction of Interest

Generally, sums paid on interest are deductible, provided that the capital was used for the production of taxable operational income. As a general rule, all income is expected to be associated with a cost, and therefore it is acceptable to deduct the cost of that income to arrive at the gross taxable profit.

2.6 Basic Rules on Consolidated Tax Grouping

Jordanian law does not allow for consolidated tax grouping. Each corporate entity has its own tax number and file.

2.7 Capital Gains Taxation

Capital gains on the sale of depreciable assets are considered taxable income. Capital gains from the sale of shares in publicly listed companies are exempt from income tax. However, the sale of shares in a non-listed company will trigger an escalating income tax from 0.5%–5%, based on the value of the sale and not the capital gains realised.

2.8 Other Taxes Payable by an Incorporated Business

All contracts executed by incorporated businesses are subject to stamp duty at 0.3% for contracts among private parties, and 0.6% of the value of contracts among private and governmental entities.

VAT/sales tax is paid by the final consumer, and not by the manufacturing or selling company; however, incorporated entities are responsible for collecting and forwarding the sales tax to the Income and Sales Tax Department (ISTD). Excise tax, however, is paid directly by the incorporated entity. Excise tax is regulated by Cabinet resolution and falls only on specified goods and activities, such as cigarettes, alcohol and cellular devices. Transfer tax applies to the sale of real estate.

2.9 Incorporated Businesses and Notable Taxes

Jordan charges VAT/sales tax on transactions in Jordan and on the importation of goods and services into Jordan, the standard rate of which is currently 16%, and 7% for the ASEZ. A transaction that is a sale of goods is deemed to have taken place in Jordan if, in the case of a tangible asset, it was delivered in Jordan or exported and if, in the case of an intangible asset, the seller is a Jordanian resident. Brokerage firms and financial institutions are subject to 24% income tax, and banks are subject to 35% income tax.

There is a tax on paid salaries (salary tax), which is deducted from the salary of the employee and delivered by the employer to the ISTD. Salary tax is an escalating tax starting at 5% up to 30%, subject to certain adjustments. Businesses are entitled to recover input VAT/sales tax costs in connection with goods or services used by them to create their taxable (including a zero rate) supply.

Jordan imposes customs duties in accordance with the Customs Law.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

It is difficult to ascertain how most closely held businesses operate in practice. However, in the event that they do incorporate, the responses laid out below will apply.

3.2 Individual Rates and Corporate Rates

The Jordanian corporate tax regime only taxes the corporation and does not impose any taxation for the distribution of dividends, therefore it is not based on two-tier taxation. The corporate tax rate for incorporated businesses in 2021 is 20%, except for entities that work in the telecommunications, electricity generation and distribution, mining, insurance and reinsurance, and brokerage sectors, which have a corporate tax rate of 24%. The corporate tax rate for banks is 35%.

The highest applicable marginal tax rate on ordinary income is 30% (in 2021).

3.3 Accumulating Earnings for Investment Purposes

Closely held corporations are taxed on the income that stems from their operations, based on the income tax rate specific to their specific sector. The corporate tax rate for incorporated businesses in 2021 is 20%, except for entities that work in the telecommunications, electricity generation and distribution, mining, insurance and reinsurance, and brokerage sectors, which have a corporate tax rate of 24%. The corporate tax rate for banks is 35%.

In addition, in the event that a closely held corporation has not distributed a dividend, the distribution of the dividend does not damage or negatively impact the company, and the lack of distribution is not a means of tax avoidance because there are no taxes on dividends.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are subject to 0.08% tax upon the sale or purchase of shares in publicly traded companies. Dividends of publicly traded companies are not subject to taxation.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are subject to 0.08% tax upon the sale or purchase of shares in publicly traded companies. Dividends of publicly traded companies are not subject to taxation.

The sale of shares in a non-listed company will trigger an escalating income tax from 0.5%–5%, based on the value of the sale and not the capital gains realised.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of an applicable income tax treaty, the following particular withholding taxes apply to foreign residents.

- In general, payments made to foreign individuals and foreign corporations are subject to 10% withholding tax.
- Interest and royalties paid to non-resident corporations are generally subject to withholding tax of 10%. Certain interest payments to non-resident investors are generally exempt from withholding tax, such as interest on certain traded government bonds.
- Dividends distributed to foreign shareholders are not subject to withholding tax.
- Income from interest, deposits, commissions, and profits of deposits in banks and paid by banks and financial companies in Jordan to any resident or non-resident person is subject to withholding tax at the rate of 5% for individuals and 7% for legal persons. These withheld amounts are considered final tax for the non-resident legal person and the natural person.

4.2 Primary Tax Treaty Countries

Jordan has entered into income tax treaties with Algeria, Azerbaijan, Bahrain, Bulgaria, Canada, Croatia, the Czech Republic, Egypt, France, India, Indonesia, Iran, Iraq, Italy, South Korea, Kuwait, Lebanon, Libya, Malaysia, Malta, Morocco, the Netherlands, Pakistan, Palestine, Poland, Qatar, Romania, Saudi Arabia, Sudan, Syria, Tunisia, Turkey, Ukraine, United Arab Emirates, the United Kingdom, Uzbekistan and Yemen.

Jordan signed the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in 2019.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Jordan does not have a formal position on the use of treaty country entities by non-treaty country residents.

4.4 Transfer Pricing Issues

Tax law requires all transactions between related parties to be based on arm's-length terms such that if a preferred price was obtained due to a special relationship between the parties, the transaction is expected to be reported based on the market's actual price. The ISTD would often compare the price of the transaction with the price of a similar international transaction between unrelated parties. The ISTD must amend the price between the related parties to match the price otherwise used between unrelated parties.

There is likely to be more focus in the future on transfer pricing as a result of the OECD's initiatives on BEPS, and the forthcoming implementation of legislation following such initiatives.

4.5 Related-Party Limited Risk Distribution Arrangements

In Jordan, an agent acting for the foreign principal does not constitute a permanent establishment as a dependent agent in Jordan. Therefore, if a foreign company sells goods via subsidiaries or other affiliates in Jordan that do not assume the responsibility of a fully fledged distributor, no tax is assessed on the foreign company's revenue generated from the sale in Jordan, because the ISTD views such revenue as generated from sales to Jordan and not as income generated by sales in Jordan.

ISTD regulations and Jordanian courts have not addressed the issue of existence of a permanent establishment in Jordan in the case of commissionaire arrangements with a foreign principal.

Jordan signed the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in 2019. It is not clear if this signing will affect the way the ISTD addresses the status of foreign principals using distributors in Jordan, or if it will result in a revised definition of permanent establishment.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The OECD Transfer Pricing Guidelines are not explicitly included in Jordanian legislation, but the Income Tax Law contains a reference to international standards, and guidelines on transfer pricing issued by international agreements concerned with taxation. Thus, the OECD guidelines alongside could be used for referencing and interpretation when ISTD auditors deal with transfer pricing cases.

4.7 International Transfer Pricing Disputes

In 2021, there have been no international transfer pricing disputes resolved through double tax treaties and mutual agreement procedures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

There is currently very limited application of specific transfer pricing rules or mechanisms.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

The income of Jordanian or overseas companies is taxable if it is accrued in, or derived from, Jordan.

Important points to note regarding branches include:

- there is an automatic withholding tax on money transfer as income accrued in Jordan to overseas entities of 10%; and
- the ISTD deems intercompany interest and royalty income derived from Jordan by a branch of an overseas company to be accrued and derived from Jordan, and thus subject to tax in Jordan.

5.3 Capital Gains of Non-residents

Capital gains on the sale of depreciable assets are considered taxable income. Capital gains from the sale of shares in publicly listed companies are exempt from income tax. However, the sale of shares in a non-listed company will trigger an escalating income tax from 0.5%-5%, based on the value of the sale and not the capital gains realised.

5.4 Change of Control Provisions

Transfer tax is payable on the transfer of ownership of real estate located in Jordan, even where such ownership is indirectly held through intermediate holding companies. The transfer tax is 9%, traditionally split 5%-4% between seller and buyer.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No specific formulas are used by the tax authorities to determine the income of foreign-owned local affiliates.

Rather, the taxable profits of a local branch of a foreign company are generally calculated by reference to the income and deductions attributable to the branch under the assumption that it operates as an independent business unit and in accordance with transfer pricing rules.

5.6 Deductions for Payments by Local Affiliates

There is no specific standard applied in allowing a deduction for payments by local affiliates for local management and administrative expenses incurred by a non-local affiliate. The deduction must be carried out in accordance with the fair market value of such services.

5.7 Constraints on Related-Party Borrowing

A tax deduction is allowed for any interest paid or payable to a person not resident in Jordan. Interest paid to a person not resident in Jordan is subject to 10% withholding tax.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Income accrued in, or derived from, Jordan is taxable. However, to encourage transit commerce, the government exempts income generated from transit of goods within the free zones and several services outside the free zone from income tax.

6.2 Non-deductible Local Expenses

Expenses that are not wholly and exclusively used in the production of taxable income are treated by the tax authorities as non-deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received from a foreign subsidiary are taxed based on a flat rate of 10%. Also, any foreign income realised using funds or deposits generated from any activity in Jordan and then used to invest outside Jordan is subject to a flat rate of 10% of the net income generated from such investment.

6.4 Use of Intangibles by Non-local Subsidiaries

In general, in order for non-local subsidiaries to use intangibles developed by local corporations, the intangibles must be sold to the foreign corporation, or the local corporation may sign a licensing or royalty agreement with the non-local subsidiary, according to which, it may use the intangibles in return for proper consideration. All the above is subject to compliance with transfer pricing rules.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Income from a controlled foreign corporation (CFC) has to be included in the gross income of the parent company and will be taxed at a 10% income tax rate. CFC income is determined for each individual foreign entity level based on its audited financial statements, and then attributed to the Jordanian parent company to be taxed.

Resident companies must include in taxable income their relevant share of the undistributed profits of a CFC, as CFC income is determined for each individual foreign entity level based on its audited financial statements, and then attributed to the Jordanian parent company to be taxed. This means that Jordanian CFC rules apply to passive and active income; that is, income derived from active business operations.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no specific rules that relate to the substance of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains from the sale of overseas assets was not addressed within the scope of the Tax Code in Jordan.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Anti-avoidance provisions empower the ISTD to disregard part or all of any arrangements or transactions deemed artificial and/or fictitious with a goal of reducing payable taxes.

This is often seen with refusal to consider unjustified expenses, and transfer pricing not on an arm's-length basis. All those would normally be subject to restrictions and limitations pursuant to the application of general anti-avoidance principles.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The ISTD determines the entities that will be subject to audit based on a statistical sample of the companies that filed a tax return for that year. The tax returns filed by companies not included in the sample are considered accepted by the ISTD, even though such nominally accepted tax returns can still be audited within two years if the ISTD Director decides additional income information was revealed.

In addition, within four years of inclusion in the sample (and, in certain circumstances, two years from the date the tax return was filed), the assessing officer must audit a company's tax return or it will be deemed accepted. The assessment of the officer may be appealed to a committee within the ISTD. The decision of the committee is subject to appeal to the tax court. The decision of the tax court may be appealed to the tax appeals court.

9. BEPS

9.1 Recommended Changes

Jordan signed the OECD's Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting in 2019.

Jordan has already begun to implement certain BEPS recommendations, especially in the area of transfer pricing as incorporated in the latest amendments of the Income Tax Law effective in 2019. In this regard, the taxpayer may be required to provide the ISTD with complete documentation of the international transaction, including the method used for price calculation. This would fall within the BEPS Action 13 recommendation regarding transfer pricing documentation.

Furthermore, consistent with BEPS Action 5, which addresses harmful tax practices, the ISTD recently enacted legislation granting preferential tax rates to technology and hi-tech companies with respect to capital gains derived from sales of shares in such companies. Specifically, Jordanian tax law allows IT companies that create, process or store data, as well as companies working in programming, to exempt from corporate taxation all capital gains generated from the sale of company shares. Such changes can also be viewed as being part of the governmental push for attracting capital investments.

The authors expect this process to continue gradually, although it is not clear at what pace and to what extent implementation will happen through changes in the interpretation of existing law and tax treaties, as opposed to changes in legislation.

One notable area still untouched is e-commerce. The newly amended Tax Code has explicitly declared as taxable the income generated from e-commerce for goods and services. However, the ISTD has yet to issue guidance on what that actually means from an implementation point of view. Specifically, what, if any, procedures will be applied to enforce taxation of income applicable to non-Jordanian internet companies selling goods or providing services to the Jordanian market through the internet, as well as the VAT/sales liability of internet services companies. The governmental response to this area has largely been, thus far, through the Customs Department's treatment of goods received through the mail service from non-Jordanian internet companies.

9.2 Government Attitudes

As a result of Jordan signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, the ISTD has no option except to follow and implement the OECD's recommendations in the BEPS reports and, accordingly, the authors expect to see amendments to domestic legislation, the enactment of regulations and the publication of guidance papers by the ISTD, which will indicate the ISTD's position.

9.3 Profile of International Tax

International tax has significant media exposure and hence a high public profile in Jordan, especially with respect to the taxation of non-Jordanian internet companies. Jordanians are not receptive to the attempts to tax payments made to such companies, because they view such purchases as legitimate overseas shopping that should not be subject to taxation.

The recently implemented increased customs fees on goods purchased from internet companies such as Amazon were not well received by the public. There is not much discussion on taxation of the non-Jordanian internet companies themselves, and whether they are paying sufficient tax on their activity in Jordan. The newly amended Tax Code has explicitly declared as taxable the income generated from e-commerce for goods and services. The ISTD has yet to issue guidance as to what that actually means from an implementation point of view. It is not clear yet how the media focus on this issue, together with signing the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, will increase Jordan's motivation to implement the BEPS recommendations.

9.4 Competitive Tax Policy Objective

The government is trying to encourage investment in the Jordanian economy and make it a business-friendly jurisdiction. However, the government has been struggling with determining what level of personal and corporate taxation does not discourage economic activity. Recent income tax increases have had a mixed record in terms of increased tax collection, and there is considerable concern about tax burden saturation. A considerable challenge for Jordanian tax policy is to have a more equitable collection of tax revenues from income and VAT/sales tax. Currently, approximately 75% of Jordan's tax returns are collected from VAT/sales tax, which is considered lopsided.

9.5 Features of the Competitive Tax System

As part of the Investment Law, Jordan grants extensive tax benefits to commercial activities within economically disadvantaged, developmental or free zone areas:

- up to 30% reduction on the applicable tax rate to industrial and economic activities established in economically disadvantaged areas;
- income tax ranges from 5–10% for all activities created within the development area;
- income tax is at 0% within free zones for activities related to transit services within the free zone; and

- VAT/sales tax is at 0% on goods or services used by entities created within the development and free zone areas within Jordan, and is capped at 7% and 0%, as opposed to the standard 16%, for services sold within the development areas or free zones, respectively.

To ensure that any granted tax incentives are quickly put to use by the beneficiary, the concerned project must start operation within two years from the date the tax exemption was granted.

9.6 Proposals for Dealing with Hybrid Instruments

There are currently no proposals for dealing with hybrid instruments.

9.7 Territorial Tax Regime

Jordan has a semi-territorial tax regime. Foreign income derived from Jordanian-based funds – eg, dividends or capital gains income from foreign companies – is taxable if the foreign assets were acquired using funds located in Jordan. There is a de facto presumption that dividends and capital gains acquired by Jordanian companies from overseas fall under taxable income.

9.8 CFC Proposals

Income from a CFC has to be included in the gross income of the parent company and will be taxed at a 10% income tax rate. CFC income is determined for each individual foreign entity level based on its audited financial statements, and then attributed to the Jordanian parent company to be taxed. The authors do not expect any significant change to the current Jordanian CFC regime.

9.9 Anti-avoidance Rules

Jordan maintains a conservative approach with respect to granting treaty benefits. Anti-avoidance provisions empower the ISTD to disregard part or all of any arrangements or transactions deemed artificial and/or fictitious with a goal of reducing payable taxes.

This is often seen in the refusal to consider unjustified expenses, and transfer pricing not on an arm's-length basis. All those would normally be subject to restrictions and limitations pursuant to the application of general anti-avoidance principles.

9.10 Transfer Pricing Changes

Given that there are presently few specific provisions in place, the authors cannot comment on the likelihood of having more specific transfer pricing requirements introduced to Jordan. Before deciding to introduce further language, the ISTD could potentially test the current level of documentation required to be compiled by local entities who are part of multinational companies.

Regarding profits from intellectual property, the rule is that such income, including royalties, received from overseas sources is taxable at a rate of 10%. The authors cannot comment yet on the potential impact on Jordan from BEPS proposals involving intellectual property.

9.11 Transparency and Country-by-country Reporting

The authors believe that the BEPS proposal for transparency and country-by-country reporting will improve enforcement.

9.12 Taxation of Digital Economy Businesses

The newly amended Tax Code has explicitly stated that the income generated from e-commerce for goods and services is taxable. The ISTD has yet to issue guidance as to how that actually works from an implementation point of view. Specifically, what, if any, procedures will be applied to enforce taxation of income applicable to non-Jordanian internet companies selling goods or providing services to the Jordanian market through the internet, as well as the VAT liability of internet services companies.

The governmental response to this area has largely been, thus far, through the Customs Department's treatment of goods received through the mail service from non-Jordanian internet companies.

9.13 Digital Taxation

No information has been provided in this jurisdiction.

9.14 Taxation of Offshore IP

No information has been provided in this jurisdiction.

Shaddad & Partners was founded in 1995 and specialises in tax matters. It offers a detailed and customised approach to clients combined with deep knowledge of taxation and financial matters. Shaddad & Partners acts for a wide range of clients in Jordan, from private individuals to corporations, and covers taxation work related to the various tax systems within Jordan, including free zones, development zones and the Aqaba Special Economic Zone. Its corporate tax team handles litigation, tax planning and advice, and forensic accounting.

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LAW OFFICE

LITHUANIA

Trends and Developments

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General Trends in Tax Regulation and Administration, and the Role of the Tax Authorities under COVID-19 in Lithuania

The challenges to the Lithuanian economy brought about by COVID-19 have also inevitably affected the focus and operations of the tax authorities. Besides taking up a significant role in assisting the government and other public authorities in identifying businesses and sectors suffering the most from the pandemic lockdown and restrictions (by invoking an enormous amount of tax data gathered via various mandatory reports and returns), granting tax deferrals and implementing other state support policy measures, the Lithuanian tax authorities still carried on with business as usual – tax collection and control, making sure everyone continues to pay their fair share.

With entire sectors (hotels, tourism, bars and restaurants, wellness and beauty services, etc) being practically frozen or highly restricted from March until late May of 2020, and being the least concerned about possible underpayment of taxes from non-existing revenues, others swiftly moved online or (a surprisingly significant part), after some initial uncertainty and hesitation, continued their business as usual. Taxmen, in that light, had to adapt to the changes, modify their methods of operation and priorities of control, and engage new means of monitoring the activities of taxpayers, especially those benefiting from the tax payment moratorium but continuing their (limited) operations, generating revenues and VAT, and continuing to accumulate indebtedness to the national and social security budgets.

One of the notable trends in the practice of the tax authorities is increased interest of the tax inspectors in the current and past tax compliance of high net worth individuals (HNWI) and business owners, including an assessment on where their wealth is coming from, what is the structure of their income, and whether there are cases of obvious private consumption or luxury hidden in the financial statements of their companies. Corporate restructurings and changes in the ownership chains also attract additional attention in terms of sufficiency of economic substantiation and reasoning of such restructurings, and scrutiny on if and what due or undue tax benefits such corporate conversions might create for the companies and their stakeholders.

On the other hand, the tax authorities are still actively working with controversial pre-COVID topics in the area of tax compliance: transfer pricing, amortisation of goodwill and thin capitalisation, among others.

As for the tax regulatory changes, most of those seen during 2020 were related to and caused by the pandemic: adjustments facilitating more flexible and targeted responses to the situations faced by the taxpayers in terms of liquidity, their ability to settle outstanding tax bills, ease of the procedures for tax loans, deferrals, transfers of tax arrears from one taxpayer to another (cashless settlements), and the introduction of other EU-approved state aid measures in the field of taxation. As 2020 was Parliament election year in Lithuania, significant changes both in corporate income tax (CIT) and the tax system in general were not seen (although a changing tax environment has become typical for Lithuania in recent years). However, even in the light of COVID-related challenges, the tax authorities still had to deal with certain novelties in the Lithuanian CIT system, recently introducing a pan-European EBITDA-related interest deduction limitation, explaining exit tax, new tax anti-avoidance rules and national policy measures such as a "patent box" or the large-scale investment incentive.

Lithuanian Large-Scale Investment Incentive – What Should Be Considered before You Plan to Accept This Challenge

Lithuanian CIT incentives were historically modelled either to attract investment, such as hi-tech or innovations, develop the economy in certain areas (eg, free economic zones, or FEZ), or support certain activities (such as cinema production). After a last huge step, the introduction of a special CIT regime at the end of 2018 (a patent box regime), in 2020 Lithuania introduced another very competitive regime for large investors applicable as of 2021: the large-scale investment incentive, which includes not only tax benefits, but also simplifications for zone planning, administrative decision-making processes, migration permits and others. The main requirements and tax benefits for such large-scale investments are highlighted below.

Why?
Companies engaged in large-scale investment projects that meet the requirements set out in the Lithuanian Law on Corporate Income Tax could pay 0% CIT on the taxable income generated by the large-scale investment project for 20 years or until the maximum state aid intensity is reached. The incentive will not be limited to specific geographic areas of the country and will apply to companies located in any part of Lithuania; however, if a company benefits from the FEZ incentive, the large-scale incentive is not available.

Requirements
In order to make use of the incentive, a company has to conclude a Large Investment Agreement (an "Agreement") with the Ministry of Economics and Innovation (MEI).

An investment in Lithuania should reach at least EUR20 million, or EUR30 million if the company is investing in the Vilnius (the capital) region. This investment threshold has to be reached within five years after concluding the Agreement; ie, it is not required to make an initial investment of EUR20 million or EUR30 million – it could be accumulated over a few years (though the application of CIT relief would be postponed until this minimum investment amount would be reached). Investments should be made into capital expenditure (assets and know-how). To confirm the level of investments, the company has to obtain auditors' confirmation.

Another important criterion is that the average number of new employees in a company during a tax year should be at least 150 (or 200, if the company is investing in the Vilnius region). "New employees" is determined by counting the average number of employees before and after the investment is made.

Investment made as of 1 January 2021 until the Agreement is signed as well as new employment places created during this period could be acknowledged as part of large-scale investment project, if the application is submitted within two months after implementing legal acts come into force.

It is also important that at least 75% of the company's income is received from either data processing or internet server services and related activities or manufacturing activities. Although the remaining part of the income (apart from the large-scale investment project) is taxed regularly (the standard CIT rate in Lithuania is 15%), it should not exceed 25%.

It is important to comply with those criteria, because if the investment amount or new employees number falls below the mentioned thresholds, the CIT relief application would be suspended until the requirements would be rebuilt; however, the term (20 years) would continue.

When?
The incentive was introduced in the middle of 2020 and entered into force from 1 January 2021. Applications to sign an Agreement couldbe filed from 1 January 2021 and the deadline for signing an Agreement is 31 December 2025.

Implementing legal acts (including those setting up requirements for the applicants, procedure and evaluation criteria) are still published as drafts at the time of writing (23 February 2021); thus, those regulations could be amended. However, significant amendments should not be expected.

Applicants
The investor could be a company registered in Lithuania or the shareholders of such company. In the latter case, both the company and its shareholders are jointly liable for the implementation of the project. Shareholders of a future company, registered in Lithuania, could also act as investors for the purposes of an application, however, the company should be registered in Lithuania until signing the Agreement. Natural persons, who could be engaged in the mentioned activities, could also be investors.

The total annual operating income of the investor (including the income of the investor's group companies or companies controlled by the investor) for at least one financial year in the previous three financial years has to be at least EUR10 million and the applicant should be engaged in manufacturing activities for at least five years or service activities for at least three years. The investor must be able to demonstrate that it is economically capable to ensure execution of the Agreement.

Process
The investor should prepare an investment project and submit an application to the MEI. The application could be submitted in either Lithuanian or English (a translation could be required) and could be signed electronically. The whole project is to be presented in the application in detail and should receive at least 50 points (lower-valued projects are rejected) during an evaluation process performed by a governmental investment agency, Invest Lithuania.

The aspects most relevant in the evaluation process are:

- the number of new jobs created due to the project;
- the percentage of highly qualified workers in the total number of new jobs;
- the average wage compared to the average wage in the municipality where the major project is being implemented;
- the location of the project;
- the percentage of exported goods (in the case of manufacturing activities); and

- the impact on the economic development and competitiveness, and increase of public welfare in Lithuania.

To sum up, expectations of the country due to the large-scale investment project incentive are high. Business (both national and international) is also interested in such possibilities and, with the joint efforts of the MEI and Invest Lithuania, it will most likely attract investment from large businesses. Moreover, other CIT incentives are also applied to those intending to use the large-scale investment incentive, such as an investment project incentive (a double deduction of the costs of certain new assets) and an R&D incentive (a triple deduction of costs). However, it is important to observe the requirements and state aid intensity (as the maximum 20 years of CIT relief could be much shorter in reality).

Tax Amortisation of Goodwill – New Controversy in Lithuania

Historically, a number of foreign investments in Lithuania ended up with a similar corporate/financing structure: acquisition of a target via a local special-purpose vehicle (SPV), having internal and/or external debt financing, followed by a merger of the target and SPV. Depending on the situation and circumstances, the merger could be downstream (the SPV is merged into the target, which is the most suitable and effective choice in most cases) or upstream (the target is merged into an SPV – more of a unicorn, because the merger of an operating business does not matter if manufacturing, retail, services or even developed real estate, trigger much more hassle and legal risks). The usual consequence of a downstream merger is new debt, used to finance the acquisition, "landing" on the target with its inherent interest expenses.

At the end of the day, an upstream or a downstream merger gives a rather comparable outcome: an acquired business with a changed owner, potential additional debt, interest expense and goodwill – the positive difference (if any) between the market value of the target's assets and the price paid for the shares of the target, to be potentially amortised for CIT purposes in the next 15 years.

The Lithuanian Law on Corporate Income Tax – allowing the amortisation of goodwill (if positive) and imposing immediate recognition of income (if negative) in share acquisition situations, followed by a merger – does not impose any additional requirements in relation to direction of the merger, timing (a possible gap between the share acquisition and merger), reasons for the merger or others. In an upstream merger, when an actual business "moves" into an SPV, that borrowed funds and spends them for the acquisition, the link between expenses (part of which form goodwill) and the acquired business (assets, contracts, reputation) and income it is supposed to generate is direct and easily seen. It is quite hard to argue that a taxpayer (an SPV) actually spends money on an "asset" that generates taxable income for the company it had not been generating before and that it does have a right to amortise/depreciate the acquisition price of that "asset" (although it might be the same business, generating the same level of revenue as before, but, as a consequence of the acquisition and merger, is encumbered with the loan, interest expenses and goodwill amortisation).

However, in the case of an alternative merger – downstream, when an acquiring SPV (now parent company), usually having no significant prior business or much traditional substance (premises, employees or equipment) is merged into an operating business – the situation might be seen quite differently: successfully (not a fact) operating and profitable taxpayer is, upon such merger, encumbered with a loan, which was used to finance its acquisition, interest and goodwill depreciation, further reducing the tax bill of a previously successful (not a fact) business, bringing no material change to it.

Although the ultimate result in both cases is absolutely the same, and the choice of the method of the merger might have very practical and logical reasoning, having nothing to do with taxation (licences held by the acquired target, land lease agreement, distribution contracts or just saving time and funds because of a simpler process), a downstream merger is considered to be a highly tax-motivated transaction, the tax outcome of which is highly questioned by the tax authorities and the threshold of reasoning and substantiation for which are set very high: to demonstrate clear economic reasoning and benefits from the merger itself (not the acquisition), and show how this accumulated goodwill is actually used (like any other "common" asset) in the further business operations.

The first concern for the market in this Lithuanian goodwill controversy, on which courts are yet to have their say, is the fact that such downstream mergers upon acquisition have been a long-standing market practice, some of which was upheld by the binding rulings or non-binding written consultations issued by the tax authorities. Now, without any changes in the laws or judicial practice on this matter, the authorities are making a U-turn in their approach and reassessing transactions already completed and goodwill amortisation deductions made, applying tests and criteria that were never there (in the law or their public commentary).

Another aspect that is not easy to comprehend and accept is the logic of this new approach, targeted at and critically assessing downstream mergers only. It gives no clear answer if and how it could or would apply (if at all) on an upstream merger or a merger where two companies would merge into an entirely new corporate entity (taxpayer). And one might also ask if and how this same logic on tax recognition of the goodwill would apply in an opposite situation, when a target is acquired for less than the market value of its assets and, upon subsequent merger, negative goodwill is formed, which, under the Lithuanian Law on Corporate Income Tax as it stands, is to be booked as taxable income immediately. Would, in such case, any additional assessment criteria be applicable, or would the provisions of the law be applied directly and literally?

All those questions above are currently being considered by the courts and there is much hope in the market that the courts, in their rulings, will shortly not only add more clarity on the concept of goodwill and content of the provisions of the law for the future, but also give guidance on how such situations of changing administrative practices are to be resolved for the past.

WALLESS is a modern full-service business law firm with a wall-less attitude. Launched as a spin-off from one of the biggest law firms in Lithuania and the Baltics at the end of 2018, with its third year on the market WALLESS now unites more than 50 professionals in Lithuania. Following the merger of WALLESS, of Lithuania, Derling Primus, of Estonia, and Primus Derling, of Latvia, in October 2020, WALLESS now serves clients in all three Baltic states. WALLESS has a vision of a modern Baltic law firm that is built on earned client trust, openness, innovation and kept promises. The WALLESS tax team in Lithuania consists of six professionals. The team is highly experienced in working with international and domestic clients in multiple fields of tax and customs law, including sophisticated tax litigation nationally and internationally, tax advice and structuring (tax risk mitigation) in complex transactions, dealing with tax authorities on innovative tax and legal issues, tax compliance and tax controversy.

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LUXEMBOURG

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Luxembourg are generally and historically conducted through limited liability companies with the following corporate form:

- private limited liability company (*société à responsabilité limitée*, or Sàrl);
- public limited liability company (*société anonyme*, or SA); and
- partnership limited by shares (*société en commandite par actions*, or SCA).

The Sàrl and the SA are the most commonly used corporate forms in Luxembourg. Both the Sàrl and the SA are incorporated by a notarial deed, are governed by a board of managers/directors and have a minimum nominal share capital of EUR12,000 (for the Sàrl) and EUR30,000 (for the SA). However, the shares of an Sàrl cannot be listed on a stock exchange, cannot be freely transferred, and the number of shareholders is limited to 100.

The SCA is the more commonly used legal form for collective investment structures. It is a partnership limited by shares, incorporated by a notarial deed and its shares can be listed. Next to its general partner, who is governs the SCA and carries unlimited liability, the SCA must also have one or more limited partners.

These Luxembourg corporate forms are fully subject to Luxembourg tax, and more specifically to corporate income tax (CIT), municipal business tax (MBT), withholding tax (WHT) and net wealth tax (NWT).

Other legal forms, less commonly used, are:

- the simplified stock company (*société par actions simplifiée*, or SAS);
- the simplified private limited liability company (*société à responsabilité limitée simplifiée*, or Sàrl-S);
- the European company (*société européenne*, or SE);
- the Cooperative (*société coopérative*, or Coop); and
- the European Cooperative (*société coopérative européenne*, or SE Coop).

The common law concept of a trust does not exist under Luxembourg law. However, Luxembourg recognises trusts that are validly created in foreign jurisdictions.

1.2 Transparent Entities

Different from the corporate structures mentioned in **1.1 Corporate Structures and Tax Treatment**, Luxembourg has several legal forms that may even have legal personality but are considered transparent for Luxembourg tax purposes (with a possible exception for MBT):

- common limited partnership (*société en commande simple*, or SCS); and
- special limited partnership (*société en commandite spéciale*, or SCSP).

The SCS and SCSP are the most commonly used transparent entities, especially in collective investment structures, and provide for more structural flexibility compared to the corporate forms. The SCS and SCSP are considered tax transparent and, as such, are not subject to tax (any income is recognised at the level of the partners). The main difference is that the SCS has legal personality, whereas the SCSP does not. Both the SCS and SCSP can be incorporated by notarial deed but can also be established under private seal.

The SCS and SCSP, even though considered tax transparent, may be subject to MBT if they are engaged in an active business enterprise or are deemed to be engaged in a business enterprise, which would be the case if the general partner of the SCS or SCSP holds at least a 5% interest.

Other, less commonly used, transparent entities are:

- the general partnership (*société en nom collectif*, or SNC); and
- the civil company (*société civile*, or SC).

1.3 Determining Residence of Incorporated Businesses

A company is a tax resident and subject to tax in Luxembourg on worldwide income if either its statutory seat (*siège statutaire*) or place of central administration (*administration centrale*) is located in Luxembourg.

There is no separate definition in Luxembourg tax law of central administration, but it is generally understood as the place where the company is effectively managed and controlled; ie, where the management board resides and board meetings are generally held, where the company's officers make their day-to-day decisions, where the company's financial book and records are kept, where the central accounting is maintained and where other, similar factors evidencing management occur.

Companies that are incorporated in Luxembourg like the Sàrl, SA and SCA will be considered tax residents of Luxembourg irrespective of whether their central administration is located in Luxembourg.

1.4 Tax Rates

Corporate Tax Rates

As from 2021, the general combined CIT rate for Luxembourg tax-resident companies is 24.94%.

- The CIT rate is 17% for income over EUR200,000. For corporate income below that threshold, the applicable CIT rate is as follows:
  - (a) 15% for income below EUR175,000; and
  - (b) EUR26,250 plus 31% for income above EUR175,000 and below EUR200,001.
- A 7% surcharge is calculated on the CIT rate for the contribution to the unemployment fund (increasing the CIT rate to 18.19%).
- The MBT, the rate of which depends on where the statutory seat is located, varies between 6.75% and 10.5%. For companies that are incorporated in Luxembourg City, the rate is 6.75%.

Luxembourg corporate companies are also subject to an annual NWT on their net assets, determined as per January 1st of each year at the following rates:

- 0.5% rate on the NWT base up to EUR500 million; and
- 0.05% rate on the NWT base portion exceeding EUR500 million.

A minimum amount of NWT applies of EUR4,815 if:

- the financial assets (eg, cash at bank, fixed assets and transferable securities) exceed 90% of the total gross assets; and
- the balance sheet total is higher than EUR350,000.

When one of these requirements is not met, the Luxembourg companies would be subject to a minimum amount of NWT varying between EUR535 (for a balance sheet total up to EUR350,000) and EUR32,100 (for a balance sheet total exceeding EUR20 million).

Please see **2.9 Incorporated Businesses and Notable Taxes** for further information on the NWT and minimum NWT.

Individual Tax Rates

Businesses owned by Luxembourg resident individuals directly or through a transparent entity are subject to their applicable progressive income tax rate, which ranges from 8% on taxable income in excess of EUR11,265 to 42% on income in excess of EUR200,004 (to be increased with a 7% contribution to the unemployment fund or 9% for income exceeding EUR150,000). The maximum rate would thus be 45.78%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxable result for Luxembourg companies is determined by the difference between the net assets invested at the end of the accounting period and the net assets invested at the start of the period, increased by the distributions made during the relevant period and decreased with the capital contributions made.

The taxable income is thus based on the company's commercial accounting (*accrochement fiscal*), unless Luxembourg tax law specifically exempts the income (eg, participation exemption), denies the deduction of expenses (eg, expenses in relation to exempt income) or imposes a different valuation principle (eg, arm's-length pricing principle).

For Luxembourg tax purposes, there is no distinction made between distributed and undistributed profits.

Luxembourg tax law further provides for depreciation and amortisation of assets used by Luxembourg companies.

Fixed assets may be depreciated for wear and tear provided that the useful economic life of the relevant asset is longer than one year and that the acquisition price is higher than EUR870. Land is not depreciable for tax purposes.

Depreciation is allowed on the basis of the cost and expected useful economic life of the asset, taking into account normal wear and tear (technical as well as economic), accelerated depreciation and obsolescence. The depreciation period begins at the moment the asset is acquired or utilised.

The depreciable base is the historic cost of the asset; ie, the acquisition price (or cost of production) increased by related non-recoverable levies, taxes, installation expenditures, etc.

Depreciation may be achieved as follows:

- the straight-line depreciation method, which is the most commonly used; or
- the declining-balance method, which is only used for certain tangible movable assets.

Luxembourg administrative circulars provide for the depreciation rate of certain assets. No specific rates have been established for the straight-line method given that the rate depends on the period of utilisation of the asset. The general applicable rates are as follows:

- 2% to 3% for office buildings, with an estimated useful economic life ranging from 20 to 50 years (land may not be depreciated);
- 4% to 5% for industrial business;
- 10% to 20% for office equipment; and
- 25% for vehicles.

When the relevant asset is transferred or disposed of, the capital gain or loss is determined as the difference between what is received upon disposal of the asset and the tax value of the asset itself (ie, its historical cost minus the depreciation and devaluation previously deducted).

2.2 Special Incentives for Technology Investments

There are no economic zones in Luxembourg.

Luxembourg tax law does provide for various incentives, subject to specific requirements, for, amongst others, risk capital, audio-visual activities, environmental protection, and research and development (R&D).

Investment Tax Credits

The most commonly used incentives are investment tax credits. Luxembourg tax law provides for two types of investment tax credits.

First, a tax credit is available that amounts to 13% of the increase in investments in tangible depreciable assets made during the tax year. The increase in investment over a given tax year is computed as the difference between the current value of all qualifying assets and the reference value allocated to the same type of assets.

Independently, the company may benefit from an 8% tax credit on the first EUR150,000 of qualifying new investments and a 2% tax credit on the amount of new investments exceeding EUR150,000 in tangible depreciable assets as well as investments in sanitary and central heating installation in hotel buildings and investments in buildings used for social activities. The above 8% and 2% rates are increased to 9% and 4% for investments eligible for special depreciation (ie, investments favouring the protection of the environment, the realisation of energy savings, or the creation of employment for handicapped workers). However, certain investments are excluded from the credit calculation, including investments in real estate, intangible assets and vehicles (unless specifically allowed by the law).

Intellectual Property

The OECD-driven new Luxembourg intellectual property (IP) regime has been applicable since 1 January 2018.

Per the revised IP regime, Luxembourg companies or Luxembourg permanent establishments of foreign companies (Beneficiaries) may benefit from an 80% exemption on eligible income derived from qualifying IP rights resulting from IP created, developed or improved by the Beneficiary as of 31 December 2007, either in Luxembourg or through a foreign permanent establishment located in a European Economic Area. In the case of the latter, the costs of the creation, development and improvement of the IP must be allocated to the Luxembourg Beneficiary per application of the relevant double tax treaty.

Qualifying IP rights include protected software and invention, utility models and certain patents. Trade marks and commercial IP assets are not qualifying.

Qualifying IP income includes:

- income earned for the use or for the concession of the right to use the eligible IP rights;
- capital gains realised upon disposal of the eligible IP assets;
- IP income incorporated in the price of products or services (ie, embedded royalties); and
- indemnities obtained in the framework of a legal or an arbitration proceeding related to the eligible IP.

The IP eligible income is determined by computing the IP income minus the deduction of (i) the total expenditure linked to the IP asset (ie, eligible expenditure, acquisition costs and R&D expenditure) and (ii) the indirect expenditure. On the basis of the OECD nexus approach principles, the net eligible IP income must be balanced on the basis of the "nexus ratio", which corresponds to the ratio between 130% of the eligible expenses and the total expenditure related to the IP. The nexus ratio may not be higher than 1.

2.3 Other Special Incentives

Financial Support for Research and Development

Luxembourg entities involved in innovative and R&D activities can benefit from financial support in addition to the specific IP tax regime and general tax incentives.

Innovation loans may be granted by the *Société Nationale de Crédit et d'Investissement* and may carry a fixed interest rate lower than the market rate. Financial support may also be granted in the form of cash grants or interest subsidies.

R&D projects or programmes may receive financial support up to a maximum eligibility (percentage of costs eligible for the incentives) depending on the size of the beneficiary. These incentives are available for experimental development, experimental development and co-operation, industrial research, industrial research and co-operation, or fundamental research.

Investment Funds

Investment funds incorporated as a company in Luxembourg (ie, UCITS, SIF, SICAR, RAIF) may be exempt from CIT, MBT, NWT and WHT.

Private Wealth Management Company (Société de Gestion du Patrimoine Familial, or SPF)

As a general rule, an SPF is exempt from Luxembourg CIT, MBT, NWT and WHT in Luxembourg. A yearly subscription tax of 0.25% is due on the basis of paid-up capital, share premium and excessive debts. Subscription tax, however, is capped at EUR125,000. As from 1 July 2021, an SPF will not be allowed to hold real estate investments indirectly via one or more Luxembourg or foreign transparent entities (ie, partnerships) or common funds (fonds commun de placement).

Securitisation Vehicles (Société de Titrisation, or SVs)

A securitisation vehicle is subject to the normal CIT system and the minimum NWT, but commitments towards any holder of securities (both capital and debt) issued by the securitisation vehicle are tax deductible and not subject to WHT.

Financial Institutions

Banks, securities depositaries, and insurance and reinsurance companies, as well as other financial service companies, may benefit from specific regulations when establishing their taxable basis for CIT (eg, provision for the neutralisation of unrealised exchange gains, general banking risk provision, provision for guarantee of deposits, mathematical reserves and/or catastrophe reserves).

Shipping Companies

Luxembourg-resident shipping companies are not subject to MBT and can benefit from investment tax credits and accelerated depreciation (even for used assets).

2.4 Basic Rules on Loss Relief

Luxembourg tax law provides for a carry-forward of losses that are generated after 1 January 2017 for a maximum period of 17 years. Losses generated before January 2017 can be carried forward indefinitely. Losses cannot be carried back.

2.5 Imposed Limits on Deduction of Interest

Interest expenses (accrued or paid) are generally deductible in Luxembourg if they are made in the interest of the business enterprise of the company.

However, as from 1 March 2021, interest or royalties accrued should no longer be tax deductible when the beneficiary is a related enterprise established in a blacklisted country, unless it can be demonstrated that the transaction triggering the deductible interest or royalties is used for valid economic reasons reflecting economic reality. A country is blacklisted if it is listed in the European Union list of non-cooperative jurisdictions that for the first year was published on 1 March 2020, and for future years on January 1st of each year.

Furthermore, interest may not be deductible if it is:

- economically linked to income that is neither interest income nor exempt income and exceeds the higher of (i) EUR3 million or (ii) 30% of EBITDA (the Interest Deduction Limitation Rule, or IDLR);
- not in line with the arm's-length pricing principles or the thin capitalisation rules (no formal rules apply but generally an 85:15 ratio is applied for participations and real estate);
- economically connected to exempt income; or
- due on certain profit participating bonds.

More specifically on the IDLR, excessive borrowing costs (ie, borrowing costs that are in excess of "interest revenues") shall only be deductible in the tax period in which they are incurred up to the higher of (i) 30% of the taxpayer's EBITDA or (ii) EUR3 million. Interest capacity may, however, be carried forward for a period of five years. Interest capacity is created when the amount of interest deducted for the year is below the limitation set by the IDLR. Interest capacity equals the difference between the interest that could have been deducted based on the IDLR and the amount of interest actually deducted.

Interest revenues means interest income or economically similar income. It is to be determined on a case-by-case basis if a gain realised on discounted and distressed debt is to be treated as interest revenues within the meaning of the IDLR.

2.6 Basic Rules on Consolidated Tax Grouping

Luxembourg companies may form a tax consolidated group (ie, fiscal unity), provided that the following conditions are met:

- each company that is part of the tax group is a fully taxable company that is resident in Luxembourg (the top entity may be a Luxembourg permanent establishment of a fully taxable non-resident company);
- at least 95% of each subsidiary's capital is directly or indirectly held by the head of the fiscal unity;
- each company's fiscal year starts and ends on the same date; and
- tax unity is requested jointly by the top company and each subsidiary that becomes a member of the group.

The fiscal unity applies for a minimum period of five years, and the taxable income/loss of the tax unity is computed as the sum of the taxable income/loss of each integrated entity.

Tax losses incurred before the consolidation period may be offset only against tax profits of the company that incurred the loss. Tax losses that are sustained by a group member during the consolidation period can be offset against the tax profits of the other group members. Tax losses arising during the consolidation period that remain after the consolidation remain attributed to the parent company.

Further to European Court of Justice case law dating 1 January 2016, the Luxembourg group consolidation rules have been extended to so-called horizontal tax consolidation; ie, qualifying companies held by a common parent company established in any European Economic Area country and subject to a tax comparable to Luxembourg CIT in its country of residence (ie, minimum 8.5% CIT on a comparable basis) may form a tax consolidated group. A tax consolidated group may further include a Luxembourg permanent establishment of a company established in any country that is subject to a tax comparable to Luxembourg CIT. The permanent establishment is thus considered as the "integrated" entity.

2.7 Capital Gains Taxation

As a general rule, capital gains derived by Luxembourg companies are fully subject to CIT and MBT. It is possible to defer the taxation of gains on certain fixed assets where the proceeds are used to have the fixed asset replaced. Capital gains and hidden reserves may be deferred or exempted and remain untaxed in a merger or another form of reorganisation of resident companies or other EU companies under certain conditions.

Capital gains derived by Luxembourg resident companies from qualifying shareholdings are exempt from CIT and MBT. Subsidiaries are deemed qualifying if they meet one of the following characteristics:

- a Luxembourg-resident entity fully subject to Luxembourg income taxes; or
- a non-resident capital company subject to an income tax in its country of residence comparable to the Luxembourg CIT (ie, minimum 8.5% CIT on a comparable tax basis); or
- an entity resident in a member state of the European Union as defined in Article 2 of EU Directive 2011/96/UE of 30 November 2011 (the Parent-Subsidiary Directive, or PSD).

Shareholdings are deemed qualifying if the shareholding:

- represents at least 10% of the nominal paid-up capital or, in the case of a lower percentage, has an acquisition cost price of at least EUR6 million; and
- has been held, or is committed to be held, at the time of the sale, for an uninterrupted period of at least 12 months.

Capital gains realised on the sale of shares are not exempt up to the amount of expenses previously deducted and economically related to the shares sold (recapture rule). Where such expenses resulted in a loss for the company, such losses can be carried forward up to 17 years to offset the taxable part of the capital gain so no taxation should occur.

Capital losses on qualifying subsidiaries are tax deductible.

2.8 Other Taxes Payable by an Incorporated Business

Value Added Tax (VAT)

Luxembourg entities, incorporated or not, are, in principle, required to be registered for VAT if they are engaged in activities subject to VAT. Luxembourg entities that are only carrying on VAT-exempt activities are not required to register for VAT unless they are liable to self-assess VAT on goods or services received from abroad.

Luxembourg entities whose activities are subject to VAT, and not exempt, are entitled to offset against their VAT payable the amount of VAT charged to them by their suppliers or self-assessed by them on import or acquisitions of goods or services from abroad.

Luxembourg VAT is due at the standard rate of 17% on the supply of goods and services that are deemed to take place in Luxembourg. Lower VAT rates may be applicable, as follows:

- 14% on some wine, advertising pamphlets, management and safekeeping of securities, management of credit and credit guarantees;
- 8% on the supply of gas or electricity; and
- 3% on food and (most) non-alcoholic beverages, pharmaceutical products, books and e-books, most radio and television broadcasting services, shoes, accessories, and certain children's clothing.

Banking, financial, insurance, fund management and reinsurance transactions are generally exempt from Luxembourg VAT. Services that have a direct and immediate link with VAT-exempt activities cannot be deducted/refunded except when related to services performed for persons established outside the European Union.

Two or more Luxembourg entities can opt for the VAT grouping regime to act as a single VAT person. Transactions between VAT group members are disregarded for VAT purposes, and only the VAT returns of the group must be submitted.

Customs/Excise Duties

Based on a European regulation and in addition to VAT, goods entering the territory of the European Union may be subject to customs duties/import tariffs. Applicable rates are based on the nature and quantity of the products.

In Luxembourg, these products are electricity, mineral oils, manufactured tobacco and alcohol.

Registration Duty

A fixed registration duty of EUR75 is levied on transactions involving Luxembourg legal entities that need to be registered in the public register (ie, incorporation, amendment to the articles of association and transfer of seat to Luxembourg).

Chamber of Commerce Fee

Luxembourg companies that mainly perform a holding activity are subject to a lump sum contribution fee of EUR350. Luxembourg companies in a loss situation are subject to a minimum contribution of EUR70 for an Sàrl and EUR140 for other corporate companies. Luxembourg companies that are neither performing a sole holding activity nor are in a loss situation are subject to the contribution at a decreasing rate, from 0.2% for income up to EUR49,500,000 to 0.025% for income above EUR111,500,000.

Real Estate

A sale or transfer of immovable property located in Luxembourg is generally subject to a transfer tax of 7% (plus a city surtax of 3% if the building is located in Luxembourg City) unless exempt in the context of a reorganisation. If the immovable property located in Luxembourg is contributed in exchange for shares, a proportional registration duty of 1.1% applies (plus a city surtax of 0.3% if the building is located in Luxembourg City).

As from 1 January 2021, undertakings for collective investment Part II, SIF, and RAIF (provided that these investment funds have legal personality) are subject to the annual real estate tax (*prélèvement immobilier*) that is levied annually on the gross amount of the real estate income, excluding VAT. The types of income subject to this annual real estate tax are rental income, capital gains and any income from the disposal of interests (any transfer of property incurring through a sale, exchange, contribution, merger, demerger or liquidation) of a transparent entity holding property situated in Luxembourg.

2.9 Incorporated Businesses and Notable Taxes

Net Wealth Tax

Luxembourg companies are subject to an annual NWT on their net assets on January 1st at the rate determined in the following manner:

- a 0.5% rate on the NWT base up to EUR500 million; and
- a 0.05% rate on the NWT base portion exceeding EUR500 million.

Under the same conditions as for the participation exemption for dividends (except that no minimum holding period is required; please see **6.3 Taxation on Dividends from Foreign Subsidiaries**), qualifying participations held by Luxembourg companies are exempt from NWT.

Debt payables can be deducted against the fair market value of the assets to the extent that they are not in direct economic connection with assets exempt from NWT.

The annual NWT may be credited against the CIT liability of the previous year, if any, and provided that the Luxembourg company establishes a specific NWT reserve representing five times the NWT reduction demanded. This reserve should be kept for at least five years, otherwise the NWT reduction granted is to be fully recovered.

Luxembourg companies are further subject to a minimum NWT of EUR4,815 if their financial assets (eg, cash at bank, fixed assets and transferable securities) exceed 90% of their total gross assets and (ii) their balance sheet total is higher than EUR350,000.

Alternatively, where the above requirements are not met, a Luxembourg company would be subject to the minimum NWT varying from EUR535 to EUR32,100, depending on the balance sheet total.

Where a Luxembourg company is part of a fiscal unity, the aggregate minimum NWT due by members of the fiscal unity group is limited to EUR32,100.

The minimum NWT is automatically reduced by the CIT liability of the previous year, if any.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most local businesses in Luxembourg usually operate in a corporate form.

3.2 Individual Rates and Corporate Rates

The aggregate Luxembourg CIT rate is lower (ie, 24.94%) than the maximum individual tax rates (ie, 45.78%). However, upon distribution of the profits by the Luxembourg company, the Luxembourg resident individual would be subject to a (reduced) income tax rate, that in combination with the CIT rate would result in approximately the same applicable tax rate as the maximum individual tax rate. No specific rules are in place to prevent individual professionals from earning their income through Luxembourg companies subject to CIT rates.

3.3 Accumulating Earnings for Investment Purposes

Controlled Foreign Corporation (CFC)

Luxembourg historically did not have any rules preventing domestic or foreign closely held corporations from accumulating earnings for investment purposes. However, further to the introduction of controlled foreign companies rules, imposed under the first EU Anti-Tax Avoidance Directive (ATAD 1), Luxembourg has introduced rules that target non-distributed income of controlled foreign corporations arising from non-genuine arrangements that have been put in place for the essential purpose of obtaining a tax advantage.

An entity is a controlled foreign company if the taxpayer by itself or together with its associated enterprises holds a direct or indirect participation of more than 50% of the voting rights or capital, or is entitled to receive more than 50% of the profits of that entity.

A tax advantage will be considered obtained if the actual corporate income tax paid by the controlled foreign corporation is lower than 50% of the CIT charge that would have been payable in Luxembourg under Luxembourg domestic tax rules had the controlled foreign corporation been resident or established in Luxembourg.

If both these tests are met, the taxpayer should include in its taxable basis the non-distributed income of the controlled foreign corporation to the extent arising from non-genuine arrangements, except if the controlled foreign corporation has an accounting profit of no more that EUR750,000 or an accounting profit of no more than 10% of its operating costs for the period.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends derived by Luxembourg resident individuals are, in principle, fully subject to personal income tax. However, dividends derived from a qualifying shareholding benefit from a 50% exemption.

Shareholdings are deemed qualifying if they meet one of the following conditions:

- a Luxembourg-resident entity fully subject to Luxembourg income taxes; or
- a non-resident capital company subject to an income tax in its country of residence comparable to the Luxembourg CIT (ie, minimum 8.5% CIT on a comparable tax basis); or
- an entity resident in a member state of the European Union as defined in Article 2 of the PSD.

Capital gains derived by Luxembourg resident individuals on the sale of shares are subject to personal income tax.

- If the sale of shares occurs less than six months after acquisition, at the normal progressive income tax rate.
- If the sale of shares occurs more than six months after acquisition:
  (a) and the shares represent less than a 10% shareholding, the capital gain will be fully tax exempt; or
  (b) the shares represent more than 10%, at 50% of the applicable personal income tax.

Individuals further benefit from a EUR50,000 allowance on the capital gain (EUR100,000 in the case of joint taxation).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Capital gains realised by individuals on the sale of shares in publicly traded companies follow the same rules as capital gains derived from non-listed companies.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Luxembourg does not impose a WHT on arm's-length royalty payments and interest payments, except for interest paid on certain profit participating bonds.

Dividend distributions (including hidden dividend distributions) are, in principle, subject to a 15% WHT (or 17.65% if the dividend WHT is not charged to the shareholder, gross up), unless a lower rate applies under applicable tax treaties.

A domestic exemption from WHT on dividends applies if the following conditions are met.

- The parent company is:
  - (a) a fully taxable Luxembourg resident company; or
  - (b) an entity resident in a member state of the European Union as defined in the PSD or a permanent establishment of such company; or
  - (c) a company resident in a member state of the EEA other than an EU member state and is subject to a comparable tax, or a permanent establishment of such company; or
  - (d) a company resident in a jurisdiction with which Luxembourg has concluded a treaty for the avoidance of double taxation and is subject to a comparable tax; or
  - (e) a company resident in Switzerland and subject to tax in Switzerland without benefiting from an exemption.
- The parent company holds, or commits itself to hold, a participation of at least 10% in the share capital of the Luxembourg company paying the dividend or, in the case of a lower percentage, a participation having an acquisition price of at least EUR1,200,000 for an uninterrupted period of at least 12 months.
- The exemption from WHT does not apply if the dividend is paid in the context of an artificial structure or artificial transaction (general anti-abuse rule, or GAAR).

Distributions of profits in the context of a liquidation or partial liquidation of the Luxembourg company are not subject to WHT.

4.2 Primary Tax Treaty Countries

As a jurisdiction with one of the largest networks of double tax treaties and being a recognised and preferred jurisdiction for setting up platform investment structures and real estate holding structures, a wide number of countries are investing through Luxembourg and there is no specific tax treaty that would prevail over another.

Furthermore, Luxembourg signed the OECD Multilateral Instrument (MLI) on 7 June 2017 and opted to apply the principal purpose test (PPT) to all its tax treaties. The PPT allows the Luxembourg tax administration to deny the benefits of the application of a double tax treaty in situations where the purpose of the structure or transaction was to obtain a tax benefit that would not have been granted otherwise.

Luxembourg currently has 84 tax treaties concluded and 18 tax treaties pending negotiation.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Although Luxembourg always had a rather general anti-abuse provision (GAAR), historically Luxembourg did not really challenge the use of tax treaty jurisdictions or entities covered by the EU parent subsidiaries by non-treaty country residents.

However, as per the introduction of the EU Parent-Subsidiary Directive-driven GAAR, the benefits provided by the amended EU Parent-Subsidiary Directive (ie, exemption of tax for dividends received and WHT for dividends paid) are not available for arrangements that are put in place in which one of the main purposes is obtaining a tax advantage that defeats the object or purpose of the Directive and are “not genuine”.

An arrangement is considered “not genuine” in so far as it was not structured for “valid commercial reasons that reflect economic reality”. The Luxembourg tax authorities have not yet provided any further guidance or interpretation of these EU-driven measures.

It is noted that:

- the exemption from Luxembourg WHT may still be available if the EU parent is a corporate entity that is fully liable to a tax similar to the Luxembourg CIT and that resides in any country (including one within the European Union) that maintains a tax treaty with Luxembourg; and
- the exemption from CIT for dividends received may still apply if the subsidiary is a corporate entity that is fully subject to a tax similar to the Luxembourg CIT.

4.4 Transfer Pricing Issues

Although Luxembourg did already apply the arm’s-length pricing principle, the principle itself was only codified in Luxembourg tax law in 2014, stating that pricing of transactions between related parties (cross-border as well as domestic) is to be determined for tax purposes as if these parties would be unrelated and that sufficient supporting documentation is kept on record.

The Luxembourg tax administration has issued further guidance for Luxembourg companies engaged in intra-group financing activities.

- On the application of transfer pricing methodology (ie, return on equity approach) to determine the remuneration, reference is made to OECD guidelines.

- On the Luxembourg economic and organisational substance:
  - (a) the majority of the members of the board of directors, the directors or the managers who have the capacity to engage the group financing company are either residents or non-residents carrying on a qualifying professional activity in Luxembourg and taxable in Luxembourg on at least 50% of their income; and in the event that a legal person is a member of the board of directors, it must have its registered office and its central administration in Luxembourg;
  - (b) the company must have qualified personnel able to control the transactions carried out by the company; it may nonetheless outsource the functions that do not have a significant impact on the control of the risk;
  - (c) key decisions relating to the management of the company must be made in Luxembourg;
  - (d) at least one general meeting must be held each year in Luxembourg; and
  - (e) the company must not be considered tax resident of another state.
- Relating to disclosure of being engaged in transactions with related parties.

If a Luxembourg company is not in line with these published guidelines, the Luxembourg tax administration may decide to automatically exchange information.

4.5 Related-Party Limited Risk Distribution Arrangements

Related-party risk distributions are subject to the arm's-length principles.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Luxembourg tax administration has specifically stated that the Luxembourg transfer pricing rules will rely on the OECD standards and guidelines.

4.7 International Transfer Pricing Disputes

Generally, resolving disputes through double tax treaties and mutual agreement procedures is a time-consuming process and therewith not often used. Guidance was published (Circular D.I. No 60 on 28 August 2017) to facilitate these procedures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

No information has been provided in this jurisdiction.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-resident corporate companies are not taxed differently to Luxembourg resident companies for CIT purposes. The branch is only subject to MBT if the branch is carrying on a commercial activity in Luxembourg.

5.3 Capital Gains of Non-residents

Non-resident capital gains are only subject to Luxembourg income tax:

- in the case of a capital gain derived from the sale of shares in a Luxembourg company (irrespective of whether the Luxembourg company would predominantly own real estate located in Luxembourg) (i) that belongs to a direct shareholding representing more than 10% in the Luxembourg company, and (ii) the shares sold were acquired less than six months prior to the sale; or
- where the selling shareholder of the Luxembourg company was a Luxembourg resident for more than 15 years and became a non-resident less than five years before the moment of the sale of the shares in the Luxembourg company.

Even though the non-resident capital gains tax is not often triggered, the large network of double tax treaties that Luxembourg has concluded generally provides for taxation of the capital gain in the state where the alienator is located.

5.4 Change of Control Provisions

Luxembourg tax law does not provide for specific change of control provisions, although a change of control of a Luxembourg company having suffered substantial tax-deductible losses may jeopardise the loss carry-forward as it may be considered abusive under the GAAR.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Other than the general arm's-length principle for transactions between related parties, no formulas are used in Luxembourg to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

Expenses incurred by a non-local affiliate can only be deducted by a Luxembourg company if and when:

- they are on-charged to the Luxembourg company;
- the on-charge is in the interest of the business enterprise; and
- the expense is compliant with the arm's-length principle.

5.7 Constraints on Related-Party Borrowing

Related-party borrowings paid by foreign-owned Luxembourg subsidiaries to foreign companies are subject to the Luxembourg arm's-length principles as well as the interest deduction limitation rules (see **2.5 Imposed Limits on Deduction of Interest**).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Luxembourg tax-resident companies are subject to taxation on their worldwide income, including foreign income, causing potentially double taxation.

If double taxation is not eliminated under the applicable tax treaty, Luxembourg domestic tax law provides for a tax credit of foreign tax incurred. This provision allows the deduction of foreign tax paid (that must be corresponding to the Luxembourg CIT) relating to the foreign income against the Luxembourg CIT (and thus not MBT) but the tax credit cannot be more than the Luxembourg CIT due on that same amount of income. Any foreign taxes paid in excess of the tax credit are deductible as an expense.

Per application of the double tax treaties with Luxembourg, foreign real estate income and income from permanent establishments are generally exempt from taxation (CIT and MBT) in Luxembourg where foreign withholding taxes can typically be credited against Luxembourg tax.

6.2 Non-deductible Local Expenses

Expenses in economic relation to exempt income are not tax deductible in Luxembourg. These expenses typically include interest expenses on the loans financing the asset generating exempt income but expenses can also be allocated on a pro rata basis. (see **2.5 Imposed Limits on Deduction of Interest**).

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends (including liquidation dividends) derived from a shareholding are exempt from CIT and MBT in Luxembourg if the following apply.

- The Luxembourg company owns a direct participation representing at least 10% of the nominal paid-up share capital of its subsidiary or, in the event of a lower percentage, a direct participation having an acquisition price of EUR1,200,000; and
- the Luxembourg company held (or committed itself to hold) such qualifying participation for an uninterrupted period of at least 12 months (if the 12-month period is not met, 50% of the dividend income may still be exempt); and
- the subsidiary entity is:
  - (a) a Luxembourg-resident entity fully subject to Luxembourg income taxes; or
  - (b) a non-resident capital company subject to an income tax in its country of residence comparable to the Luxembourg CIT (ie, minimum 8.5% corporate income tax on a comparable tax basis) (Comparable Tax Test); or
  - (c) an entity resident in a member state of the European Union as defined in Article 2 of the PSD.

Where a dividend is received from a subsidiary mentioned under the second point above, the exemption does not apply if (i) the dividend received has been deducted from the taxable base in the jurisdiction of the subsidiary or (ii) the dividend is received in the context of an artificial structure or artificial transaction (PSD general anti-abuse rules).

6.4 Use of Intangibles by Non-local Subsidiaries

The use by a foreign subsidiary of intangibles developed by a Luxembourg company must be remunerated (ie, royalties) as per application of the arm's-length pricing principle guidelines. The royalties received derived by the Luxembourg company are fully subject to taxation. Please refer to **2.2 Special Incentives for Technology Investments** for a description of the new IP regime.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

CFC rules were transposed in Luxembourg tax law on 21 December 2018 and are applied with no distinction between foreign subsidiaries and foreign permanent establishments.

CFC Definition

A CFC is defined as an entity or a permanent establishment (i) whose income is neither taxable nor exempt in Luxembourg and (ii) that meets the following conditions.

- In the context of an entity, the Luxembourg taxpayer, alone or together with its associated enterprises, holds a direct or indirect participation of more than 50% in such entity. The threshold is determined in terms of participation in the share capital, voting rights or the entitlement to profits.
- The entity or permanent establishment is subject to a corporate tax lower than 50% of the Luxembourg CIT that would have been levied if the entity or permanent establishment had been established in Luxembourg. A permanent establishment of a CFC that is neither taxable nor tax exempt in its state of location is not taken into account for the above.

The term "associated enterprises" refers to:

- resident or non-resident taxpayers subject to Luxembourg CIT, or entities that are transparent under Luxembourg law (eg, partnerships), in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or is entitled to receive 25% or more of the profits of that entity;
- individuals, resident or non-resident taxpayers subject to Luxembourg CIT or transparent entities that hold directly or indirectly a participation in terms of voting rights or capital ownership in the taxpayer of 25% or more, or are entitled to receive 25% or more of the profits of the taxpayer; and
- all entities, including the taxpayer, that are held directly or indirectly by an individual or a resident or non-resident corporate taxpayer or a transparent entity for 25% or more in terms of voting rights or capital ownership in the taxpayer and one or more entities.

Rules Governing Taxation of CFC Income

The non-distributed income of a CFC is to be included in the tax base of the Luxembourg company if the income arises from non-genuine arrangements that have been put in place for the main purpose of obtaining a tax advantage. Interim dividends (ie, distributions allocating profits of the same tax year) distributed by the CFC reduce the amount of the CFC inclusion.

An arrangement or a series of arrangements is regarded as non-genuine provided that, if it were not controlled by a taxpayer who carries out the significant people functions relevant to those assets and risks, and are instrumental in generating the CFC's income, the CFC would not own the assets that generate all or part of its income or would not have undertaken the risks.

The net income included in the Luxembourg tax base is limited to the amounts derived from assets and risks in relation to which the significant people functions are carried out by the controlling Luxembourg entity, as determined in application of the arm's-length principle under the Luxembourg transfer pricing provisions.

The net included income is deemed a commercial profit. As such, expenses are deductible only to the extent that they are economically linked to the income that is to be included in the tax base. Only positive net income is taken into consideration; negative net income is not included in the tax base in order to avoid that such negative income of the CFC artificially reduces the tax burden of the taxpayer.

However, where the CFC realises a positive total net income, the taxpayer may deduct the negative net income (which has not been previously deducted nor could be deducted in any subsequent years) up to this total. In other words, the negative net income of the CFC can only be compensated with its own positive net income. This applies to losses realised by a CFC after the entry into force of the CFC provisions. The income to be included in the tax base is calculated in proportion to the taxpayer's participation in the CFC.

Where the taxpayer disposes directly or indirectly of its participation in the CFC or the permanent establishment, any part of the capital gain from such disposal that has been previously included in the tax base of the Luxembourg taxpayer as CFC income will be deducted from the tax base up to the amount of such part of the capital gain (unless already exempt).

CFC income is excluded from the MBT basis.

6.6 Rules Related to the Substance of Non-local Affiliates

The EU GAAR as implemented in Luxembourg tax law (as outlined in **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**) may also be used to validate the substance and presence of a company in a foreign country. As a matter of fact, in order to meet the EU GAAR, the foreign company must not be considered "not genuine" in so far as it was structured for "valid commercial reasons that reflect economic reality". Such a requirement is generally more easily met if the foreign company has sufficient substance in the foreign country.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Please see **2.7 Capital Gains Taxation**.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Luxembourg tax law includes anti-abuse provisions relating to (i) the simulation and (ii) the abuse of tax law.

The simulation of tax law refers to fictitious situations where the legal description of a structure or transaction does not match its factual reality. To that end, Luxembourg tax law is applied per application of the "substance over form" principle, according to which, the tax treatment of a structure or transaction is not tied to its legal characterisation, and taxation is determined on the sole basis of the substance of the structure or transaction.

The abuse of tax law (*abus*) refers to situations where a structure or transaction is in violation of the spirit of the law. In such cases, the taxation is established as if the structure or transaction had been set up according to the law.

Furthermore, Luxembourg signed the OECD Multilateral Instrument on 7 June 2017 and opted to apply the principal purpose test to all its tax treaties (please see **4.2 Primary Tax Treaty Countries**).

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Luxembourg companies' annual accounts must be subject to an audit performed by a statutory auditor (*Réviseur d'entreprise agréée*), unless an exemption is available.

Small-sized companies are exempt from the obligation to be audited. Luxembourg companies are deemed "small companies" if at least two out of the following conditions are met, for two consecutive years:

- the annual balance sheet total of the Luxembourg company does not exceed EUR4.4 million;
- the annual turnover of the Luxembourg company does not exceed EUR8.8 million; and
- the average number of full-time staff employed by the Luxembourg company does not exceed 50.

For an SA that meets these requirements, a report would still need to be made by an internal auditor (*commissaires aux comptes*). Companies subject to the supervision of the *Commission de Surveillence du Sector Financier* (CSSF) or *Commissariat aux Assurances* (CAA) as well as securitisation vehicles must have their annual accounts audited, whatever the size and the legal form of the company.

9. BEPS

9.1 Recommended Changes

Most of the BEPS recommended action points have already been implemented in Luxembourg via the transposition of related European directives (ATAD 1 and 2):

- Action 2 – anti-hybrid rules;
- Action 3 – CFC;
- Action 4 – interest deduction limitation rules;
- Action 5 – IP box;
- Action 6 – treaty abuse;
- Action 8-10 – transfer pricing;
- Action 13 – country-by-country reporting; and
- Action 15 – Multilateral Instrument.

9.2 Government Attitudes

With the events of LuxLeaks, the Panama Papers and the State Aid investigations initiated by the European Commission against Luxembourg still freshly in the mind, Luxembourg has positioned itself as a full supporter of the fight against harmful tax competition and therewith of the BEPS initiative (resulting in ATAD 1 and 2 and the MLI). It is to be expected that Luxembourg will continue supporting any further developments.

9.3 Profile of International Tax

Luxembourg has been for many years the jurisdiction of choice for cross-border investment structures for large multinational enterprises all over the world as well as for the largest (regulated and unregulated) collective investment structures (ie, UCITS, AIFs). Given this rather high public profile for international tax in Luxembourg, you would expect Luxembourg to be reluctant to implement the BEPS recommendations but, as we have seen, Luxembourg has proven the contrary by fully supporting the BEPS initiative and largely implementing the recommendations.

9.4 Competitive Tax Policy Objective

Given the size of Luxembourg as a jurisdiction, Luxembourg will always want to remain competitive with its fellow EU member states when it comes to taxation, but has accepted that because of the success of the BEPS initiative, it will not strive to continue the success of previous years.

9.5 Features of the Competitive Tax System

One of the key features of the competitive tax system in Luxembourg has always been the advance tax ruling (ATR) and advance pricing agreements (APA) system. Although the tax ruling system is still in place, it has been completely reorganised and lost therewith its attraction.

9.6 Proposals for Dealing with Hybrid Instruments

Luxembourg has successfully implemented ATAD 1 of 12 July 2016, which aims to neutralise hybrid mismatches. As the scope of these hybrid mismatch rules only covers hybrid mismatches between member states of the European Union, the impact was rather limited.

However, the law implementing the provisions of ATAD 2 of 29 May 2017 has been passed by the Luxembourg Parliament on 19 December 2019, and entered into force on 1 January 2020. ATAD 2 extends the scope of the hybrid mismatch rules to:

- hybrid mismatches with third countries; and
- additional types of hybrid mismatches, mainly imported mismatches, hybrid transfers, tax residency mismatches and reverse hybrid mismatches.

Based on the bill, a hybrid mismatch is a situation where a payment under a financial instrument gives rise to a deduction without inclusion income where:

- such payment is not included for tax purposes at the level of the beneficiary within a reasonable period of time; and
- the mismatch outcome is attributable to the difference in the characterisation of the instrument or the payment made under it.

In the case of deduction without inclusion, the deduction shall be denied at the level of the payer. A hybrid mismatch situation can also arise if payments are made to a hybrid entity.

A hybrid mismatch would be limited to situations arising between associated enterprises. Generally, an associated enterprise would be defined as:

- an entity in which the taxpayer holds directly or indirectly a participation in terms of voting rights or capital ownership of 25% or more, or is entitled to receive 25% or more of the profits of that entity; or
- an individual or entity that holds directly or indirectly a participation in terms of voting rights or capital ownership in a taxpayer of 25% or more, or is entitled to receive 25% or more of the profits of the taxpayer.

The threshold is increased to 50% in certain situations. A definition of associated enterprise would also include an entity that is part of the same consolidated group for financial accounting purposes as the taxpayer, an enterprise in which the taxpayer has a significant influence in the management, or an enterprise that has a significant influence in the management of the taxpayer.

In addition, in order to avoid that the threshold of 50%/25% in relation to associated enterprises is circumvented by notably splitting the holding of the participation into several persons or entities, the bill provides that an individual or entity who is acting together with another individual or entity in respect of the voting rights or capital ownership of an entity shall be treated as holding a participation in all of the voting rights or capital ownership of that entity that are held by the other individual or entity.

Luxembourg was also known for its (hybrid) financing structure with the USA. These typical and very common structures will now have to be assessed and closely monitored to determine if they are affected by ATAD 2.

9.7 Territorial Tax Regime

Luxembourg does not have a territorial tax system but rather a tax system that taxes worldwide income and allows for exemptions for certain foreign income under the participation exemption and under tax treaties. Because of these exemptions, the interest deduction limitation is of lesser relevance for people investing in Luxembourg.

9.8 CFC Proposals

No information has been provided in this jurisdiction.

9.9 Anti-avoidance Rules

Luxembourg has been for many years the jurisdiction of choice for cross-border investment structures for large multinational enterprises all over the world as well as for the largest (regulated and unregulated) collective investment structures (ie, UCITS, AIFs).

The possibility of benefiting from the Luxembourg tax treaty network has been a part of that success. The introduction of the PPT under the MLI will definitely have an impact on the ability to benefit from the tax treaty network for some investment structures, but most of the investment structures with the appropriate adjustments, sufficient business rationale and substance should continue to benefit from the tax treaty network.

9.10 Transfer Pricing Changes

Luxembourg has never been very successful in attracting intellectual property-related activities so the changes related thereto in transfer pricing were not perceived as difficult.

The primary changes in transfer pricing principles were more aimed at intra-group financing activities, but as the effective (tax) impact of these changes was rather small, these changes were not a source of controversy.

9.11 Transparency and Country-by-country Reporting

Luxembourg has implemented the laws requiring country-by-country reporting to increase transparency in cross-border transactions. Although we all should be in favour of increased transparency in international tax matters, the authors believe that the cacophony of new reporting measures (FATCA, CBCR, CRS, DAC6, automatic exchange tax ruling, UBO register, etc) overreaches by far its goals and will eventually be counter-productive.

9.12 Taxation of Digital Economy Businesses

No suggestions, proposals or changes have been initiated in Luxembourg in relation to the taxation of digital economy businesses operating from outside Luxembourg.

9.13 Digital Taxation

In the context of the OECD's interim report on the "Tax Challenges Arising from Digitalisation", released on 16 March 2018, the European Commission issued two directive proposals on 21 March 2018 for a common system of digital services tax on revenues from certain digital services.

This approach is aimed at preventing disparities within the European Union resulting from the implementation of unilateral measures by each member state. The proposed directives introduce a co-ordinated tax (the Digital Service Tax) of 3% on gross revenues from qualifying services, to be applied on profits derived from digital services provided by foreign companies with significant digital presence in Luxembourg.

Luxembourg has expressed concerns that this approach will make the European Union less competitive than non-European Union countries as well as threaten business relations with the USA, which is the country of establishment of approximately half the companies that would fall within this approach.

9.14 Taxation of Offshore IP

Luxembourg tax law does not set forth any provisions dealing with the taxation of offshore intellectual property deployed within Luxembourg.

AKD is a leading Benelux law firm with over 475 lawyers, tax advisers, civil law notaries and support staff in Belgium, the Netherlands and Luxembourg. For its clients, the firm is the gateway from, to and in the Benelux. Luxembourg has long been at the forefront of the trends and evolutions relating to the financial markets and structured finance environment. A well-established financial centre in Europe with worldwide recognition, it is known as one of the world's safest and most business-friendly environments. AKD's Luxembourg office boasts a highly experienced team of lawyers and tax specialists, offering top-level service and putting strong emphasis on customer care. The team works closely with many US and UK international firms that do not have a footprint in Luxembourg. Luxembourg's famously diverse population is reflected in AKD's multilingual and multinational staff.

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MALAYSIA

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

A business in Malaysia can exist in various forms, namely:

- private limited company;
- public limited company;
- company limited by guarantee;
- foreign company;
- sole proprietorship;
- conventional partnership; and
- limited liability partnership (LLP).

Each form differs on the level of ownership and extent of the owner's liability. Nevertheless, it is more common for businesses to adopt a corporate form (as opposed to a sole proprietorship or conventional partnership) when setting up a business in the country.

Companies and LLPs acquire the characteristics of a separate legal entity and are treated as a separate "person" in law. Given this, the owners or shareholders of a company or LLP will not be personally liable for the company's or partnership's debts, save for the amount which they have paid or agreed to contribute.

Conventional partnerships and sole proprietorships, however, do not acquire the characteristics of a separate legal entity under the law. The owners of a partnership (or sole proprietorship) may therefore be personally liable without any limit for the partnership's debts and be sued in their personal capacity in respect of the partnership's obligations.

Financial and Compliance Requirements

Another key difference between the various forms of business entities is the financial and compliance requirements. For instance, a company is legally required to prepare audited accounts and circulate the same to its shareholders every year. Such requirement does not exist for conventional partnerships or sole proprietorships. It is also not mandatory for LLPs to prepare annual audited accounts unless stated otherwise in the partnership agreement.

Companies and LLPs, being separate legal entities, will file their own tax returns and be taxed as corporate entities. Conversely, while conventional partnerships and sole proprietorships are also required to file their own tax returns, their business profits will be taxed as the owners' chargeable income.

In the case of a conventional partnership, the business profit will be apportioned among the partners according to their rights in the partnership.

1.2 Transparent Entities

The commonly used transparent entities in Malaysia are conventional partnerships (if there are two or more partners) and sole proprietorships (if there is only one partner). As discussed in **1.1 Corporate Structures and Tax Treatment**, both entities are not regarded as separate legal entities and do not have to pay their own taxes.

The business profits will be taxed as the owners' chargeable income and be subject to the graduated tax rates applicable to individuals. Nevertheless, conventional partnerships and sole proprietorships are required to file their own tax returns on an annual basis.

1.3 Determining Residence of Incorporated Businesses

A business entity will be regarded as a tax resident in Malaysia if, at any time during an assessment year, the management and control of its affairs are exercised in Malaysia. Management and control are generally regarded as exercised in Malaysia if the board of directors (or partners) holds a meeting in Malaysia to conduct the business affairs of the company (or partnership). Management and control may also be established if the entity has a fixed place of business in Malaysia.

1.4 Tax Rates

Companies and LLPs are generally subject to a corporate tax rate of 24%. However, companies or LLPs with paid-up ordinary share capital of MYR2.5 million or less and gross income of not more than MYR50 million will be subject to a two-tier tax rate of 17% and 24%. Transparent entities such as conventional partnerships or sole proprietorships, conversely, will be taxed at the owners' level at the graduated rates applicable to individuals, which range from 0% to 30%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

In general, taxable profits are calculated by deducting allowable expenses incurred in the production of gross income and certain other allowances provided under the law from the said income. Taxable profits are computed based on accounting profits subject to the necessary adjustments provided under the Income Tax Act 1967 (ITA).

Such adjustments include the deduction of non-taxable income and exempt income, capital or reinvestment allowances, current year or carried forward losses, and other expenses allowed under the ITA. Disallowable expenses and any balancing charges will also be added back into the computation of the taxable profit. Profits are taxed on an accrual basis.

2.2 Special Incentives for Technology Investments

Other than those provided under the ITA, tax incentives are provided under the Promotion of Investments Act 1986 (PIA), which is a statute specifically enacted to promote investments via the provision of tax incentives.

Companies intending to participate in promoted activities or produce promoted products in areas of new and emerging technologies ("High Technology Companies") are qualified to apply for incentives in the form of a Pioneer Status or Investment Tax Allowance under the PIA. Upon receiving Pioneer Status, the High Technology Companies would enjoy a 100% exemption of their statutory income for a period of five years. Under the Investment Tax Allowance, up to 60% of such company's qualifying capital expenditure can be utilised to offset against 100% of its statutory income.

Research and Development

Companies engaged in research and development (R&D) activities or the provision of R&D services in Malaysia can apply for similar incentives, depending on the nature and recipient of the R&D activities. Through the Finance Act 2020, the special deductions provided for R&D expenditure has been restricted to persons resident in Malaysia, and double deduction is only allowed if the R&D expenditure incurred outside of Malaysia is equal to or less than 30%. Applications for such incentives should be submitted to the Malaysian Investment Development Authority and would be subject to the approval of the Minister of International Trade and Industry. During the tabling of the country's budget for 2021, the government also proposed to reintroduce the tax incentive for the commercialisation of non-resource-based R&D findings which had expired on 31 December 2017.

Malaysian companies which operate as principal hubs and undertake research, development, and innovation activities in addition to business unit management activities (which is compulsory) for their network companies are also given tax exemption in respect of their value-added income and intellectual property income. The government has proposed to relax the conditions for renewal of this tax incentive, relating to the number of high value jobs, annual operating expenditure, and the number of key posts.

Further, special incentives are given to companies involved in green technology activities, such as Green Investment Tax Allowance (GITA) and Green Income Tax Exemption (GITE). Companies incurring capital expenditure in green technology projects and in acquiring green technology assets will qualify for such GITA and companies providing green technology services can claim GITE up to 100% of their statutory income.

Additional Incentives

The ITA allows additional incentives in the form of double deduction of revenue expenditure and industrial building allowance. For example, companies can enjoy double deduction on revenue expenditure incurred for research that is approved by the Minister of Finance. Double deductions are also available for contributions and donations to approved research institutes, and payments for the services of approved research institutes and companies, R&D companies, or contract R&D companies.

Upon fulfilment of certain criteria, local and foreign companies involved in ICT related businesses can apply for Multimedia Super Corridor (MSC) Malaysia Status which entails, amongst other incentives, 70% to 100% exemption from income tax. From 1 January 2019 onwards, the number of promoted activities for income tax exemption has been revised to 16 activities, including big data analytics, artificial intelligence, financial technology, cybersecurity, and robotics.

2.3 Other Special Incentives

Generally, Malaysia provides a broad range of tax incentives for the promotion of investments in selected industry sectors. Examples of such tax incentives include:

- pioneer status;
- investment tax allowance;
- accelerated capital allowance;
- industrial building allowance;
- reinvestment allowance;
- income tax exemptions;
- double deductions;
- exemption from import duty;
- special deductions and capital allowances;
- stamp duty remission and exemptions;
- RPGT exemptions; and
- sales tax exemptions.

Different incentives are applicable to each specific industry and the industries include manufacturing, agriculture, ICT, education, tourism, healthcare, financial services, biotechnology, communications, utilities, transportation, green technology, waste recycling, real estate investment trust (REIT), Islamic financing, venture capital industry, shipping, and integrated logistics services.

In the *Pelan Jana Semula Ekonomi Negara* (PENJANA), ie, a stimulus package introduced by the government in response to the COVID-19 pandemic, additional tax incentives have been proposed for companies relocating their operations to Malaysia and undertaking new investments:

- a 0% tax rate for ten years for companies in the manufacturing sector with investments in fixed assets between RM300 million to RM500 million;
- a 0% tax rate for 15 years for companies in the manufacturing sector with investments in fixed assets above RM500 million; and
- 100% investment tax allowance for five years for existing companies in Malaysia that will relocate their overseas facilities to Malaysia with capital investment above RM300 million.

2.4 Basic Rules on Loss Relief

Corporate loss relief can be claimed in the current year or carried forward to subsequent years. Carry back losses are not allowed.

In computing a company's chargeable income (ie, income that will be charged to tax) for a current year, the cumulative losses of the company from all of its sources of income (business or otherwise) can be set-off against income from any of its sources of income.

Any unutilised business losses can be carried forward to the subsequent years and be utilised against income from any business source. From the year of assessment (YA) 2019 onwards, unutilised business losses can only be carried forward for a maximum period of seven consecutive YAs. This time limitation applies to all unutilised business losses accumulated up to YA 2018 which must be fully utilised by YA 2025 and will be disregarded in YA 2026.

Dormant Companies

For dormant companies, the accumulated tax losses cannot be carried forward if there was a substantial change in the shareholding of the company, ie, more than 50%.

Further, the ITA allows a group of Malaysian companies to claim group relief whereby companies are allowed to surrender up to 70% of their adjusted losses to one or more of its related companies. From YA 2019 onwards, this relief has been restricted to only allow losses of new companies to be surrendered for three consecutive YAs following the company's first 12-month fiscal year operations. Prior to this, there was no time limitation.

If the claiming company has unutilised investment tax allowances or adjusted losses from a pioneer business, it will not be entitled to the group relief.

Related Companies

The definition of "related companies" for group relief has been further restricted. Previously, when the surrendering company and claimant company are indirectly held by another company resident and incorporated in Malaysia through a medium company, there is no requirement for the medium company to also be resident and incorporated in Malaysia. With the amendment introduced in the year 2020, such medium companies must also be resident and incorporated in Malaysia from YA 2022 onwards.

2.5 Imposed Limits on Deduction of Interest

purposes are deductible under the ITA, whereas other expenses are not deductible if they are capital in nature. However, if borrowings made for business purposes are partly used for non-business purposes such as the provision of loans or investments which are not part of the company's business, the interest relating to the portion used for the non-business purposes are restricted and would not be deductible. The portion of the interest expenditure restricted can be deducted against the company's other sources of income, wherever relevant.

However, there is a restriction on the deduction of interest expenses incurred for payments made to all Labuan entities, regardless of whether such Labuan entity satisfies the substance requirement or not. Under the ITA, only 75% of interest payments made to Labuan entities can be deducted.

Earning Stripping Rules

With effect from 1 July 2019, a new provision was inserted into the ITA to provide for the application of Earning Stripping Rules (ESR) in Malaysia. This initiative reflects Malaysia's commitment to adhere to the recommendations in the BEPS Action 4 Final Report. Essentially, ESR restricts the interest deductible by a company for any financial assistance granted in a controlled transaction, ie, transactions between parties controlled by the same person, or where one party has control of the other party.

The details of the ESR as contained in the Income Tax (Restriction on Deductibility of Interest) Rules 2019 ("ESR Rules") are as follows:

- only applicable to business interest expenses incurred in relation to a business source;
- applicable to other payments which are economically equivalent to interest (such as profits from sukuk, discounts, or premiums);
- financial assistance refers to any type of monetary aid, including the provision of any security or guarantee;
- De Minimis threshold applies – ESR applies to a person whose total interest expenses for all finance transactions from all its business sources exceeds RM500,000;

- the maximum amount of interest deduction allowed is 20% of Tax-EBITDA; and
- any excess interest expenses can be carried forward and deducted against the adjusted business income for subsequent YAs.

The ESR does not apply to the following:

- individuals;
- financial institutions;
- insurance and reinsurance businesses;
- takaful and retakaful businesses;
- special purpose vehicles as defined under Section 60I(1) of the ITA;
- construction contractors who are subject to the Income Tax (Construction Contracts) Regulations 2007; and
- property developers who are subject to the Income Tax (Property Developers) Regulations 2007.

It is stated in the Restriction of Deductibility of Interest Guidelines issued by the Malaysian tax authority, name the Inland Revenue Board of Malaysia (IRB), that the ESR will only apply to cross-border financial transactions. However, this concession by the IRB does not have any force of law as the ESR Rules do not make such distinction and adopts a blanket approach to apply to all financial transactions.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is not permitted in Malaysia and each company is required to file separate tax returns. However, locally incorporated companies with paid-up capital of ordinary shares exceeding MYR2.5 million at the beginning of the basis period can claim for group relief to utilise separate company losses, subject to the requirements provided in Section 44A of the ITA (see **2.4 Basic Rules on Loss Relief**).

2.7 Capital Gains Taxation

Capital gains are not taxed in Malaysia save for gains derived from the disposal of real property or shares in a real property company (RPC) which will be taxed in the form of a real property gains tax (RPGT).

The amount of RPGT payable is dependent on the period between the acquisition date of the real property and the date of disposal. The rate for disposals made within three years from the acquisition date is 30% and is 20% for disposals in the fourth year, 15% for disposals in the fifth year, and 10% for disposals in the sixth year and thereafter. Disposals by foreign companies within five years are subject to a flat rate of 30% and 10% thereafter.

The scope of RPGT is fairly wide as "real property" is defined to include any interest, option, or other right in or over land. Further, once a taxpayer obtains RPC shares, the gains derived from the disposal of the RPC shares would still be chargeable to RPGT even after the company ceases to be an RPC. An RPC is a company in which the value of its real properties or RPC shares is at least 75% of its total tangible assets.

Computing

In computing, the gains from the disposal of a real property, taxpayers can deduct all expenditures incurred to enhance or preserve the value of the asset as well as incidental costs relating to the disposal. It is highlighted that transactions between related parties are deemed to not be at arm's length and the consideration for the transaction would be based on the asset's market value.

However, certain transactions are deemed to have no gain, ie, the disposal price is deemed to be the same as the acquisition price, and no RPGT would be payable. Such transactions include conveyance of an asset by way of security, disposal due to compulsory acquisitions, and disposals due to a financing scheme approved by the Central Bank or Securities Commission which is in line with the principles of Syariah (Islamic Law).

RPGT Exemptions

The Minister of Finance is also able to provide RPGT exemptions. Examples of such exemptions given by the Minister include disposal of assets to a REIT or property trust fund (PTF), restructuring scheme of a licensed insurer or takaful operator which is approved by the Central Bank, and disposal of assets to a trustee manager on behalf of a business trust.

2.8 Other Taxes Payable by an Incorporated Business

If a transaction involves the execution of instruments, such instruments would be liable to stamp duty and the amount chargeable is dependent on the type of instruments. Certain instruments such as agreements for conveyances, services, loans, and charges would be charged to stamp duty at ad valorem rate. The stamp duty for other instruments would be at a nominal rate of MYR10.

A transaction may also attract indirect tax, ie, sales tax and service tax.

Sales Tax

Sales tax is a single-stage tax imposed on taxable goods manufactured locally by a registered manufacturer or goods imported into Malaysia. All goods are taxable unless specifically exempted by the Minister of Finance. The standard rates for sales tax are 5% and 10%, depending on the class of goods.

Service Tax

Service tax is a consumption tax levied on taxable services provided in Malaysia including, amongst others, the provision of accommodation and foods and beverages, certain professional services, certain telecommunication services, domestic flight services, and management services. With effect from 1 January 2020, digital services are also included as a taxable service. However, certain intra-group services would not be taxable subject to the fulfilment of certain criteria. Service tax is levied at a rate of 6%.

VAT

There is no value-added tax in Malaysia since the abolishment of the goods and service tax (GST) regime.

2.9 Incorporated Businesses and Notable Taxes

Other notable taxes include custom duties (import and export duties) and excise duties.

Import/Export Duties

Import duties are levied on goods imported into the country on an ad valorem basis or on a specific basis. The current ad valorem rate ranges from 2% to 60%, depending on the type of goods imported. Export duties are generally imposed on Malaysia's main export commodities, such as petroleum and palm oil.

Excise Duties

Excise duties are levied on a selected range of goods manufactured in or imported into Malaysia. Examples of such goods are alcoholic beverages/spirits, tobacco products, and motor vehicles. Similarly, the excise duty rates are either specific or ad valorem.

Employers and Property

Employers in Malaysia are also required to deduct and withhold tax from their employees' salaries each month and remit such taxes to the revenue authorities. Employers are also required to make social security contributions on behalf of their employees to the Employees' Provident Fund (12% or 13%) and Social Security Organisation (up to MYR69.06).

Each state also levies "quit" rent on real properties at varying rates each year.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most of the closely held local businesses operate in a corporate form.

3.2 Individual Rates and Corporate Rates

The highest corporate tax rate is 24%, whereas the tax rate of the highest tax bracket for individuals is 30%. There is no tax rule which prevents professionals from earning income in a corporate form. Subject to the respective code of conduct, professionals are allowed to form any business entity which they deem fit. For instance, accounting firms can operate as LLPs whereas law firms are still confined to conventional partnerships only.

3.3 Accumulating Earnings for Investment Purposes

There are no rules in place to prevent closely-held corporations from accumulating earnings for investment purposes. There are, however, mechanisms in place which encourage distribution of earnings to the investors. For instance, REITs and PTFs are exempted from paying income tax if they distribute at least 90% of their income to the unit holders.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Malaysia has a single-tier system whereby shareholders are exempted from paying taxes on dividends which they receive. Individuals (or shareholders) are also not required to pay capital gains tax for the sale of shares in a company, unless the company is an RPC, see **2.7 Capital Gains Taxation**.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Similar to **3.4 Sales of Shares by Individuals in Closely Held Corporations**, individuals are exempted from paying taxes on dividends which they receive. They are also not required to pay capital gains tax on the sale of shares in a company, unless the company is an RPC. This is the position notwithstanding the fact that the company is a public listed company.

However, individuals who actively engage in the buying and selling of shares in publicly traded companies for the purposes of earning profit (or income) may be regarded as being in the business of trading in publicly listed shares. In such cases, the gains received by the individual will be subject to income tax.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Ordinarily, payment of royalty and interest by a Malaysian tax resident to a non-resident is subject to withholding tax at the rate of 10% and 15% respectively. Payment of dividends, however, is not subject to withholding tax.

Apart from payment of royalty and interest, there are other types of payment which are subject to withholding tax in Malaysia, for example, payment for services or advice, rental of movable property, and contract payments. The withholding tax rate imposed by the ITA would apply unless reduced under a double taxation treaty.

The Minister of Finance can also grant certain exemptions or reliefs for withholding tax. For example, companies are exempted from their withholding tax obligations in respect of payments made for advice given or services rendered outside of Malaysia.

4.2 Primary Tax Treaty Countries

Malaysia has executed double taxation treaties with various countries to minimise (or prevent) double taxation of the same income in two countries in an international trade or cross-border transaction. Nevertheless, the majority of foreign direct investments in Malaysia are from Asian countries, with the most common being China, Japan and Singapore.

On 24 January 2018, Malaysia became a signatory to the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) and has committed to implement a number of the OECD's BEPS recommendations, including BEPS Action 6, which is aimed at tackling treaty shopping or treaty abuse practices. This will see Malaysia adopting the "principal purpose test" for all its double taxation treaties upon ratification, whereby treaty benefits will be denied if it is reasonable to conclude that obtaining the treaty benefit is one of the principal purposes of a particular transaction.

On 18 February 2021, Malaysia has deposited their instrument of ratification for the MLI. The MLI will enter into force on 1 June 2021. In effect, the Malaysian government may now modify the application of its double taxation treaties with other signatories of the MLI in accordance with the MLI without making any change to the treaties.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Generally, the IRB will not challenge the use of double taxation treaties by non-treaty country residents, unless there are instances of tax avoidance.

4.4 Transfer Pricing Issues

One of the biggest transfer pricing issues in Malaysia is arguably the IRB's selection of comparables for benchmarking analysis. The revenue authority tends to limit the selection of comparables to local companies and at times, fails to appreciate that the selected comparables have radically different business plans or are in a different market group.

There are also instances where the IRB may have inadvertently misused transfer pricing principles to adjust related parties' transactions which are profitable or beneficial to the Malaysian company but detrimental to the overseas counterpart.

There is a disagreement between the IRB and taxpayers on the appropriate method for benchmarking analysis. The IRB generally prefers the Transactional Net Margin Method (TNMM) as opposed to other traditional methodologies, such as the Comparable Uncontrolled Pricing Method (CUP).

4.5 Related-Party Limited Risk Distribution Arrangements

Arrangements and transactions between related companies (one of which could be a limited risk company) for the sale of goods or provision of services locally are subject to transfer pricing rules. Any transaction which has a direct or indirect effect of altering the incidence of tax which is payable by one party to a transaction or relieving any tax liability may be varied and adjusted by the IRB. The test is whether the related companies engaged in the arrangement or transaction at arm's length.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The transfer pricing rules in Malaysia are largely based on the OECD Transfer Pricing Guidelines. Companies in Malaysia are generally advised to follow the OECD standards in respect of its transfer pricing documentation. The local transfer pricing guidelines issued by the IRB are also based on the arm's length principle as set out under the OECD Transfer Pricing Guidelines.

Other than cross-border transactions, Malaysia's transfer pricing rules also apply in a domestic context, that is resident companies within the same group would also need to adhere to all transfer pricing rules and regulations.

4.7 International Transfer Pricing Disputes

International tax disputes involving double taxation treaties and inconsistencies in the interpretation or application of the treaties may be resolved through the domestic appeal process (ie, an appeal to the Malaysian tax tribunal) or in accordance with the provisions of the Mutual Agreement Procedure (MAP) in the respective treaties. Both mechanisms are not mutually exclusive. An aggrieved taxpayer may resort to both the MAP process and domestic appeal concurrently. However, the domestic appeal will not be heard until the MAP process is concluded. The MAP process is also not applicable to aggrieved taxpayers who have completed their domestic appeal and obtained an order from the Malaysian tax tribunal.

The IRB first introduced MAP Guidelines in January 2015 in line with BEPS Action 14. The guidelines were subsequently updated in December 2017, signifying the IRB's acceptance of the MAP process. Nevertheless, the majority of the transfer pricing disputes (international or domestic) in Malaysia are resolved through the domestic appeals process.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

If a transfer pricing adjustment is made on one of the parties to a transaction, the law allows the other party to request for an offsetting adjustment to be made on the tax assessment of the other party.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

A local branch of a non-resident company and a local subsidiary of the non-resident company are taxed similarly, where all income of both entities derived in Malaysia is subjected to corporate tax at a rate of 24%.

However, if the management and control of a branch are exercised outside of Malaysia, the local branches will be treated as non-residents in Malaysia.

Thus, the key difference between a local branch and local subsidiary of non-resident companies lies in the ineligibility of the local branch to claim for tax incentives provided under the ITA and PIA which would otherwise be available to local subsidiaries. Further, certain payments (for example, royalties, interest, and services fees) made to a local branch would be subject to withholding tax.

5.3 Capital Gains of Non-residents

As there is no capital gains tax in Malaysia, capital gains earned by non-residents would similarly not be taxed, save for gains derived from the sale of real property or shares in an RPC (see **2.7 Capital Gains Taxation**).

Hence, capital gains of non-residents from the disposal of shares in a company will not be taxed unless the shares in question are shares of an RPC.

5.4 Change of Control Provisions

There are no change of control provisions in Malaysia which will trigger tax or duty charges. However, if there is a major change in the shareholding of a dormant company, any unutilised losses of the company cannot be carried forward to subsequent years. Certain tax incentives relating to transactions between related parties would also be revoked if there is a change in control which renders the parties to cease being related parties.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no special formulas used to determine the income of foreign-owned local affiliates in Malaysia. Local affiliates of foreign companies will be taxed on all income accrued or derived in Malaysia and the chargeable income (income which is taxable) will be computed in the same manner as local companies.

5.6 Deductions for Payments by Local Affiliates

Payments made by a local affiliate to its foreign affiliate for management and administrative expenses incurred by the foreign affiliate will be allowed as a deduction if the payments are made at arm's length, and services rendered by the non-local affiliate has conferred economic benefit or value to the local affiliate's business. Further, such services cannot be duplicative or involve shareholder activities.

5.7 Constraints on Related-Party Borrowing

All related-party borrowings are required to comply with transfer pricing laws, ie, the interest rates must be charged at arm's length. Further, the deductibility of interest expenses by the borrowing company is subject to the ESR, see **2.5 Imposed Limits on Deduction of Interest**.

Interest paid by a local subsidiary to a non-resident would also be subject to withholding tax at 15% (or any other rate stipulated in the applicable double taxation treaty).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The income of local corporations derived from outside Malaysia but received in Malaysia is exempted from income tax, except for companies engaged in the business of banking, insurance, sea transport or air transport.

6.2 Non-deductible Local Expenses

Generally, only expenses incurred wholly and exclusively in the production of gross income is deductible. As foreign income is exempted from tax and would be disregarded for the purpose of the ITA, all expenses attributable to such foreign income correspondingly cannot be deducted.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by resident companies from foreign companies are still generally regarded as foreign-sourced income. Thus, these dividends would also be exempted from tax unless the resident company is engaged in the business of banking, insurance, sea transport, or air transport.

6.4 Use of Intangibles by Non-local Subsidiaries

If a foreign related company is licensed to use intangibles developed by a local Malaysian company, such transactions would be subject to transfer pricing laws. If the ownership of the intangible property does not vest with the developer of the property, the developer shall receive an arm's length consideration for the development of the property.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Malaysia does not have controlled foreign corporation (CFC) rules.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no rules relating to substance requirements of non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

As there is no capital gains tax in Malaysia, gains from the sale of shares in non-local affiliates will not be taxed. However, gains received from the disposal of shares in a non-local affiliate will be subject to RPGT if the non-local affiliate is an RPC. See **2.7 Capital Gains Taxation** for the definition of an RPC.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Section 140 of the ITA is a general anti-avoidance provision which provides wide powers to the IRB to disregard or vary a transaction and to recompute the tax liability of a taxpayer. The revenue authority may do so where there is reason to believe that any transaction alters the incidence of tax, relieves a person from tax liability, evades or avoids any duty or tax liability, or hinders or prevents the operation of the ITA. There are procedural safeguards that must be complied with before the anti-avoidance provision can be invoked, namely that the revenue authority must identify the purported effect of the taxpayer's transaction and provide grounds for recomputing the tax payable.

In determining whether a transaction constitutes tax avoidance, regard must be had to the dominant purpose of a transaction. While taxpayers have the freedom to structure their transactions to their best tax advantage, there must be genuine commercial purpose to the transaction apart from tax savings in order for the transaction to not be caught within the meaning of tax avoidance.

The ITA contains a specific transfer pricing provision (Section 140A) which empowers the IRB to substitute an arm's length price of a transaction between related parties. Further, the IRB can disregard any transaction structure if its economic substance differs from its form or if the arrangement is not one that would be adopted by independent persons behaving in a commercially rational manner.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The IRB does not have fixed audit cycle for each taxpayer and taxpayers can be audited at any time. Businesses are selected for audit through a computerised system based on various risk assessment criteria and information, including the taxpayer's own tax returns and information from third parties. The revenue authority may also select companies based on their participation in targeted industries or their locality.

In general, the IRB will audit businesses on their returns for the past three to five years. However, the IRB can raise tax assessments going as far back as five years and if evidence shows that there is any element of fraud, negligence, or wilful default, there is no limitation period.

There are two types of audits carried out: desk audits and field audits.

Desk Audits

Desk audits are typically used for simpler and straightforward issues which can be resolved via correspondence, ie, letters and email. The IRB will review documents and information submitted by taxpayers and may require taxpayers to attend interviews at the IRB's office if necessary.

Field Audits

Field audits involve a review of the taxpayer's business records at the taxpayer's premises. Taxpayers will usually be given prior notice of a field audit.

The IRB has resolved to complete all tax audits within 90 days.

9. BEPS

9.1 Recommended Changes

Malaysia has implemented a number of reforms arising from OECD's BEPS recommendations. Malaysia has introduced transfer pricing legislation in 2012 (BEPS Actions 8-10), and subsequently country-by-country reporting and automatic exchange of information between tax authorities (BEPS Action 13) in 2016. Recently, Malaysia has also implemented ESR (BEPS Action 4), which is explained in further detail in **2.5 Imposed Limits on Deduction of Interest**.

In addition, a comprehensive review of both IP and non-IP tax incentives (including principal hub, Multimedia Super Corridor (MSC) Malaysia, and pioneer status incentives) was carried out to eliminate harmful tax practices identified by the Forum on Harmful Tax Practices (FHTP) (BEPS Action 5). For IP incentives, Malaysia has amended its existing incentives so that tax exemption is only given where R&D expenditures is incurred and carried out in Malaysia. For non-IP incentives, legislation was passed to enable the incentive regimes to comply with the substantial activities requirement and to remove ring-fencing.

Malaysia also became a signatory to the MLI (BEPS Action 15) and has recently ratified the convention, which will come into effect on 1 June 2021 (see **4.7 International Transfer Pricing Disputes**). Significantly, Malaysia has introduced a tax on digital services in a bid to address the taxation of the digital economy (BEPS Action 1) (see **9.13 Digital Taxation**).

9.2 Government Attitudes

Although Malaysia is not a member of the OECD, the Malaysian government remains committed in implementing the BEPS Action Plan and adhering to the OECD Inclusive Framework on BEPS' (IF) minimum standards, as evident from the reforms undertaken over the past years following the country's entry as an Associate Member to the IF in 2017. Malaysia is focused on countering harmful tax practices in preferential regimes; preventing the granting of treaty benefits in inappropriate circumstances; complying with OECD standards for transfer pricing documentation and country-by-country reporting; and increasing the efficacy of dispute resolution mechanisms under double taxation agreements.

From an enforcement perspective, the IRB has increasingly been conducting transfer pricing audits on multinational enterprises and has introduced new transfer pricing penal provisions. The failure to furnish contemporaneous transfer pricing document is now an offence and the IRB has the power to impose a penalty between RM20,000 and RM100,000. Additionally, a surcharge of 5% can now be imposed on any transfer pricing adjustment made.

While some of the BEPS reforms introduced in Malaysia are at their infancy and thus far, there has yet to be any indication of BEPS centred audits apart from transfer pricing ones, the IRB will typically scrutinise compliance with new legalisation such as the ESR when carrying out its routine audits.

9.3 Profile of International Tax

In Malaysia, international tax does not generally have a high public profile beyond multinational corporations and tax practitioners. However, there is certainly growing awareness amongst taxpayers in light of recent BEPS measures introduced by the government as well as increased cross-border economic activities by businesses.

9.4 Competitive Tax Policy Objective

The Malaysian government has made clear its intention to revamp and create a more competitive, transparent, and attractive tax incentive framework and has been actively conducting a comprehensive study of the existing structure. Malaysia's economic objectives for 2021 include making Malaysia a destination for high-value service activities. New measures introduced include the extension of principal hub incentives to 31 December 2022 and relaxation of the conditions for the five-year extension of the incentive (see **2.2 Special Incentives for Technology Investments**).

Additionally, the government has also introduced a new Global Trading Centre tax incentive which grants eligible taxpayers a concessionary tax rate of 10% for a period of five years with an additional five years on renewal. Eligible manufacturing companies that have relocated their operations to Malaysia are also afforded special tax rates (see **2.3 Other Special Incentives**).

Nevertheless, as discussed above at **9.2 Government Attitudes**, Malaysia has undertaken to implement the OECD BEPS standards and to review its legislation and tax regime for compliance. Thus, Malaysia will likely ensure that any incentives it offers or introduces will meet the OECD requirements. Further, as more and more jurisdictions in the region also implement BEPS-related measures, there will be less concerns of needing to reduce or limit the introduction of BEPS reforms to maintain Malaysia's competitiveness.

9.5 Features of the Competitive Tax System

Malaysia's preferential regimes that offered incentives in respect of mobile geographical services activities related to IP and non-IP services are a key attribute of the country's competitive tax policy. However, as discussed in **9.1 Recommended Changes**, these regimes were identified by the FHTP as having features that would facilitate BEPS and Malaysia has subsequently addressed these vulnerabilities through various regulations, orders, and guidelines.

9.6 Proposals for Dealing with Hybrid Instruments

Unlike other jurisdictions, Malaysia has not enacted any rule specifically addressing the tax treatment of hybrid instruments and whether such hybrid instruments are debts or equities for income tax purposes. Further, notably, although Malaysia is a signatory to the MLI, Malaysia has reserved its right to opt-out of most of the treaty-based measures aimed at neutralising the effects of hybrid mismatch arrangements, including Article 5 which deals with double non-taxation that may arise from cross-border hybrid instruments.

This may indicate that Malaysia is still contemplating the appropriate methods of addressing hybrid mismatches which would require considerations of domestic legislation (such as the use of general anti-avoidance provisions in the ITA) as well as national treaty policies. It remains to be seen whether Malaysia would adopt the approach taken in other jurisdictions of denying or restricting deductions for cross border payments made to related entities on hybrid instruments if such payments are not correspondingly taxed in the recipient country.

9.7 Territorial Tax Regime

Malaysia has territorial tax regime where income tax is levied on any income accruing in or derived from Malaysia. As discussed in **2.5 Imposed Limits on Deduction of Interest**, Malaysia recently introduced ESR to restrict the deductibility of interest expenses paid between related parties in cross-border transactions. Companies are only allowed to deduct a maximum interest expenditure of 20% of the taxpayer's tax EBITDA. However, the ESR only applies where the total interest expense of a taxpayer is more than MYR500,000 a year.

9.8 CFC Proposals

Malaysia currently does not have any CFC rules. Given that Malaysia has a territorial tax system, CFC rules that require taxation of offshore subsidiaries regardless whether any substantial activity or economic nexus has been established in Malaysia or not would appear to be fundamentally at odds with the tax regime. Hence, if any CFC rules were to be implemented, these rules may likely be designed narrowly to only apply to income that should have been subject to tax in Malaysia and would also necessarily be limited to targeting profit shifting.

Further, given that there are considerations such as double taxation, overlap with existing transfer pricing legislation, maintaining competitiveness with jurisdictions without CFC rules, and administrative and compliance burdens that will need to be taken into account, this may give Malaysia pause in introducing CFC rules any time soon.

9.9 Anti-avoidance Rules

Consequent to the signing of the MLI by Malaysia, an anti-abuse provision will be incorporated into all of Malaysia's double taxation treaties. Malaysia has chosen to adopt the principal purpose test as opposed to a limitation on benefits provision, see **4.2 Primary Tax Treaty Countries**.

In respect of anti-avoidance rules, Malaysia's tax legislation contains general anti-avoidance provisions (see **7.1 Overarching Anti-avoidance Provisions**). Given that many jurisdictions are similarly adopting anti-abuse provisions in respect of their double taxation treaties, it is difficult to envisage any significant impact that the provisions or rules may have on inbound and outbound investors.

9.10 Transfer Pricing Changes

Malaysia's existing transfer pricing regime is largely based on governing OECD standards and the general arm's length principle. Thus, it is unlikely that the proposed transfer pricing changes by the OECD, including the revisions to its Guidelines, will radically alter the structure of the transfer pricing framework in Malaysia. For example, the Malaysian Transfer Pricing Guidelines 2012 have been amended to adopt the recommendations on BEPS Actions 8-10 relating to intangibles without causing any major upheaval to the current system or controversy.

9.11 Transparency and Country-by-country Reporting

Malaysia has introduced legislation on country-by-country reporting and automatic exchange of information indicating Malaysia's approval of enhancing transparency in combatting BEPS. In line with OECD recommendations on BEPS Action 13, country-by-country reporting only applies to multinational corporation groups which have their ultimate holding company in Malaysia and have a consolidated minimum group revenue of MYR3 billion. Local subsidiaries are generally not required to file a country-by-country report (CbCR) as Malaysia will obtain the CbCR via automatic exchange of information with the jurisdiction of the parent companies.

However, in a situation where a CbCR has been filed in another jurisdiction and that jurisdiction does not have a tax treaty or a multilateral competent authority agreement with Malaysia, local subsidiaries are not compelled to file the CbCR locally. This means that Malaysia will not have access to this information, giving rise to a potential for any BEPS to remain undetected.

9.12 Taxation of Digital Economy Businesses

Malaysia has recently introduced a tax on digital services by widening the scope of its existing service tax. With effect from 1 January 2020, foreign service providers of digital services must now register with the Royal Malaysian Customs Department and charge 6% service tax on all digital services provided to consumers in Malaysia.

"Digital service" has been defined broadly under the Service Tax Act 2018 and according to Customs, includes services such as providing software, applications, and music; streaming services; digital advertising services; and offering online platforms to sell products and services. Thus, companies such as Netflix, Spotify and Google are expected to register and remit service tax to Customs. Foreign service providers must be registered if the value of the digital services provided by it to consumers in Malaysia exceeds RM500,000 over a period of 12 months.

9.13 Digital Taxation

As discussed above, Malaysia's current approach to taxing the digital economy is to expand the scope and application of its service tax to digital services rendered by foreign service providers. There has yet to be any indication so far of Malaysia's position in respect of the proposals by the OECD on digital taxation, namely the allocation of taxing rights in favour of market and user jurisdictions and implementing a global minimum tax. Given Malaysia's commitment in principal to implementing the OECD BEPS actions, Malaysia could in the future adopt the consensus-based solution by the IF which is expected to be finalised by mid-2021.

9.14 Taxation of Offshore IP

Malaysia's tax regime generally imposes a 10% withholding tax on all royalties paid to non-residents and makes no distinction where the IP owner is resident in a tax haven. However, IP owners who are resident in jurisdictions which have a double taxation treaty with Malaysia could avail themselves to any preferential withholding tax rate in the treaty.

Lee Hishammuddin Allen & Gledhill is one of Malaysia's leading and largest law firms, with a specialised and highly experienced tax, sales and service tax (SST) and customs practice group. The team advises on all aspects of tax law, including tax planning, transfer pricing, and corporate restructurings. The team is also highly sought after for its expertise in indirect tax matters, and anti-dumping, safeguard duties, and trade facilitation matters involving the Ministry of International Trade and Industry. Other than advisory services, the team is particularly well experienced in tax dispute resolution and regularly represents clients in tax investigations and appeals before the Special Commissioners of Income Tax and judicial review applications at the High Court. The firm is also an active member of Multilaw and Interlaw, associations of worldwide independent law firms.

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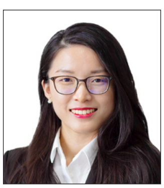

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Trends and Developments

Contributed by:
Jason Tan, Ivy Ling, Keith Lim and Chris Toh
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In late 2020, three of the main objectives in the Malaysian government's 2021 budget were supporting business continuity, combating the COVID-19 outbreak and safeguarding the welfare of the people.

Whilst some quarters may dismiss these objectives as lofty platitudes and mere rhetoric, Budget 2021 must be recognised for its well-intended efforts in paving the path back to economic recovery for the country. Amongst others, a total of MYR4.09 billion has been allocated to combat the COVID-19 pandemic (vaccination programmes, medical equipment, and one-off grants to medical front liners), whilst tax breaks and reliefs were also made available to individuals (eg, for vaccinations, medical expenses and reskilling courses). Notably, the income tax rate for individuals resident in Malaysia has also been reduced by 1% (for the chargeable income band between MYR50,001 and MYR70,000).

However, it remains to be seen whether the key tax measures which would affect corporate taxpayers under the Finance Act 2020 gazetted on 31 December 2020, is truly a force for "business continuity" as pledged, or otherwise. Amongst the key concerns are restrictions to claims for capital allowance, increased powers for the tax authorities in transfer pricing matters, and apparent attempts to limit the courts' ability to grant a stay of payment in tax matters.

On indirect tax matters, taxing the digital economy continues to be at the forefront of the government's efforts in increasing its revenue stream. With the current trend of increasing tax collection, there is potential for the government to widen the scope of the current digital tax to also apply to digital currencies and digital tokens.

Capital Allowance – Restrictive Definition for "Plant" Introduced into the Income Tax Act 1967 (ITA)

Capital allowance affords relief to taxpayers for the wear and tear of their fixed assets, by allowing for the depreciation suffered on such assets to be used to reduce the tax payable by the taxpayer.

Under the ITA, taxpayers who incur qualifying capital expenditure on 'plant' or machinery used for the purposes of their business are entitled to claim capital allowances.

Prior to 1 January 2021, the ITA did not provide for the definition of "plant" and guidance had to be derived from case law. Amongst others, the courts have decided that "plant" includes buildings and other intangible assets. The leading decision on this issue is the 1887 decision by the English Court of Appeal in Yarmouth v France that "plant": "in its ordinary sense, it includes whatever apparatus is used by a business man for carrying on his business – not his stock in trade which he buys or makes for sale, but all goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment in his business".

Such interpretation has been accepted and applied by the Malaysian courts in, amongst others, Director General of Inland Revenue (DGIR) v Tropiland Sdn Bhd and DGIR v CIMB Bank Berhad. The courts allowed the taxpayers' claim for capital allowance on qualifying expenditure in respect of a multi-storey car park in Tropiland (ie, a building), and core deposits and customers' credit card databases in CIMB Bank (ie, an intangible asset).

In Tropiland, the Court of Appeal held that the phrase "plant and machinery" should be interpreted widely, giving due consideration to the taxpayer's particular industry and taking into account the specific circumstances of the taxpayer's business. In CIMB Bank, the Court accepted that the Databases were important apparatuses for the taxpayer's banking business by applying the principles established in Yarmouth v France, despite the Databases being virtual and intangible.

Paragraph 70A

The recent insertion of paragraph 70A into Schedule 3 ITA by Section 28(a) of the Finance Act 2020 appears intended to sweep away 134 years of legal precedents on the definition of "plant", by providing that: "In this Schedule, 'plant' means an apparatus used by a person for carrying on his business but does not include a building, an intangible asset, or any asset used and that functions as a place within which a business is carried on."

The insertion of paragraph 70A, Schedule 3 ITA would certainly be unsettling for businesses, by discouraging investment in capital assets that could otherwise be used to increase local production capacity. One cannot help but wonder whether the full implications of such a restriction on the decision-making process of businesses to invest have been fully considered.

Contributed by: *Jason Tan, Ivy Ling, Keith Lim and Chris Toh,* ***Lee Hishammuddin Allen & Gledhill***

Transfer Pricing – Penalties, Surcharges, Powers to Disregard, and Recent Decisions by the Special Commissioners of Income Tax

Three key changes to transfer pricing were introduced in Malaysia effective 1 January 2021. Firstly, Section 113B ITA provides an offence for taxpayers who fail to furnish contemporaneous transfer pricing documentation, punishable with a fine of between MYR20,000 to MYR100,000 on conviction. Where no prosecution is instituted, a penalty of an amount in the same range can be imposed.

Secondly, Section 140A(3C) ITA allows the DGIR to impose a surcharge of up to 5% on all transfer pricing adjustments, regardless of whether there is tax payable in the adjustments. Thirdly, Section 140A(3A) and Section 140A(3B) ITA has been introduced to give the DGIR the power to disregard and re-characterise the structure in a controlled transaction. This power can be invoked if the economic substance of the transaction differs from its form, or if the arrangement is not commercially rational.

Multinational companies

Multinational companies for which transfer pricing issues are of great importance to would certainly factor the recent changes into account in their investment decisions, changes which, it must be said, does not appear to augur well for the objective of "supporting business continuity". Questions also arise as to the wisdom of essentially allowing the DGIR the power to decide on whether a particular transaction is commercially sound. After all, the courts have held that "the cases are replete in that regard in that it is never the province of either the DGIR or even the courts to tell people how to conduct their business" (Port Dickson Power Sdn Bhd v DGIR).

Judicial appeals

On the judicial front, the Special Commissioners of Income Tax (SCIT) recently issued its decisions in two landmark appeals in P&G Sdn Bhd v DGIR and SEO Sdn Bhd v DGIR. In both cases, the DGIR raised additional tax assessments after conducting transfer pricing adjustments pursuant to Sections 140 and 140A ITA respectively. The adjustments were made using the transactional net margin method, where the taxpayers' profits were adjusted to the median of the profits yielded by benchmarked companies despite their profits falling within the inter-quartile range. The SCIT quashed the assessments and ruled that such adjustments were invalid as the OECD Transfer Pricing Guidelines prescribes that no adjustment should be made when a taxpayer's profits fall within the arm's length range, ie, the inter-quartile range.

Section 103B ITA – Power of the Courts to Grant a Stay?

Over the years, our courts have in judicial review applications granted stay of payment of taxes to taxpayers seeking to quash tax assessments.

Widespread concerns arose when Section 103B ITA was introduced in 2021, which reads: "Tax payable notwithstanding institution of proceedings under any other written law. The institution of any proceedings under any other written law against the Government or the Director General shall not relieve any person from liability for the payment of any tax, debt or other sum for which he is or may be liable to pay under this Part."

Read together with the recent changes to claims for capital allowance and transfer pricing matters as highlighted above, one must surely be tempted to question whether "Ensuring Revenue Collection" is in fact the fourth unwritten objective of Budget 2021.

While the provision has not received judicial interpretation, suffice to state at this juncture that Section 103B ITA does not take away the power of the courts to grant a stay in appropriate circumstances.

Noteworthy Tax Decision at the Federal Court: Advance Rulings by the IRB not Subject to Judicial Review

The recent decision by the Federal Court in IBM Malaysia Sdn Bhd v DGIR would be of interest to corporate taxpayers who are considering applying for an Advance Ruling from the DGIR.

Under Section 138B ITA, taxpayers can apply for an Advance Ruling from the DGIR to seek the DGIR's position on the application of any provisions of the ITA to a particular arrangement for which the ruling is sought. An Advance Ruling is regarded as final and binding once issued, subject to the relevant conditions being met.

In IBM, the taxpayer was dissatisfied with the Advance Ruling issued by the DGIR and succeeded, initially, in quashing it by way of judicial review at the High Court. However, the Court of Appeal reversed the High Court's decision on the basis that the judicial review application is premature. The Court of Appeal took the view that judicial review is not available, as the taxpayer would only be 'adversely affected' after having filed its tax returns and assessed to tax by the DGIR, and held that "the Advance Ruling is a decision that does not have any tax implication as there is no assessment made". The taxpayer's appeal to the Federal Court was dismissed.

Corporate taxpayers evaluating the option of applying for an Advance Ruling must surely be forgiven for wondering:

"What is the point?" If an Advance Ruling is unfavourable, the taxpayer must still comply with it, before filing an appeal to the SCIT, or risk being slapped with penalties. Considering the Court of Appeal's apparent views on the limited usefulness of an Advance Ruling, seeking independent professional advice from tax consultants and/or tax counsel may perhaps be a better alternative.

Taxing the Digital Economy

In respect of indirect tax developments, there remains lingering uncertainty as to the scope of digital services tax in the Malaysian government's efforts to tax the digital economy. The government had begun to impose service tax on the consumption of digital services with effect from 1.1.2020. With this, relevant provisions have been incorporated to impose tax on digital services provided by local service providers as well as foreign service providers, such as those supplied by Facebook and Google.

The Service Tax Act 2018 (STA 2018) defines digital service broadly as "any service that is delivered or subscribed over the internet and other electronic network and which cannot be obtained without the use of information technology and where the delivery of the service is essentially automated". When tabling the STA 2018 in Parliament, the Deputy Finance Minister commented that under this definition, digital services would include online music and movie subscriptions, e-book subscriptions, cloud storage subscriptions, online purchases of computer software, and the use of an online marketplace platform.

Examples of digital services given in the Customs' Guide on Digital Services by Foreign Service Providers (as of 1 February 2021) are software, applications, video games, music, e-books, films, search engines, social networks, online training, database and hosting, cloud, subscription to online newspapers and journals (online newspapers and journals have been given exemption by Minister of Finance). However, Customs' Guide is silent on whether digital currencies and digital tokens are treated as digital services.

Digital currencies

Although digital currencies are not legal tender in Malaysia, digital currencies and digital tokens have been classified as securities under the Capital Markets and Services (Prescription of Securities) (Digital Currency and Digital Token) Order 2019 with effect from 15 January 2019. The mere fact that digital currencies are not legal tender does not prevent these digital currencies and digital tokens from being accepted as consideration in a transaction.

At first sight, the use of these digital currencies and digital tokens may seem to fall within the definition of digital service, however, arguably no service has been delivered given that digital currencies and digital tokens have been classified as securities. That said, it remains to be seen whether Customs will follow the lead of the Securities Commission Malaysia and afford digital currencies and digital tokens the same tax treatment as securities or separately classify them as digital services for service tax purposes.

The "consumer"

Another term defined under the STA 2018 which has the potential of creating practical issues for tax purposes is "consumer". Pursuant to the Act, a consumer is any person who fulfils any two of the following:

- makes payment for digital services using credit or debit facility provided by any financial institution or company in Malaysia;
- acquires digital services using an internet protocol address registered in Malaysia or an international mobile-phone country code assigned to Malaysia; and
- resides in Malaysia.

It would appear that the best method of determining whether a consumer resides in Malaysia is the billing address supplied by the consumer when making the online payment. If the consumer is not a Malaysian resident, he or she would most likely be making payments using a foreign debit or credit card with an overseas billing address. Conversely, a Malaysian resident would most likely make online payments using a local credit or debit card with a local billing address.

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MALTA

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Persons looking to establish a presence in Malta may choose to adopt one of various different types of available legal forms, depending on the purpose and aims of the stakeholders involved in the conduct of the business or activities in question.

The Companies Act (Chapter 386 of the laws of Malta) contemplates the possibility of setting up commercial partnerships, which can themselves take distinct forms, such as a partnership *en nom collectif* or general partnership, or a partnership *en commandite* or limited partnership.

A Maltese commercial partnership has its own separate legal personality distinct from its partners and is capable of owning and holding property under any title at law or be sued.

It is also possible to establish civil partnerships under the Maltese Civil Code (Cap. 16 of the laws of Malta) – these are typically adopted by professionals coming together to exercise their profession (including lawyers, accountants and auditors). These entities are fiscally transparent.

In terms of the Maltese Income Tax Act (Chapter 123 of the laws of Malta) (ITA), all partnerships may be taxed as separate legal entities.

The most common corporate form adopted for the purpose of conducting business in Malta is the limited liability company.

Maltese legislation also contemplates a framework for establishing trusts, foundations and associations. Trusts can either be taxed as separate legal entities or treated as transparent entities, depending on an election for either treatment to be made by the trustee. Foundations and associations are taxed as separate legal entities.

1.2 Transparent Entities

As noted in **1.1 Corporate Structures and Tax Treatment**, very few Maltese corporate forms are treated as transparent entities from a Maltese tax perspective. None of these entities are commonly adopted in particular business sectors, other than the civil partnerships.

1.3 Determining Residence of Incorporated Businesses

For the purposes of Maltese tax legislation, bodies of persons such as companies or partnerships – whether corporate or unincorporated – are deemed to be resident in Malta when the control and management thereof are exercised in Malta. Furthermore, companies incorporated in Malta, in terms of the Companies Act, are deemed to be resident in Malta by virtue of their incorporation.

In practice, the place where the control and management of a body of persons is carried out is usually deemed to be the place where the director(s) of such a company are resident and/or the place where the key decisions regarding the company's strategy and policy are taken (among other factors).

1.4 Tax Rates

Malta tax resident companies would be subject to Maltese tax on their worldwide income and capital gains, irrespective of where their income or gains arise, and irrespective of remittance of such income or gains to Malta. The chargeable income of a company resident in Malta is subject to tax at a flat rate of 35%. Certain tax refunds may be available, as further set out in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

The tax paid by individuals in respect of income attributable to such individuals through transparent entities depends on their country of residence. Malta resident persons would be subject to the following progressive rates of income tax:

- Single rates – chargeable income from:
  - (a) EUR0 to EUR9,100: 0% (subtract EUR0);
  - (b) EUR9,101 to EUR14,500: 15% (subtract EUR1,365);
  - (c) EUR14,501 to EUR19,500: 25% (subtract EUR2,815);
  - (d) EUR19,501 to EUR60,000: 25% (subtract EUR2,725); and
  - (e) EUR60,001 and over: 35% (subtract EUR8,725).
- Married rates – chargeable income from:
  - (a) EUR0 to 12,700: 0% (subtract (EUR0);
  - (b) EUR12,701 to EUR21,200: 15% (subtract EUR1,905);
  - (c) EUR21,201 to EUR28,700: 25% (subtract EUR4,025);
  - (d) EUR28,701 to EUR60,000: 25% (subtract EUR3,905); and
  - (e) EUR60,001 and over: 35% (subtract EUR9,905).
- Parent rates – chargeable income from:
  - (a) EUR0 to EUR10,500: 0% (subtract EUR0);
  - (b) EUR10,501 to EUR15,800: 15% (subtract EUR1,575);
  - (c) EUR15,801 to EUR21,200: 25% (subtract EUR3,155);
  - (d) EUR21,201 to EUR60,000: 25% (subtract EUR3,050); and
  - (e) EUR60,001 and over: 35% (subtract EUR9,050).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Accounts of a Maltese company are to be drawn up in accordance with the accounting standards set out in the International Financial Reporting Standards (IFRS). Before arriving at the taxable income for a certain year of assessment, a determination of profits made according to the IFRS principles may be subject to adjustments as imposed by the ITA, such as fiscally deductible expenses and elements of the profits deemed to be exempt from income tax by virtue of a specific exemption contemplated by the ITA.

A number of expenses that may reduce the profits of a Maltese company from an accounting perspective may not be allowable or deductible from a tax perspective, and would therefore need to be added back to the profit figure in order to calculate the chargeable income for Maltese tax purposes. This mainly applies in respect of provisions, unrealised expenses and foreign exchange differences, as well as gratuitous payments (such as donations).

On the other hand, Maltese tax law may allow for certain deductions to the taxable profits of a company that are not contemplated by the applicable accounting principles.

One of the more notable adjustments relevant from a tax perspective is that expenses that are incurred in the production of the income of the business are allowable deductions for income tax purposes. On the other hand, expenses that are not business-related, are of a capital nature, are recoverable from any insurance or are of a gratuitous nature are not allowed as deductible for income tax purposes. Expenses or amounts that have not actually been incurred, such as unrealised exchange differences or provisions, are not deductible for Maltese income tax purposes.

2.2 Special Incentives for Technology Investments

No special tax treatment, such as patent boxes, is currently in place for technology investments.

However, the Maltese legislator has introduced a number of incentives to support companies investing in research and development in different areas of science and technology. The aim of these incentives is to encourage the development of innovative, scientific products and solutions.

For instance:

- the Research and Development Activities Regulations 2020 assist Industrial Research and Experimental Development activities required by industry for the acquisition of knowledge leading to the development of innovative products and solutions. The measure also encourages co-operation between undertakings by providing additional assistance for Industrial Research and/or Experimental Development projects;
- the Tax Credits for Research and Development and Innovation Regulations introduced in 2017 provide a tax credit of EUR10,000 to undertakings that employ a person holding a doctoral degree in science, information technology or engineering for a period of at least 12 months. The credit may be claimed after the initial 12 months of such a person's employment have passed; and
- the Patent Box Deduction Rules 2019 establish a fiscal regime for income arising from patents, similar intellectual property rights and copyrighted software. The rules additionally provide that small companies may utilise the patent box rules on income from any intellectual property based on an invention that could be patented. A taxpayer qualifying for the patent box deduction will be entitled to deduct a percentage of its income from taxable income. This deduction will be adjusted depending on the percentage resulting from dividing the qualifying IP expenditure by the total expenditure related to the particular IP.

2.3 Other Special Incentives

Malta Enterprise has developed various incentives for the promotion and expansion of industry and the development of innovative enterprises, including:

- innovation aid for small and medium-sized enterprises;
- investment aid tax credits;
- financial assistance to start-ups; and
- soft loans to support enterprises through loans at low interest rates for part-financing investments in qualifying expenditure.

2.4 Basic Rules on Loss Relief

The ITA provides that trading losses that are incurred by a person or company in a certain year, in any trade, business, profession or vocation, can be set off against other trading activities or income streams and capital gains of that person or company of that year. Trading losses are deductible under the condition that such loss would have been assessable under the ITA if it had been a profit. A loss is computed in the same way as a profit and therefore can be deemed to be a negative profit for the purposes of deductibility.

Where a loss cannot be (wholly) set off against capital gains or income for the said year, it shall – to the extent to which it cannot be set off – be carried forward and set off against the income and capital gains for subsequent years. It is pertinent to note that a capital gain is brought to charge as part of the total chargeable income of a company. However, a capital loss cannot be set off against other income for the year of assessment but must be carried forward and set off against capital gains in respect of subsequent years of assessment until the full loss is absorbed.

Losses cannot be set off against types of company income that stand to be allocated to the Final Tax Account (FTA), such as interest income subject to 15% final withholding tax. Losses that are generated from sources of income that are to be allocated to the FTA are excluded from the scope of this provision and can therefore not be deducted.

The group relief provisions contemplated by the ITA also allow the surrendering of losses between companies that are considered to form part of the same group.

2.5 Imposed Limits on Deduction of Interest

The ITA allows the deduction of interest from the income of a local company, if it can be shown to the Commissioner for Revenue that the interest was payable on capital employed in the production of income by that company. This initial test constitutes the most notable limitation imposed on local companies regarding the deductibility of interest expenses: the underlying loan must be used in the production of income that, under normal circumstances, should give rise to taxability under the ITA.

2.6 Basic Rules on Consolidated Tax Grouping

Legal Notice 110 of 2019 introduced the possibility of income tax consolidation in Malta. From year of assessment 2020, companies that form part of a group may elect to be treated as a single taxpayer if they satisfy certain conditions. Upon successful registration, a parent company is considered the "principal taxpayer" of the fiscal unit, thus becoming the sole chargeable fiscal unit for the entire group.

Transactions taking place between persons forming part of the "fiscal unit" (excluding those involving immovable property in Malta) fall wholly outside the scope of Maltese income tax.

The ITA also contemplates group relief provisions. Companies resident in Malta can form a company group for the purpose of the possibility to set off losses against the profits of other companies forming part of the same group. This way, the deductible trading losses incurred by group companies can be utilised in the most optimal way.

Two companies are deemed to be part of the same company group when such companies are both resident in Malta and are not deemed to be resident for tax purposes in any other jurisdiction. Furthermore, one company must be a 51% subsidiary of the other company, or both companies must be the 51% subsidiary of a third mother company, which also must be resident in Malta.

The 51% holding that the parent company is to keep in the subsidiary should entitle the parent company to more than 50% of the voting rights in the subsidiary, more than 50% of the profits available for distribution to the ordinary shareholders of the subsidiary and more than 50% of any assets of the subsidiary upon liquidation of the subsidiary.

Once the requirements to classify as a group of companies have been met, allowable losses from one company within the group can be surrendered to another company, which can set off the surrendered losses against its profits.

These group relief provisions contain certain anti-abuse provisions, which restrict the surrendering of losses made by companies whose activities are related to immovable property situated in Malta.

2.7 Capital Gains Taxation

Capital gains that are subject to tax in Malta are listed specifically and exhaustively by the ITA. There are specific rules on how to calculate capital gains derived from the disposal of certain assets, contemplating certain adjustments. Once calculated, a capital gain is brought to charge as part of the chargeable income.

Companies that derive capital gains from a "participating holding" may qualify to apply the "participation exemption", in which case any gains derived from such participating holding would be exempt from tax. Alternatively, the Maltese company may elect to be subject to tax and pay income tax on capital gains arising from a participating holding and then, upon a distribution of profits, the shareholder is entitled to claim a full refund of the tax paid by the company on such capital gains.

A holding of equity will qualify as a participating holding for the purposes of applying this exemption to capital gains in the following circumstances:

- when the holding constitutes a direct holding of 5% or more of the equity shares or partnership capital. This participating holding entitles the company holding the shares to two out of the following three equity rights:
  (a) voting rights;
  (b) rights to profits available for distribution; or

(c) rights to assets available for distribution in the case of a winding up of the company in which the shares are held;

- when a company is an equity shareholder in a company and the equity shareholder company is entitled to first refusal in the event of the proposed disposal, redemption or cancellation of all of the equity shares of that company not held by that equity shareholder company;
- when the amount invested in the holding is at least EUR1,164,000 and is held for an uninterrupted period of at least 183 days;
- when the shareholder in question is entitled to sit or be represented on the board of directors of the company in which the equity holding is held; or
- when the equity shares are held for the furtherance of the business and the holding is not held as trading stock for the purpose of a trade.

2.8 Other Taxes Payable by an Incorporated Business

Malta entities may be subject to the following additional taxes when undertaking a transaction.

Malta charges stamp duty on documents and transfers on certain transactions, such as transfers of immovable property situated in Malta, certain marketable securities, insurance contracts and certain other transactions.

In addition, Malta imposes value-added tax at a standard rate of 18% on any supply of goods and services that is not exempt or subject to the reduced rate of either 5% or 7%.

2.9 Incorporated Businesses and Notable Taxes

Maltese entities may be subject to customs duties, which are levied on certain imports from non-EU countries. Excise duties are levied on particular classes of goods, such as alcohol and tobacco.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

The majority of local business is conducted in corporate form. The most common legal form for businesses in Malta would be the private limited liability company.

3.2 Individual Rates and Corporate Rates

The income tax rate applicable to companies and the majority of other corporate-form entities is 35%. The highest personal tax rate imposed on Maltese tax resident individuals is also 35%. Accordingly, there is no need for rules to prevent individual professionals from earning income at corporate rates.

3.3 Accumulating Earnings for Investment Purposes

In principle, companies established in Malta can accumulate earnings and profits for investment purposes, without any rules constricting or impacting such accumulation of profits. A capital tax or duty is not imposed through the ITA or any other form of fiscal legislation. In this context, no distinction is made between closely held companies or other types of companies.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends

Malta operates a full imputation system, which means that profits will first be taxed at the level of the company at the flat rate of 35%. However, when distributed to shareholders by way of dividend, the dividend carries an imputation credit of the tax paid by the company on the profits so distributed. The credit results in the elimination of Malta tax that is chargeable at shareholder level on dividends received. As stated earlier, the highest personal tax rate imposed in Malta is 35%. Where a shareholder is not subject to tax or qualifies for a lower rate of tax than the 35% already paid by the company, such shareholder will be entitled to a tax refund equivalent to the "excess percentage" of the tax paid by the company. This system avoids any double taxation of distributed corporate profits.

Shareholders in receipt of dividends distributed out of certain profits of a Maltese company that has the correct structures and compliance in place may be entitled to claim a refund of the tax paid in Malta on those profits. The rate of tax refund to which a shareholder will be entitled depends on a number of factors, including:

- the nature of the underlying profits (allocated to one of the five tax accounts – namely the Maltese Taxed Account, the Foreign Income Account, the Final Tax Account, the Immovable Property Account and the Untaxed Account) out of which dividends will be distributed by the Maltese company, including whether the income is of an active or passive nature; and
- the application of any double taxation relief by the Malta company on such profits.

The possible refunds and the resulting effective tax rates are as follows:

- 6/7ths refund: in most cases, the tax refund entitlement of a registered shareholder would be of 6/7ths of the Malta tax suffered on the profits out of which the dividend is

distributed, particularly in the case of profits derived from trading activities. The effective tax rate would equate to 5% in such cases.
- 5/7ths refund: this refund would apply where the profit out of which a dividend is distributed consists of passive interest or royalties. It also applies to Maltese companies holding shares in an underlying company that does not qualify as a "participating holding" and is therefore not eligible for a participation exemption. The 5/7ths refund results in an ultimate tax leakage of 10%.
- 2/3rds refund: this applies to dividends distributed out of profits in respect of which the Malta distributing company would have claimed double tax relief (including double tax treaty relief). The effective tax rate in this case would be between 2.49% and 6.25%.
- 100% refund: this applies where the company is entitled to claim the participation exemption but chooses not to. This is an exemption in respect of income derived from a participating holding or gains that it derives from the transfer of such a holding, as long as certain conditions are met (as detailed in **2.7 Capital Gains Taxation**).

Malta does not charge any type of withholding tax on inbound or outbound dividends.

The participation exemption detailed in **2.7 Capital Gains Taxation** can also be applied to dividend income.

Capital Gains

Malta tax resident persons are subject to income tax on capital gains derived from the sale of certain specific assets as contemplated by the ITA at the progressive rates detailed in **1.4 Tax Rates**, which go up to 35%.

It may be pertinent to note that persons who are resident but not domiciled in Malta are not subject to tax on foreign source capital gains, regardless of whether or not they are remitted to Malta.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The receipt by individuals of dividends from a publicly traded company is treated from a tax perspective in the same manner as when such dividends are paid by closely held companies (ie, the full imputation system applies). The same applies to capital gains; however, it is pertinent to note that gains or profits derived from the transfer of shares listed, or in consequence of a listing, on the Malta stock exchange (not being securities in a collective scheme) are not subject to tax in Malta.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Subject to any applicable provisions in double tax treaties, distributions of dividends and payments of interest or royalties from a Maltese company to a resident or non-resident person are not subject to any withholding tax.

4.2 Primary Tax Treaty Countries

Malta has concluded bilateral double taxation treaties with more than 70 jurisdictions, in and outside the European Union. The majority of these double tax treaties are based on the OECD Model Tax Convention.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The local tax authorities in Malta do not specifically challenge the use by non-treaty country residents of corporate entities established in countries that have concluded a double tax treaty with Malta. Maltese tax law does not impose any specific rules or requirements on the entitlement of treaty benefits by non-treaty country residents, when such non-treaty country residents have established an entity in a country with which Malta has concluded a treaty.

However, company activities and transactions from and to Malta companies are subject to a corporate general anti-abuse rule contemplated by the ITA. The tax authorities have the power to disregard any structure or scheme that reduces the amount of tax payable, where such a scheme can be deemed to be of an artificial or fictitious nature.

It should be noted that Malta has approved of and adopted (and is in the process of further adopting) a number of the OECD's efforts in the areas of anti-tax avoidance initiatives and research and anti-abuse legislation. One of these initiatives is the future introduction of a principal purpose test to certain existing double tax treaties as a minimum-standard anti-abuse provision.

The principal purpose test is meant to assess whether one of the principal purposes of a certain transaction (the provision of a loan, for example) or a certain structure (the establishment of a subsidiary in a specific jurisdiction) is to obtain a treaty benefit granted by the tax treaties concluded between that jurisdiction and the other contracting state. Both the Maltese and foreign tax authorities might use the indicators set out in this test to challenge the use of entities established in the tax treaty partner of Malta when they believe that the use of such entities is mainly for the purpose of gaining access to certain treaty benefits.

4.4 Transfer Pricing Issues
At present, Maltese legislation does not impose any sophisticated transfer pricing regulations specifically aimed at inbound investments in local companies.

4.5 Related-Party Limited Risk Distribution Arrangements
The Maltese tax authorities do not impose any specific limitations or restrictions on the use of related-party limited risk distribution. The general anti-abuse rule laid down in the ITA could potentially challenge the use of such arrangements where it is shown that such an arrangement is artificial or fictitious in nature and reduces the amount of tax payable upon a certain income.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards
At this point, Maltese tax law does not provide for any specific, sophisticated transfer pricing regulations or provisions. When appropriate, reference is made to the research and initiatives of the OECD in the areas of transfer pricing, such as the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes
Maltese tax law does not yet provide specific transfer pricing regulations or provisions. However, local authorities are proactive in assisting taxpayers in solving cross-border issues through the MAP, and follow OECD guidelines in this regard.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
At present, Maltese legislation does not impose any related transfer pricing rules.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations
A Maltese subsidiary (ie, a Maltese company) is subject to tax on a worldwide basis, subject to any credits, relief or refunds that may be applicable on a case-by-case basis. However, branches of non-local corporations would only be subject to tax in Malta on income that is attributable to the branch. The computation of the taxable income follows the same principles adopted in respect of local companies. It would be possible for the branch to deduct a proportion of those expenses that are associated with the head office management if these are related to the Maltese branch. By way of net effect, there should be minor distinction between the taxation of a branch and a locally registered subsidiary.

5.3 Capital Gains of Non-residents
Any gain or profit derived by any person not resident in Malta on a transfer of shares or securities in a local company is exempt from tax in Malta if the beneficial owner of such gain or profit is a person not resident in Malta and is not owned and controlled by, directly or indirectly, nor acts on behalf of, an individual or individuals who are ordinarily resident and domiciled in Malta.

5.4 Change of Control Provisions
Maltese tax legislation does provide a type of change of control provision that is applicable to Maltese companies, namely the value shifting provisions. However, these are applicable in limited instances and should not come into effect in a disposal in a foreign indirect holding within the overseas group. Rather, they apply to certain changes to the share capital of certain Maltese companies.

For instance, when the market value of shares held by a person (the transferor) in a company is reduced as a result of a change in the issued share capital of the company or a change in voting rights attached to such shares and this difference in value passes onto other shares in or rights over the company held by another person (the transferee), the transferor shall be deemed to have made a taxable transfer of shares amounting to this value to the transferee. Any gains or profits shall be calculated for the transferor by taking into account the difference between the market value of the shares held immediately before and after said change.

These value shifting provisions apply primarily to Maltese companies that own directly or indirectly immovable property situated in Malta.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
IFRS is used to determine the income of local companies from an accounting perspective. This determination is then subject to adjustments imposed by the ITA (deductions, exemptions, corrections for taxable period, etc).

5.6 Deductions for Payments by Local Affiliates
The ITA sets out a list of expenses that may be deductible for tax purposes. All expenses and outgoings incurred by a person or company, including management and administrative expenses, could be deductible to the extent to which such outgoings and expenses were wholly and exclusively incurred in the production of income. This connection between expenses and taxable income is also a requirement for the expenses expressly listed in this provision.

5.7 Constraints on Related-Party Borrowing
The recently introduced tax-related anti-abuse measures based on the Anti-Tax Avoidance Directive (ATAD) include an interest limitation rule, which limits the deductibility of borrowing costs to a certain level. The ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA). The limitation is not applicable where borrowing costs do not exceed EUR3 million, and will also not apply to financial undertakings.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Malta tax resident companies would be subject to Maltese tax on their worldwide income and capital gains, irrespective of where their income or gains arise, and irrespective of remittance of such income or gains to Malta. The chargeable income of a company resident in Malta is subject to tax at a flat rate of 35%. Certain tax refunds and exemptions may be available, as further set out in **2.7 Capital Gains Taxation** and **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

In addition to the participation exemption (see **2.7 Capital Gains Taxation**), the ITA entitles companies registered in Malta to claim an exemption in respect of income that is attributable to a permanent establishment situated outside Malta or gains derived from the transfer of such a permanent establishment. The income attributable to the permanent establishment is calculated as though the permanent establishment is an independent enterprise operating in similar conditions and at arm's length. This exemption applies regardless of whether such a permanent establishment belongs exclusively or in part to the Maltese company.

6.2 Non-deductible Local Expenses
Foreign income is, in principle, taxable at the level of local corporations. No limitations on the deductibility of expenses are therefore currently specifically contemplated.

6.3 Taxation on Dividends from Foreign Subsidiaries
The specific tax treatment of dividends sourced from foreign subsidiaries depends on whether these dividends fall within the scope of the participation exemption or otherwise. If the participation exemption is applicable, such dividends would be exempt from corporate income tax.

Additional conditions to the applicability of the participation exemption are applicable in the case of dividends. The participating holding must satisfy any one of the following additional three conditions:

- it is resident or incorporated in the EU;
- it is subject to foreign tax of a minimum of 15%; or
- it does not derive more than 50% of its income from passive interest and royalties.

Alternatively, it must satisfy both of the following two conditions:

- the shares in a body of persons not resident in Malta must not be held as a portfolio investment; and
- the body of persons not resident in Malta or its passive interest or royalties have been subject to tax at a rate that is not less than 5%.

Dividends that derive from an equity holding that does not qualify as a participating holding in terms of the participation exemption will be taxable in Malta in the hands of the Maltese corporate shareholder, under the corporate income tax rate of 35%. Tax refunds may be claimed by the shareholder of the Maltese company in certain instances, as well as relief in respect of any double taxation, when these dividends have already been subject to a foreign tax or withholding tax in their country of origin.

6.4 Use of Intangibles by Non-local Subsidiaries
In principle, any gains on the transfer of intellectual property or profits from royalties derived from the licensing of intellectual property would be subject to tax at the level of the local company. However, certain deductions may be applicable.

It may be useful to note in this context that Maltese tax law allows as a deduction against royalty income any capital expenditure on the acquisition of intellectual property or intellectual property rights incurred by a company (such as fair market value of the intellectual property or intellectual property rights) when it is proved to the satisfaction of the Commissioner for Revenue that such assets are used or employed in the production of the income of such company. Such deduction will need to be spread equally over a number of years (no less than three years).

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
A number of tax-related anti-abuse measures based on the ATAD have recently been introduced, including a CFC rule that includes in the tax base of a Maltese-based company diverse types of income not distributed by a foreign-based subsidiary or permanent establishment of this company, bringing these profits to tax in Malta.

6.6 Rules Related to the Substance of Non-local Affiliates

No specific regulations or guidance in Maltese legislation apply to the substance of non-local affiliates at this time.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Depending on the circumstances, Maltese companies can apply the participation exemption in respect of gains on the sale of shares in foreign companies or affiliates. If the relative conditions are not satisfied, such gains would form part of the taxable income of the company that is calculable and taxable under the general rules.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

The ITA sets out a general anti-avoidance rule, which is applicable to any scheme that reduces the amount of tax payable and is deemed by the Commissioner for Revenue to be artificial or fictitious in nature. In such a case, the Commissioner has the competence to assess the tax payable by that person as if the scheme in question were not present.

More recently, the following tax-related anti-abuse measures based on the ATAD have been introduced:

- interest limitation rules that limit the deductibility of borrowing costs to a certain level. The ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before EBITDA. The limitation is not applicable where borrowing costs do not exceed EUR3 million and will also not apply to financial undertakings;
- an exit tax rule that applies when a company either changes its place of residence or decides to transfer its assets/business to a different tax jurisdiction. In such cases, the taxpayer is liable to be taxed at an amount equal to the market value of the transferred asset;
- an extension to the current general anti-avoidance provision already contemplated by Maltese tax legislation aiming to further target artificial arrangements put in place for the main purpose of obtaining a tax advantage in conflict with the spirit of the law; and
- a CFC rule that includes in the tax base of a Maltese-based company diverse types of income not distributed by a foreign-based subsidiary or permanent establishment of this company, bringing these profits to tax in Malta.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

No regular routine audit cycle is specifically in place. The Commissioner for Revenue generally has the power to initiate a tax audit in respect of any Maltese tax resident person at any time.

9. BEPS

9.1 Recommended Changes

No legislation or measures have yet been introduced into the Maltese tax framework specifically as a result of BEPS.

9.2 Government Attitudes

Malta has not yet formally adopted any BEPS recommendations, but as an EU Member State has adopted a number of EU Directives, some of which do appear to have been brought about as a reaction to the BEPS initiative. These include:

- the EU Administrative Co-operation Directive, which also includes Country-by-Country Reporting;
- the proposed EU Anti-Tax Avoidance Directive, which includes various recommendations derived from the BEPS initiative; and
- the anti-abuse rules in the Parent-Subsidiary Directive.

The ratification of the Multilateral Instrument (see **9.3 Profile of International Tax**) has further shown Malta's commitment to supporting developments in the areas of BEPS and anti-tax avoidance initiatives.

9.3 Profile of International Tax

International tax does have a relatively high public profile in Malta, given recent international pressures. Malta presents a stable business climate for companies forming part of international groups to establish a subsidiary or a company branch.

While fostering competitive tax policies, the Maltese authorities have continued to closely monitor the developments of the OECD and BEPS projects over recent years. A relatively important BEPS-related development has been the ongoing ratification process of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting, commonly referred to as the Multilateral Instrument (MLI). Malta was an early adopter of the MLI, in mid-2017.

At the time of signing the MLI, Malta defined 71 tax treaties as agreements it wishes to be covered by the MLI and opted to apply the following:

- the Minimum Standard, which includes provisions dealing with the purpose of covered tax agreements, the prevention of treaty abuse and the mutual agreement procedure and corresponding adjustments;
- provisions of the MLI in connection with capital gains from alienation of shares or interests of entities deriving their value principally from immovable property; and
- provisions dealing with arbitration procedures subject to certain reservations.

ATAD provisions have also now been transposed into Maltese law.

9.4 Competitive Tax Policy Objective

On a number of occasions, the Maltese Government and authorities haves expressed support for certain BEPS principles as well as the ATAD directives, and confirmed Malta's commitment to countering aggressive tax planning structures. Mechanisms and compliance processes aimed at identifying and countering elements and arrangements indicating harmful tax practices and artificial structures are already in place and are being implemented in Malta. Malta has introduced such measures and safeguards without compromising the fundamental principles on which the Maltese tax system is built. The prospective transposition of the ATAD directives and other multinational initiatives resulting from the BEPS Project should see Malta continuing in this direction.

9.5 Features of the Competitive Tax System

To date, Malta lacks sophisticated transfer pricing rules. However, a number of tax-related anti-abuse measures based on the ATAD have recently been introduced, as described in **7.1 Overarching Anti-avoidance Provisions**.

9.6 Proposals for Dealing with Hybrid Instruments

Malta is fully committed to counteracting abusive tax practices involving hybrid mismatches. For instance, following recommendations from the Code of Conduct Group in 2010, the Maltese tax authorities took action and published guidelines targeting abusive tax practices from hybrid financial instruments giving rise to double non-taxation. The Commissioner for Revenue has issued a guideline that clarifies the position vis-à-vis profit participating loans, which states that interest thereunder is chargeable to tax under the provisions of the Income Tax Act. Interest received from sources situated outside Malta is taxable in Malta and does not benefit from an exemption related to income from participating holdings under the Income Tax Act or under any other law. The guideline clarified that income from a loan – including a loan that has characteristics of both debt and equity – shall be considered to be interest and taxable under the Income Tax Act and is not considered to be income from share capital or from an equity holding for tax purposes that could result in the relative income being exempt from tax in Malta.

9.7 Territorial Tax Regime

Companies registered in Malta are considered to be resident and domiciled in Malta, so are subject to tax on their worldwide income minus permitted deductions in the corporate income tax rate, which currently stands at 35%.

One of the recently introduced tax-related anti-abuse measures based on the ATAD is an interest limitation rule that limits the deductibility of borrowing costs to a certain level. The ATAD caps the deductibility of interest expenses at 30% of a taxpayer's earnings before EBITDA. The limitation is not applicable where borrowing costs do not exceed EUR3 million, and will also not apply to financial undertakings.

Not enough time has passed since the introduction of these rules to properly assess the consequences of these rules on investment and financial services-oriented countries.

9.8 CFC Proposals

The consequences of the new CFC rules on investment and financial services-oriented countries must be carefully monitored at this point. A sweeper CFC rule may not quite be as sophisticated and well spelt out as would be appropriate for the far-reaching consequences it might have on the respective tax systems of the affected jurisdictions.

9.9 Anti-avoidance Rules

It does not appear that the additional anti-abuse legislation implemented in this area, such as a double taxation convention limitation, has had any significant effect on the current level of inbound and outbound investments in Malta.

9.10 Transfer Pricing Changes

The current developments in the area of transfer pricing are not expected to radically change Malta's tax regime. Profits from intellectual property are generally not a source of controversy in the Maltese tax jurisdiction (other than the old patent box regime, which is currently in the process of being reviewed).

9.11 Transparency and Country-by-country Reporting

Malta supports proposals in the areas of country-by-country reporting and the like, and what they aim to address. The exchange of information between tax authorities and tax subjects can help the Maltese tax authorities to identify and combat abusive structures, which may happen to involve Malta more effectively.

Malta has already adopted the country-by-country reporting regulations and applies these regulations to companies established within the Maltese jurisdiction. A parent company of a multinational entity established in Malta is obliged to file an annual report with the Commissioner for Revenue when the consolidated turnover of the group exceeds EUR750 million worldwide. Such a yearly report is compliant with the requirements of the OECD and covers all the jurisdictions in which the parent company and each subsidiary conduct business activities.

9.12 Taxation of Digital Economy Businesses

Changes to the Maltese tax rules in this regard are still in the process of being discussed, fuelled in particular by the OECD and the European Commission's proposals for fairer taxation of the digital economy.

9.13 Digital Taxation

The implementation of any of the proposed BEPS actions should be carefully assessed prior to the introduction of any new measures or laws. Once such measure or laws have been introduced, it might not be possible to undo their relative effects and consequences, and trying to do so may result in great sunk costs for society and businesses.

9.14 Taxation of Offshore IP

Malta has not yet introduced provisions dealing with the taxation of offshore intellectual property deployed within its territory.

Camilleri Preziosi offers tax expertise ranging from advising clients on direct and indirect tax matters to representing clients in front of fiscal courts and tribunals. Most of the international transactions the firm deals with relate to the use of Maltese vehicles in the context of larger transactions, be it for M&A or group restructuring exercises. The CP Tax Department is made up of five lawyers. Even though the lawyers in the tax department are specialised in taxation matters, they can be said to be "all-rounders", enabling them to provide insight to clients on a wide range of matters that might have an impact on the particular transaction and that might not be strictly related to the fiscal implications of a transaction. Camilleri Preziosi's primary practice areas in the tax sector are corporate tax, cross-border tax issues, tax structuring, personal tax, value added tax advice, and stamp duty.

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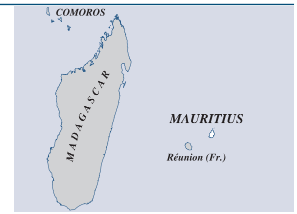

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses usually adopt a corporate form to carry out their trading activities.

Companies limited by shares are the most common structures. Depending on whether their beneficial owners are Mauritian citizens and whether the entity intends to carry out business in or outside Mauritius, companies may be required to apply for a Global Business Licence from the Financial Services Commission. Such companies are required to be centrally controlled and managed in Mauritius for regulatory purposes.

Companies may also apply for an "authorised company" licence from the Financial Services Commission. The scope of activities of an authorised company is limited and it is required to have its place of effective management outside of Mauritius. In short, it should not be tax resident in Mauritius.

Companies owned by Mauritian citizens or carrying out their business mainly in Mauritius are not required to be regulated by the Financial Services Commission. They are commonly referred to as "domestic companies".

Whilst companies limited by shares are by far the most common structures, businesses may be organised through other types of companies: companies limited by guarantee, unlimited companies and companies limited by shares and guarantee. It is also possible to incorporate protected cell companies.

All of the above-mentioned corporate structures are separate legal entities for tax purposes and are taxed as such.

1.2 Transparent Entities

Partnerships (including *sociétés*, limited partnerships and limited liability partnerships) are most commonly used as tax transparent entities. Resident partnerships are not liable to income tax, but their resident associates are liable to tax on their share of profits.

Limited partnerships/limited liability partnerships are commonly adopted in private equity funds due to the great degree of flexibility afforded to such structures as opposed to companies. Prospective investors are also keen to adopt these structures as they are commonly used in other jurisdictions, such as the USA.

It is apposite to note, however, that a partnership which holds a Global Business Licence is able to elect to be "opaque" for tax purposes and therefore may be subject to income tax at its level.

1.3 Determining Residence of Incorporated Businesses

Companies

A company is tax resident in Mauritius if it is incorporated in Mauritius or if it has its central control and management in Mauritius. The Income Tax Act was amended in 2019 to provide that, despite being incorporated in Mauritius, a company will be treated as a non-resident for tax purposes if its central control and management are situated outside of Mauritius.

Trusts

A trust is tax resident in Mauritius if it is administered in Mauritius and a majority of the trustees are resident in Mauritius. In addition, where the settlor of a trust was resident in Mauritius at the time the instrument creating the trust was executed, that trust shall also be tax resident in Mauritius.

A trust is treated as being a company for tax purposes.

Foundations

A foundation is tax resident in Mauritius if it is registered in Mauritius or has its central management and control in Mauritius.

Trusts and foundations are able to file a declaration of non-residence on a yearly basis if the trust's settlor and beneficiaries/foundation's founders and beneficiaries are all non-tax residents of Mauritius in an income year. They will then be tax-exempt.

Transparent Entities

Transparent entities (ie, *sociétés* or partnerships) will be treated as being a resident entity if their seat (or *siège*) is located in Mauritius or if they have at least one associate, *associé* or *gérant* resident in Mauritius.

1.4 Tax Rates

Headline Rate

The headline rate for corporate tax is 15% in respect of incorporated entities.

Tax Transparent Entities

For tax transparent structures, any resident partners who are individuals are taxed at the rate of 15% and may be additionally subject to solidarity levy at the rate of 25% on their leviable income (broadly their chargeable income plus dividends) if it is above MUR3 million, subject to a cap of 10% on their total chargeable income.

Grandfathered Global Business Companies

Some entities holding a category 1 Global Business Licence will continue to benefit from grandfathering provisions (if they were incorporated prior to 16 October 2017) until 30 June 2021, whereby they will be taxed at an effective rate of 3% through application of the deemed foreign tax credit. Grandfathered category 2 Global Business Licence companies (ie, those which were incorporated prior to 16 October 2017) continue to be tax exempt until 30 June 2021 (for completeness, it should be noted that there are some narrow exceptions to this exemption in connection with IP assets or IP-related income).

Other Companies

Companies that are involved in the import and export of goods are subject to a reduced rate of tax of 3%.

Special rates apply to freeport companies, subject to certain substance requirements being met.

Businesses Held by Individuals Directly

Individuals who own businesses directly are subject to tax on the chargeable income of the business at the headline rate of 15%. The solidarity levy will also be applicable if the chargeable income exceeds MUR3 million.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporate tax is applied on the “chargeable income” of an entity. The chargeable income refers to the net income of the company (ie, gross income minus any allowable deductions).

Although it is not statutorily provided for, taxable profits are generally based on accounting profits, subject to adjustments provided for in the Income Tax Act 1995.

The Mauritius Revenue Authority is able to make adjustments to the chargeable income of an entity if it is satisfied that some transactions have not been carried out in accordance with the “arm’s-length” principle or provisions applicable to controlled foreign corporations. In addition, there are other targeted anti-avoidance provisions (as well as a general anti-avoidance provisions) aimed at adjusting taxable profits or losses.

Entities report their income on an accrual basis, but small enterprises (generally a person with an annual turnover not exceeding MUR10 million) may apply to the Mauritius Revenue Authority for permission to compute their net income on a cash basis.

2.2 Special Incentives for Technology Investments

Incentives are available in respect of R&D expenditure for the period 1 July 2017 to June 2022, as follows:

- a person who has incurred any qualifying expenditure directly related to his existing trade or business, may deduct twice the amount of the expenditure in the income year in which the qualifying expenditure was incurred, provided the research and development is carried out in Mauritius; and
- a person who has incurred qualifying expenditure that is not directly related to his existing trade or business may be allowed a deduction of the expenditure in the income year in which the expenditure was incurred.

Income tax holidays are available for companies involved in innovation-driven activities (see **2.3 Other Special Incentives** for more details).

2.3 Other Special Incentives

Partial Exemption Regime

A partial exemption regime (PER) amounting to 80% of the chargeable income is available to certain streams of income and holders of certain licences, subject to fulfilling certain conditions (which broadly relate to substance such as employment and expenditure in Mauritius and the carrying out of core income-generating activities of the entity in Mauritius).

Such streams of income include dividends, certain types of interest, and aircraft and ship leasing income.

Holders of licences from the Financial Services Commission such as a Fund Manager licence or a closed-ended fund licence are also able to avail themselves of the PER.

Tax Holidays

Tax holidays (of up to eight years) are available for certain activities, including the following, in each case subject to certain substance criteria being met:

- income derived from activities of a company holding a global headquarters administration licence;
- the income of a company involved in innovation-driven activities for intellectual property assets that are developed in Mauritius or income derived by a company from intellectual property assets that are developed in Mauritius;
- income derived from the manufacture of pharmaceutical products, medical devices and hi-tech products; and
- income derived from the manufacturing of nutraceutical products.

Tax holidays of five years are available for entities holding a global treasury activities licence or a global legal advisory services licence, subject to substance criteria being met.

Other Special Rates

Special tax rates also apply to the income of banks.

2.4 Basic Rules on Loss Relief

Losses incurred in the production of gross income can be set off against gross income for that income year. Any excess loss may also be carried forward for set-off against income derived in the five succeeding income years. However, this is not applicable to any amount of loss that is attributable to annual allowance claimed in respect of capital expenditure incurred on or after 1 July 2006.

There are also restrictions on the carry forward of losses in a change of ownership of the company.

2.5 Imposed Limits on Deduction of Interest

Only interest incurred in respect of capital expenditure employed exclusively in the production of gross income is deductible. Deductions of interest may be disallowed by the Mauritius Revenue Authority where the interest is payable to a non-resident who is not chargeable to tax on the amount of the interest, or where the interest is not likely to be paid in cash within a reasonable time.

2.6 Basic Rules on Consolidated Tax Grouping

There is no tax consolidation in Mauritius for groups, except for permanent establishments being consolidated at the head office level given that they form part of the same legal entity.

2.7 Capital Gains Taxation

There is no taxation on capital gains in Mauritius.

2.8 Other Taxes Payable by an Incorporated Business

Transactions may trigger registration duty or land transfer tax if they relate to the transfer of immovable properties in Mauritius.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses may also be subject to a corporate social responsibility (CSR) charge (currently equivalent to 2% of a company's chargeable income).

Businesses in certain sectors, such as telephony service operators (in the telecommunications sector) and banks, may also be subject to an additional levy based on their income.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses would mostly operate in corporate forms, such as private companies limited by shares.

3.2 Individual Rates and Corporate Rates

The headline rates for income tax at the corporate level and the individual level are identical (other than CSR applicable for corporates).

However, it may be more tax efficient, to some extent, for individuals subject to the solidarity levy (which falls within the definition of income tax) to conduct their professional activities through a corporate vehicle. No specific anti-avoidance taxation rules have been put in place regarding personal services companies, and they are fairly commonly used in practice. If the Mauritius Revenue Authority wished to challenge these type of entities, it would have to base the challenge on the general anti-avoidance legislation.

3.3 Accumulating Earnings for Investment Purposes

There is currently no legislation preventing closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends (in cash or in shares) from Mauritius resident companies are exempt from income tax in the hands of individuals but would be accounted for when computing the solidarity levy that applies to individuals earning income above MUR3 million (see **1.4 Tax Rates**).

There is no tax on the gain on the sale of shares.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

See **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest

There is no withholding tax on interest payments being made to a Mauritius resident person.

Interest payments by a person (other than a bank or a non-bank deposit-taking institution) made to a non-resident are generally subject to withholding tax at the rate of 15%.

However, interest payments paid to a non-resident not carrying on any business in Mauritius by a corporation holding a Global Business Licence out of its foreign source income or by a bank would not be subject to withholding tax as long as the interest is paid out of gross income derived from its banking transactions with non-residents and corporations holding a Global Business Licence.

Royalties

Royalties paid to residents are subject to withholding tax at the rate of 10%.

Royalties paid to non-residents are subject to withholding tax at the rate of 15%.

Dividends

There is no withholding tax on dividends.

The above rates are subject to any exemption or reduction under any applicable double tax treaty.

4.2 Primary Tax Treaty Countries

Foreign investors wishing to invest in local corporate stock or debt usually invest locally directly.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Local tax authorities do not normally challenge the use of treaty country entities by non-treaty country residents but they may deny treaty benefits under the limitation of benefits provisions.

4.4 Transfer Pricing Issues

Transfer pricing is a very new area in Mauritius tax legislation. There is only one section of the Income Tax Act 1995 (section 75) dealing with arm's-length transactions, and there are no transfer pricing regulations or published Mauritius Revenue Authority guidance. In addition, there is currently no transfer pricing case law, and a handful of ongoing cases are being heard at the first stage of appeal of tax cases (the Assessment Review Committee).

4.5 Related-Party Limited Risk Distribution Arrangements

As far as is known, the Mauritius Revenue Authority has not challenged the use of related-party limited risk distribution arrangements for the sale of goods or provisions of services locally.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Please see **4.4 Transfer Pricing Issues**. In practice, the Mauritius Revenue Authority may rely on OECD standards.

4.7 International Transfer Pricing Disputes

As far as is known, no transfer pricing disputes have yet been resolved through double tax treaties or MAP procedures. However, the local competent authorities have promoted the use of the MAP process in a wholesale manner as part of Mauritius's BEPS commitments.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

This question is not applicable in Mauritius.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches are typically taxed on the profits attributable to that branch.

Subsidiaries (as a separate legal entity) are taxed on their worldwide profits.

5.3 Capital Gains of Non-residents

There is no taxation on capital gains in Mauritius.

5.4 Change of Control Provisions

Change of control provisions may apply if the change of control has an impact on the ownership of an immovable property in Mauritius; registration duty and/or land transfer tax may be applicable.

A change of control may also impact the availability of losses that may be carried forward. The current exemptions upon mergers or takeovers only apply to a limited category of local companies engaged in manufacturing.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

Any payments by local affiliates for management and administrative expenses incurred by a non-local affiliate may be scrutinised by the Mauritius Revenue Authority if they are not at arm's length. There have been several cases where the Mauritius Revenue Authority has sought to challenge such payments as being excessive.

5.7 Constraints on Related-Party Borrowing

There are no specific constraints on related-party borrowing, except that any such borrowing (and any related interest payments) should be made on an arm's-length basis.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on their worldwide income. The local corporation may apply for tax credit if it has suffered foreign tax on any foreign source income and if it is able to show proof of such foreign tax suffered. In addition, it may claim the PER (see **2.3 Other Special Incentives**) on any profits attributable to a permanent establishment located abroad.

6.2 Non-deductible Local Expenses

This question is not applicable in Mauritius.

6.3 Taxation on Dividends from Foreign Subsidiaries

Foreign dividends are generally subject to tax at the headline rate of 15%. However, an entity may claim the PER (ie, an exemption of 80% on its foreign dividends provided that these dividends have not been allowed in their country of source and that the entity shows that it complies with its regulatory filing obligations and has adequate resources for managing its equity participation).

Alternatively, the entity may claim credit for any foreign withholding taxes suffered or underlying tax credit (if it holds more than 5% of the shares in the foreign subsidiary).

In practice, unless the subsidiary is located in a zero-tax jurisdiction, there should be minimal tax leakage on foreign dividends in Mauritius.

6.4 Use of Intangibles by Non-local Subsidiaries

This question is not applicable in Mauritius.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

CFC rules have been enacted in Mauritius and seek to tax income (which will be attributed to the chargeable income of the resident parent company) where the non-distributed profits of a CFC are deemed to have arisen from non-genuine arrangements that have been put in place for the main purpose of obtaining a tax benefit.

A CFC is defined as a company that:

- is not resident in Mauritius;
- has more than 50% of its participation rights held either directly or indirectly by a resident company or together with its associated enterprises; and
- includes a permanent establishment of the resident company.

However, CFC rules do not apply in the following instances:

- if accounting profits do not exceed EUR750,000 and non-trading income is less than EUR75,000;
- if accounting profits represent less than 10% of its operating costs for the tax period; or
- if the tax rate in the country of residence of the CFC exceeds 50% of the Mauritian tax rate (ie, where the headline income tax rate is more than 7.5%).

6.6 Rules Related to the Substance of Non-local Affiliates

This question is not applicable in Mauritius.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Gains on the sale of shares in non-local affiliates would not be subject to corporate tax at the level of the Mauritius resident corporation.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

General Anti-avoidance Provision

The fiscal legislation in Mauritius contains a general anti-avoidance provision, which seeks to catch transactions that have been entered into or effected to provide a tax benefit to a relevant person.

Case law on the matter indicates that, in addition to several factual factors (such as the manner in which the transaction has been entered into, any change in the financial position of the parties, etc), the relevant test to establish whether the anti-provision provision has been triggered is to determine whether a reasonable person would conclude that the taxpayer entered into the impugned transaction for the dominant purpose of enabling himself or herself to obtain a tax benefit.

Special Anti-avoidance Provision

There are also specific anti-avoidance provisions that relate to the following:

- interest on debentures issued by reference to shares;
- excessive remuneration or share of profits;
- excessive remuneration of shareholders or directors;
- benefits to shareholder;
- excessive management expenses; and
- leases for other than adequate rent.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no regular routine audit cycle, but the Mauritius Revenue Authority is empowered to carry out investigations and seek documents from any person for the purposes of ascertaining his or her tax liability.

The Mauritius Revenue Authority is not able to exercise these powers in respect of a period beyond three years of assessment preceding the current year of assessment unless it has issued a notice setting out the reasons for which such information or such books and records are required. It is important to note that a right of review exists in respect of such a notice.

9. BEPS

9.1 Recommended Changes

Mauritius has been engaging with the BEPS project recommendations quite significantly.

The fiscal legislation was overhauled in 2018 in order to be compliant with the recommendations on Action 5 (Countering Harmful Tax Practices more effectively, Taking into Account Transparency and Substance). The revamped fiscal legislation is now aligned with the recommendations of the Forum on Harmful Tax Practices (FHTP).

Regimes such as the deemed foreign tax credit and the Freeport regimes were deemed to have potentially harmful tax features and have now been abolished (subject to limited grandfathering provisions, which end on 30 June 2021).

Other regimes that had been earmarked as having potentially harmful features, such as the previous regime for the taxation of banks and the Global Business Licence category 2 companies, have been reformed to ensure compliance with the BEPS proposals.

Substance requirements have also been introduced.

Mauritius has also ratified the Multilateral Instrument (Action 6: Prevention of Treaty Abuse) and enacted legislation to allow for country-by-country reporting (Action 13: Country-by-Country Reporting).

Finally, Mauritius has implemented Action 14: More Effective Dispute Resolution by inserting an article that seeks to strengthen the Mutual Agreement Procedure into its tax treaties through the operation of the Multilateral Instrument.

9.2 Government Attitudes

The government has been very vocal about its commitment to ensuring compliance with the BEPS recommendations. Mauritius is a member of the BEPS All-Inclusive Framework and has speedily implemented changes to its fiscal legislation following its review by the FHTP in 2018.

Mauritius is also in line with any EU recommendations and is not on the EU list of non-co-operative jurisdictions for tax purposes.

9.3 Profile of International Tax

Given that Mauritius wishes to retain its reputation as an international financial centre of repute and has, over the years, built up a thriving sector in that respect, international tax is a consideration of utmost importance at both industry and governmental level.

The industry stakeholders are consulted to some degree in the implementation of BEPS recommendations and are invited to provide their insight on a practical level. Investors are more attuned to the relevance of BEPS recommendations on their dealings in Mauritius.

9.4 Competitive Tax Policy Objective

Whilst at industry level it is clear that the implementation of the BEPS recommendations may result in an uneven playing field for OECD members and non-OECD members, Mauritius is committed to aligning its tax legislation to the minimum standards.

9.5 Features of the Competitive Tax System

The fiscal legislation was amended in 2018 to provide for a PER system that removes any ringfencing in the economy, and imposes key substance requirements to be tied to any eligibility to the PER. Whilst the PER has been cleared by both the FHTP and the EU, it is still subject to scrutiny on an annual basis.

9.6 Proposals for Dealing with Hybrid Instruments

In respect of hybrid mismatches, Mauritius has limited restrictions on interest deductibility. The multilateral instrument amending Mauritius's covered tax agreements (CTAs) provides that the article covering hybrid mismatches is "optional". Mauritius's position is that it has reserved the right for the entirety of this article not to apply to its CTAs.

9.7 Territorial Tax Regime
Mauritius does not have a territorial tax system.

9.8 CFC Proposals
Mauritius does not have a territorial tax system.

9.9 Anti-avoidance Rules
The proposed changes to treaties via the application of a principal purpose test are relevant in the context of cross-border investment, especially as it adds a new layer of uncertainty in terms of interpretation (Mauritius has opted for the principal purpose test, rather than the limitation of benefits clause).

Inbound investors would be wise to seek tax advice from local counsel before implementing such structures, and to properly document the commercial rationale of any contemplated structure.

9.10 Transfer Pricing Changes
Mauritius does not currently have detailed transfer pricing legislation but has a general "arm's-length" rule. However, detailed regulations on the application of the "arm's-length" rule may well be forthcoming in the near future. This would be welcome as it would add some level of certainty for taxpayers and their advisers by providing an established framework for such assessments.

As far as is known, the taxation of profits from intellectual property is not currently subject to any controversy in Mauritius. Since 1 January 2019, any income from intellectual property assets is subject to tax at the headline rate of 15% (subject to certain limited tax holidays related to intellectual property assets on innovation-driven activities).

9.11 Transparency and Country-by-country Reporting
Mauritius has been rated as being overall compliant in terms of its efforts regarding transparency, particularly the exchange of tax rulings and the implementation of automatic exchange of information systems.

Mauritius has also already implemented country-by-country reporting.

Whilst these changes place a significant compliance burden on businesses, it is important that the jurisdiction is rated favourably in these aspects in order to ensure its reputation as an international financial centre.

9.12 Taxation of Digital Economy Businesses
Mauritius is a member of the BEPS All Inclusive Framework and accordingly provides its input on developments such as Pillar 1 and Pillar 2 Blueprints.

9.13 Digital Taxation
Please see **9.12 Taxation of Digital Economy Businesses**. There has been no indication of any proposal to be implemented in Mauritius but the government are expected to be guided by the pace taken by the OECD.

The Finance (Miscellaneous Provisions) Act 2020 sought to introduce VAT on digital and electronic services but the entry into force of the legislation has not yet been proclaimed.

9.14 Taxation of Offshore IP
There are no special rules dealing with intellectual property assets (other than withholding tax rates applicable on payments of royalties and a targeted tax holiday applicable to income derived from IP assets on innovation-driven activities).

Contributed by: Johanne Hague and Nadiah Ramsamy, ***Prism Chambers***

Prism Chambers is a full-service business law firm based in Mauritius which specialises in all aspects of tax law, on a domestic and international scale. Prism Chambers' team of five fee earners is headed by dual-qualified (Mauritius and England & Wales) Johanne Hague. Prism Chambers has a leading advisory and transactional tax practice, with a particular focus on cross-border transactions involving the African continent. The lawyers at Prism Chambers also represent clients at all stages of tax controversy matters, including before the Supreme Court of Mauritius. The firm is regularly instructed to advise on international taxation matters, particularly in connection with the implementation of the BEPS proposals and on AEOI matters. Its other main practice areas include private client, corporate and commercial, and insolvency and restructuring.

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MEXICO

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form.

Commercial businesses are most commonly incorporated as a *sociedad anónima* (equivalent to a public limited company) or a *sociedad de responsabilidad limitada* (equivalent to a limited liability company).

Groups of individuals that perform independent activities, such as professional services, may opt to form a non-stock civil entity, which has a separate legal existence, called a *sociedad civil*. These entities are highly common between lawyers, architects, doctors, accountants, etc. There are no substantial differences in the tax regime applicable to this type of commercial corporation, although it has a different legal existence from its members, partners or shareholders. The unique relevant difference is that the revenue of *sociedades civiles* is taxed on a cash flow basis, while commercial corporations have to recognise their income for tax purposes on an accrual basis.

1.2 Transparent Entities

As a rule, there are no transparent entities in Mexico. Any entity incorporated as a *sociedad anómima*, *sociedad de responsabilidad limitada* or *sociedad civil* is an independent entity from its members, partners or shareholders, and is a taxable person for tax purposes.

The only figure that could be understood as a transparent entity is a trust or *fideicomiso*, as the revenue generated through such entities is taxable for their beneficiaries.

In the specific case of trusts that perform commercial activities, the trustee has the obligation to comply with several obligations applicable to corporations, such as filing monthly returns on behalf of the beneficiaries.

The trustee will also have to calculate the annual taxable profit generated by the trust's commercial activities.

Said taxable profit will be accumulated by the beneficiaries as taxable revenue to determine their personal income tax.

If there is a loss, the trustee will be entitled to offset it against the following year's profit.

Commercial trusts are regularly used for real estate activities.

1.3 Determining Residence of Incorporated Businesses

A corporation will be deemed a Mexican resident for tax purposes if its principal administration or its effective management is located in Mexico.

The principal administration or the effective management is considered to be in Mexican territory if the day-to-day decisions regarding the control, direction, management or operation of the incorporated business and its activities are taken or executed in Mexico.

As mentioned before, the general rule is that Mexican legislation does not recognise tax transparency for any kind of entities, except for trusts for commercial purposes.

If a transparent entity constituted abroad becomes Mexican resident, by statute of the law, it will no longer be transparent.

1.4 Tax Rates

Mexican resident companies are taxed at a 30% income tax rate on their annual taxable profit.

Individuals are taxed at progressive rates, depending on their gross revenue, with the highest rate being 35% of their annual taxable profit.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Corporate taxable profit is calculated by subtracting deductible expenses and paid employees' profit sharing from the gross revenue of the relevant fiscal year.

If the result is positive, the net operating losses (NOLs) of previous years can be offset. If the result is still positive after this deduction, a 30% rate is applied to calculate the liquid amount to be paid.

For business corporations, revenue is taxed and deductions are authorised on an accrual basis, while the taxable profit of non-stock entities, such as *sociedades civiles* that render professional services, is calculated on a cash flow basis.

Taxable profits are calculated by applying the specific legal provisions that explain the procedure to do so, such as those which provide the concepts deemed as revenue, deductible expenses and rules for the offsetting of NOLs.

Therefore, taxable profits are not based on accounting profits. In fact, there is a specific section on the annual tax return in which taxpayers have to reconcile their tax and accounting profit or loss, by disclosing taxable but not accounting revenue/deductions and accounting but not taxable revenue/deductions.

2.2 Special Incentives for Technology Investments

Mexican law provides an incentive for technology investments, equivalent to 30% of the investment made for R&D purposes in a relevant tax year.

This amount can be credited against the income tax of the same relevant tax year. If the incentive is higher than the tax payable, the taxpayer may carry forward the difference for ten years.

The incentive for technology investments is limited to a global amount of MXN1.5 billion collectively for all taxpayers willing to obtain the benefit, and MXN50 million per individual taxpayer, on an annual basis.

There are no particular incentives for patent box investments.

2.3 Other Special Incentives

There are other special incentives, with the most relevant being as follows:

- For investment in the following activities:
  (a) the production or distribution of Mexican films;
  (b) the production of domestic stage plays, visual arts, dance, music in orchestra conducting, instrumental and vocal performance in concert, and jazz; or
  (c) infrastructure and facilities for high performance and highly specialised athletes.
- The benefit will consist of a tax credit in an amount equal to the contribution to be offset against the income tax of a relevant fiscal year, which can be carried forward for ten years.

In order to obtain these tax incentives, taxpayers have to comply with certain special rules.

- Employers who hire handicapped or senior employees (above the age of 65) may deduct an additional 25% of the wages paid to these employees.
- In order to promote real estate projects, public trusts focused on real estate may adopt the infrastructure and real estate trusts regime (FIBRA, for its acronym in Spanish) and obtain several tax reliefs, such as an income tax payment deferral.
- Taxpayers located in the northern and southern borders may obtain tax relief equivalent to a third of the income tax for a relevant fiscal year.

A reduced VAT rate is also applicable for the activities carried out on both borders.

2.4 Basic Rules on Loss Relief

Taxpayers that incur losses in a specific year are entitled to offset them against taxable profits for the next ten years (carry forward).

Carry back of losses is not permitted.

2.5 Imposed Limits on Deduction of Interest

There are several limits on the deduction of interest by Mexican resident corporations, including the following.

- Under a thin capitalisation rule, taxpayers will not be allowed to deduct interest paid to related parties resident abroad. If the debt-equity ratio exceeds a proportion of 3:1, interest accrued by the proportion of debt that surpasses that threshold will not be deductible.

This thin capitalisation rule does not apply to interest derived from loans contracted by financial institutions or from debt contracted for construction activities, the operation or maintenance of productive infrastructure related to strategic activities, or the production of electricity.

- As of 2020, the net interest of the fiscal year exceeding the amount resulting from multiplying the adjusted net tax profits by 30% shall not be deductible.

Net interest will be the amount of the total interest due from the taxpayer's debts, minus the total income for accrued interest, which is considered as taxable revenue.

The adjusted net tax profits shall be equal to the taxable profits plus the total interest due from the taxpayer's debts and the depreciated amount for investments in the fiscal year (ie, an amount equal to the taxpayer's EBITDA).

This limitation does not distinguish if the beneficiary of the interest is a related or an independent third party, or if it is a Mexican resident or not.

This limitation shall only be applicable if the taxpayer's accrued interest expense during the fiscal year exceeds MXN20 million. If the taxpayer is part of a group or related parties, this amount shall be divided between the members of the group, in proportion to the prior fiscal year's income.

Non-deductible net interest for the fiscal year may be deductible during the following ten fiscal years, to the extent it is added to the net interest expense of the following fiscal years.

This limitation does not apply to financial institutions or to interest derived from debt to finance public works, construction, hydrocarbon-related projects, extractive industry-related projects, electricity and water-related projects, or yields of public works.

- According to a special anti-avoidance rule, interest is deemed as dividends, and therefore is not deductible when Mexican residents take loans from related parties resident abroad, and it is set forth by the parties that:
  - (a) the debtor makes a written promise to unconditionally pay all or part of the credit at a date determined at any time by the creditor;
  - (b) interest is not considered an arm's-length transaction;
  - (c) in case of default, the creditor has the right to intervene in the administration or management of the debtor;
  - (d) interest is fixed to or contingent on earning profits; or
  - (e) the loans are back-to-back loans, according to Mexican tax law.

2.6 Basic Rules on Consolidated Tax Grouping

Subject to specific legal requirements, groups of corporations may request an authorisation from the tax authority, in order to pay income tax as a consolidated group.

The relevant benefits of this regime are mainly that taxable profits generated by one member may be offset by the tax losses of another, in order to determine the group's taxable profit.

The group may defer the income tax for up to three years.

2.7 Capital Gains Taxation

The transfer of real estate, land, fixed assets, securities, shares, ownership of interests or governmental certificates, among others, may result in a capital gain for the seller.

Corporations are taxed on the profit obtained from such transactions, calculated by subtracting the acquisition price, adjusted by inflation, from the price for which the good was sold.

In the specific case of the sale of shares, the profit will be calculated by subtracting the current cost of the shares for tax purposes from the price for which they were sold.

If the result is positive, there is a profit to the taxpayer that should be added to its other revenue to determine income tax.

Foreign residents who sell shares issued by Mexican companies are subject to a 25% tax on the gross revenue, without any deductions. Nevertheless, foreign residents with a local representative in Mexico have the option to be taxed at a 35% rate on the net gain.

There are no relevant reliefs or exemptions for Mexican residents; foreign residents are entitled to take the benefits of a double taxation treaty, if applicable.

2.8 Other Taxes Payable by an Incorporated Business

At a federal level, incorporated businesses are obliged to pay Value Added Tax (VAT) and the Special Tax on Production and Services (IEPS, for its acronym in Spanish).

VAT is triggered by the sale of goods, the rendering of independent services, the leasing of property, and the importation of goods and services.

The general rate is 16% on the price of the transaction and VAT is transferred at every step of the productive chain to the purchaser of goods and services, so that the final consumer absorbs the cost of the tax.

There are several special rates: for example, sales of groceries and prescription drugs, among others, are taxable at 0%. In the northern and southern border areas, transactions are taxed at an 8% rate.

Input VAT is creditable against the triggered tax, with taxpayers paying the positive difference between the latter and the former.

If the difference is negative, there is a favourable balance for the taxpayer, which is refundable.

IEPS is triggered by the sale of specific goods and the rendering of specific services, mainly those that may cause harm to personal and collective health and wellbeing, and thereby may trigger additional costs to the State, such as tobacco, alcohol, junk food, etc.

At a local level, real estate owners are subject to property tax at progressive rates, depending on the value of the property.

2.9 Incorporated Businesses and Notable Taxes

Incorporated businesses are not subject to any other notable taxes.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses are publicly held companies with a small number of shareholders, and commonly operate in a corporate form.

According to Mexican legislation, any company or entity with a legal existence different to its partners or shareholders must adopt any of the corporate forms described in **1.1 Corporate Structures and Tax Treatment**.

It is important to bear in mind that the tax regime for closely held companies, as they adopt a corporate form, is essentially the same as for public companies or large multinational groups.

The only alternative would be for individuals to perform business activities in their own name, in which case they would be directly responsible before the tax authorities and the specific rules for individuals would be applied (progressive rates, revenue taxed on cash flow, among others).

3.2 Individual Rates and Corporate Rates

Corporate tax rate is 30%, while individuals are subject to a progressive rate, with the highest rate being 35%.

There are no particular provisions that prevent individual professionals (eg, architects, engineers, consultants, accountants, etc) from earning income at corporate rates through corporations, in such cases that they constitute a *sociedad civil* (a non-stock entity), which is a common practice among professionals.

Nonetheless, revenue gained directly by individuals in the form of dividends or salary assimilated income will be taxed according to the rates provided for individuals.

3.3 Accumulating Earnings for Investment Purposes

There are no rules that prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

As a rule, dividends paid by closely held corporations to individuals are taxed at the corporate level. This means that the tax triggered by the distribution of dividends must be paid by the company that makes the distribution, not by the shareholder.

This tax will not be triggered if the dividend comes from the "net after-tax profit account" (CUFIN, for its acronym in Spanish).

Individuals must include the dividends in their yearly revenue, but they are entitled to credit the tax paid by the corporation for the distribution of the dividend against the tax due in their annual tax return.

Additionally, individuals will be subject to a withholding tax of 10% for the distribution of dividends.

It is important to note that these rules are applicable for any kind of corporation, even if it is a closely held business or a public corporation, whether it is domestic or part of a multinational group.

Individuals are taxed on the sale of shares in closely held companies, or in any other company, on the net gain on the transaction for tax purposes – ie, the sale price minus the current cost of the shares.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on the dividends from publicly traded corporations in the same way as they would be if the dividend comes from a closely held corporation, as explained in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

Regarding the sale of shares of publicly traded corporations, individuals are subject to a 10% rate tax on the net gain – ie, the sales price minus the acquisition cost.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interest, dividends and royalties paid by Mexican residents to foreign residents are taxed at different rates in the absence of income tax treaties.

It is important to bear in mind that the withholding is triggered when the payment is effectively made or even when it is due, whichever happens first.

The different tax rates are as follows:

- interest is subject to different withholdings of 4.9%, 10%, 15%, 21%, 35% and 40%, depending on the beneficiary and the type of credit that triggers the interest;
- dividends are taxed at a 10% withholding rate; and

- royalties, in general, are taxed at a 25% withholding rate, with the following additional special rates:
  - (a) royalties for the leasing of railroad cars, containers, trailers and ships for commercial use are subject to a rate of 5%;
  - (b) royalties for the use of patents, inventions, improvement certificates, trade marks, trade names and advertising are taxed at 35%; and
  - (c) royalties for the use of aircrafts for commercial activities are taxed at a 1% rate.

However, Mexico has signed a large numbers of tax treaties, so withholding rates provided in domestic legislation may be subject to treaty relief, depending on the residence of the beneficiary.

4.2 Primary Tax Treaty Countries

Mexico has an extensive tax treaty network that gives investors the opportunity to obtain tax reliefs for equity and/or debt investments conducted in Mexico.

The relevant countries with a tax treaty with Mexico are the US, the UK, the Netherlands, Luxembourg, Switzerland, Spain and Canada.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Mexican legislation requires the residence of the beneficiary of the revenue to be demonstrated as a condition to obtaining a tax relief as per the tax treaty.

Additionally, during their audits, tax authorities request a demonstration that the recipient of the revenue is the beneficial owner, in order to determine whether it is entitled to treaty reliefs or is merely treaty shopping.

4.4 Transfer Pricing Issues

Mexican transfer pricing rules follow OECD standards as the OECD's Transfer Pricing Guidelines are mandatory for the interpretation of the law.

The main issues and concerns for Mexican resident parties of multinational groups are mainly related to the compliance of the global and country-by-country reports that must be submitted to the Mexican authorities.

When an audit is carried out by Mexican authorities regarding transfer pricing issues, a major concern for taxpayers is the threshold of documentary evidence that must be submitted to support that intercompany transactions follow the arm's-length principle.

Authorities regularly state that the evidence provided by the company is not sufficient or suitable.

This issue transcends to litigation processes, as the burden of proof lies with the taxpayer who challenges an assessment issued by the tax authorities.

Nevertheless, it has become common practice for transfer pricing controversies to be resolved by an alternative dispute resolution procedure before the Mexican tax ombudsperson.

It is important to point out that there are cases in which it is possible to settle a potential controversy with the authorities at the audit stage, as they accept the validity of the documentation and evidence provided by the taxpayer.

4.5 Related-Party Limited Risk Distribution Arrangements

In recent years, the tax authorities have challenged several low-risk distributor structures, mainly through transfer pricing audits. However, there have been cases where the authorities have assessed the creation of a permanent establishment derived from such arrangements. Most low-risk distributor structures currently in place may require re-evaluation given the positions taken by the Mexican Government in respect of the Multilateral BEPS Convention (which has not been approved by the Senate and, therefore, is not yet in force), especially concerning the introduction of the concept of "closely related" agent.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Local transfer pricing rules and their enforcement follow OECD standards.

4.7 International Transfer Pricing Disputes

It is not common for transfer pricing disputes to be resolved through mutual agreement procedures (MAPs) provided in double tax treaties.

Mexican tax authorities are not eager to use MAPs in transfer pricing issues.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When a transfer pricing claim is settled and a Mexican resident company did not follow the arm's-length principle, the corresponding adjustments must be made in the company's relevant tax returns.

If a foreign resident related party of a Mexican company suffers from an adjustment in its taxable profit involving transactions with the Mexican resident, the Mexican tax authorities may allow the latter to make the corresponding adjustments in its relevant tax return.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

As a rule, branches are not incorporated as Mexican companies, but are deemed permanent establishments and are therefore subject to the same tax obligations as Mexican residents. These obligations include submitting reports and returns, and keeping records for tax attributes and assets in the same manner (CUCA, CUFIN, NOLs, etc).

On the contrary, if a subsidiary is incorporated as a Mexican company and complies with the corresponding legal requirements, it will be deemed resident in Mexico for tax purposes and will therefore be obliged to comply with all the provisions stated in domestic law.

5.3 Capital Gains of Non-residents

Non-residents are taxed on the gains from the sale of shares, as the source of the revenue is deemed to be in Mexico in the following two specific cases:

- when the shares are issued by a Mexican resident company; or
- if the shares are not issued by a Mexican resident, and their value is represented, directly or indirectly, in a proportion equal or higher than 50% by real property located in Mexican territory.

In any case, capital gains from the sale of stocks are taxed at a 25% withholding rate over the gross revenue obtained from the transaction, without any deductions.

If the non-resident appoints a legal representative in Mexico and complies with certain requirements, the transaction may be taxed at a 35% rate on the net gain.

5.4 Change of Control Provisions

If the transfer of shares is part of a multinational group's restructure, the shares may be assigned without triggering any tax, as long as certain conditions provided by statute are met and the shares remain within the control of the group.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no formulas to determine the income of foreign-owned local affiliates selling goods or providing services. However, the compensation for such transactions must comply with the arm's-length principle.

5.6 Deductions for Payments by Local Affiliates

The following general standards must be complied with in order to deduct payments by local affiliates:

- taxpayers must demonstrate that the transaction was materially executed (services were in fact rendered, goods sold were in fact delivered, etc), which routinely gives rise to significant documentation problems for taxpayers to satisfy the burden of proof;
- the expense must be strictly necessary for the business activity of the Mexican resident taxpayer; and
- transactions must be carried out according to the arm's-length principle.

If a foreign affiliate incurs administrative expenses on behalf of a Mexican resident, the tax authorities will expect the latter to demonstrate that the previously mentioned conditions are met.

It should be noted that prorated expenses are disallowed by statute.

Additionally, in 2020 a new standard for the deduction of payments by a Mexican resident company to a foreign resident affiliate was introduced into Mexican legislation. These payments will not be deductible if the beneficiary's revenue is subject to a preferential tax regime in its place of residence.

This limitation is not applicable if the revenue derives from business activities and the foreign affiliate is able to demonstrate that it has the human resources and the assets to conduct such activities.

The foregoing is true unless the revenue is subject to a preferential tax regime due to a hybrid mechanism, in which case the payment will not be deductible.

5.7 Constraints on Related-Party Borrowing

There are no legal provisions that prevent or impose any constraint, from a civil or commercial perspective, on borrowing by foreign-owned local affiliates paid to non-local affiliates.

However, the deduction of interest is subject to several limitations, such as thin capitalisation, back to back rules, and the 30% of the net profit threshold, as explained in **2.5 Imposed Rules on Deduction of Interest**.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Local corporations are taxed on their worldwide revenue, regardless of its source. Therefore, such revenue will be added to the Mexican-sourced income to determine the taxable profit, to which a 30% tax rate will be applied.

However, if such revenue triggered income tax in the source country, this amount may be credited against the Mexican income tax for the relevant tax year.

In the specific case that the revenue is sourced at a preferential tax regime or derives from transparent foreign entities, CFC rules are applied, primarily regarding the moment at which the revenue must be recognised for Mexican tax purposes.

6.2 Non-deductible Local Expenses

As mentioned in **6.1 Foreign Income of Local Corporations**, foreign income is taxable for Mexican resident companies.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by Mexican corporations from foreign subsidiaries are taxed as any other revenue, as the worldwide income principle is applicable.

However, the income tax triggered and paid in the country of residence of the subsidiary may be credited against the Mexican income tax.

Additionally, the Mexican entity is entitled to credit the corporate tax paid by the foreign subsidiary abroad.

If the dividends distributed by a second-level foreign subsidiary of a direct subsidiary reach the Mexican resident entity, they can be credited against the tax paid.

In order for such taxes paid abroad to be credited, the Mexican corporation must hold no less than 10% of the capital stock of the foreign subsidiary, for at least six months prior to the dividend being paid.

6.4 Use of Intangibles by Non-local Subsidiaries

There are no legal restrictions on foreign subsidiaries using intangibles developed and owned by Mexican corporations, as the revenue of the latter will be taxed for Mexican purposes according to the worldwide income principle applicable to local residents.

However, transactions must comply with the arm's-length principle.

According to a non-mandatory interpretation of the law published by the Mexican authorities, if a Mexican resident pays royalties to a foreign related party for the use of an intangible developed or originally owned by the local resident, it must demonstrate that the transfer of the intangible was an arm's-length transaction in order for the expense to be deducted.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Under Mexican Law, local corporations are bound to pay income tax on income received from a foreign subsidiary or controlled foreign company whose revenue is subject to a preferential tax regime.

A preferential tax regime is defined as a jurisdiction in which revenue tax is exempted or where the effective income tax to be paid is lower than 75% of the tax rate that would have applied in Mexico for the same income.

In this case, income generated by the foreign entity is deemed to be obtained directly by the Mexican resident and must be recognised, for tax purposes, when it is accrued by the foreign controlled company, not when it is effectively distributed to the Mexican corporation.

The same rule is applicable to income gained through fiscally transparent vehicles (whether they are characterised as an entity or otherwise), regardless of whether or not they are located in a low-tax jurisdiction.

6.6 Rules Related to the Substance of Non-local Affiliates

Under rules applicable to revenue obtained by Mexican residents from non-local affiliates subject to a preferential tax regime, the income of foreign affiliates engaged in an active trade or business may be exempted from CFC treatment.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Local corporations are taxed on gains on the sale of shares in their foreign affiliates, according to the rules explained in **2.7 Capital Gains Taxation**.

If the transfer of shares is part of a multinational group's restructure, the shares may be assigned without triggering income tax, as long as certain conditions provided by statute are met, as described in **5.4 Change of Control Provisions**.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

In 2020, a general anti-avoidance rule was introduced into Mexican legislation, according to which tax authorities will be entitled to deny tax benefits or even reclassify transactions and arrangements when taxpayers are not able to demonstrate their business reason and commercial substance.

A transaction or structure will be deemed to lack a business reason when the reasonably expected quantifiable economic benefit is lower than the tax benefit obtained, or when the reasonably expected economic benefit may be achieved through less legal acts, and the tax effects of such acts would have been more burdensome.

In this regard, a tax benefit is any reduction, elimination or temporary deferral of a contribution, including those arising from deductions, exemptions and non-subjection.

A reasonably expected economic benefit is deemed to exist when, among others, the taxpayer's transaction seeks to generate income, reduce costs, increase the value of goods and assets, or improve the taxpayer's position in the market.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no legal provision that establishes a regular routine audit cycle for taxpayers.

However, in the past two years, tax authorities have focused their efforts on high-income taxpayers to review the compliance of their tax obligations and carry out audits.

A new rule entered into force in 2021, according to which Mexican tax authorities will make public the parameters of what they consider reasonable profit margins, deductions and effective tax rates for each economic sector.

If the tax authorities consider that a taxpayer does not comply with said parameters, they will issue a notice addressed to the managers, directors or legal representatives, informing them of said situation.

Although SAT's parameters are not mandatory and the aforementioned notice is not a formal audit, it is foreseeable that audits will be carried out against the companies that do not comply with the parameters issued by the authorities.

9. BEPS

9.1 Recommended Changes

In recent years, Mexico has included the following BEPS recommendations in its domestic legislation:

- reporting standards for Mexican corporations regarding transactions with foreign related parties. This includes the obligation to submit a local report, a master report and a country-by-country report;
- a general anti-avoidance rule, as described in **7.1 Overarching Anti-avoidance Provisions**;
- limitations on the deduction of interest, as explained in **2.5 Imposed Limits on Deduction of Interest**;
- limitations on the deduction of payments made to related parties resident in low-tax jurisdictions, or hybrid instruments, as described in **5.6 Deductions for Payments by Local Affiliates**; and
- mandatory disclosure rules, regarding potentially aggressive structures, for tax advisers and taxpayers.

9.2 Government Attitudes

The general attitude of the Mexican government is to adopt as many BEPS recommendations as possible.

The specific target of the Mexican Tax Administration Service is to increase the collection of taxes, without making a substantial legal reform, by limiting Mexican taxpayers' ability to implement aggressive tax planning strategies and structures.

As the rules described in **9.1 Recommended Changes** are relatively new in Mexican legislation, there is not yet any specific knowledge or practical experience on how authorities will implement such mechanisms to audit taxpayers.

9.3 Profile of International Tax

In recent years, Mexican authorities have become aware of the need to prevent tax avoidance carried out through cross-border transactions, specifically among related parties and in light of transfer pricing obligations.

Therefore, it is likely to see an intensive implementation of BEPS recommendations in legal amendments but also in audit procedures in the future.

9.4 Competitive Tax Policy Objective

Mexico does not have a comprehensive competitive tax policy. On the contrary, the tendency in recent years has been to increase tax rates for individuals and corporations. As previously explained, the implementation of additional instruments such as BEPS recommendations (but not limited to them) to enforce tax legislation and increase taxpayers' burden and collection have been brought forward.

9.5 Features of the Competitive Tax System

As mentioned in **9.4 Competitive Tax Policy Objective**, Mexico does not have a competitive tax system.

9.6 Proposals for Dealing with Hybrid Instruments

To date, the only provision in Mexican legislation regarding hybrid instruments is the limitation of the deduction of payments made to related parties resident abroad. In such cases and due to the existence of a hybrid instrument, the revenue is subject to a preferential tax regime.

It is foreseeable that legal reforms will enact provisions to deal with these kinds of mechanisms.

9.7 Territorial Tax Regime

Mexico does not have a territorial tax regime. Mexico has a worldwide income system for its residents.

9.8 CFC Proposals

Mexico does not have a territorial tax regime.

9.9 Anti-avoidance Rules

As the general anti-avoidance rule described in **9.1 Recommended Changes** is relatively new in Mexican legislation, there is not yet any specific knowledge or practical experience on how authorities will implement such mechanisms to audit taxpayers and, in turn, the impact on investors.

9.10 Transfer Pricing Changes

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and its amendments have already been adopted in Mexican legislation, so no major change is expected.

The taxation of profits from intellectual property is already covered by Mexican legislation, so no change is expected on that matter either.

9.11 Transparency and Country-by-country Reporting

Country-by-country reporting regarding transactions with related parties has already been included in domestic legislation.

9.12 Taxation of Digital Economy Businesses

As of 2020, digital services such as the download of audio-visual content and the intermediation in the sale of goods and the rendering of services are subject to VAT when such services are rendered to a Mexican resident.

Individuals who sell goods and render services through an intermediation app are taxed on their revenue at variable withholding rates, depending on the goods that are being sold or the services being provided.

Nevertheless, there is no serious discussion among public officers and legislators on how to tax profits generated in Mexico by digital economy businesses resident abroad.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Please see **4.1 Withholding Taxes** and **6.4 Use of Intangibles by Non-local Subsidiaries** for the relevant provisions regarding the taxation of foreign intellectual property deployed in Mexico.

Ortiz Abogados Tributarios is a Mexican law firm with more than 30 years of experience in tax law, covering comprehensive advisory, consultancy, litigation and alternative dispute resolution in tax controversies, regarding domestic and cross-border transactions. The firm is composed of four partners, two associates and two law clerks, and its offices are located in Mexico City. As a boutique firm, from the very beginning Ortiz Abogados has provided personalised, strategic and timely attention, regardless of the client's size or the case's complexity. The firm recently handled a complex transfer pricing controversy regarding a multinational company in the technology industry, which was resolved through a mediation mechanism before the Mexican Taxpayers' Rights Defence Agency.

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Trends and Developments

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The Reportable Schemes Regime in Mexico and Its Implications

As part of the numerous legislative reforms instigated by Mexico's incorporation as a member State of the Organisation for Economic Co-operation and Development (OECD) in 1994, as well as a bolder intention to combat tax avoidance, tax havens, hybrid schemes and other mechanisms soundly described in the Base Erosion and Profit Shifting (BEPS) Actions, the Mexican legislative branch has taken measures to incorporate many recommendations made by the OECD in order to combat these schemes that pose a great challenge for tax authorities worldwide.

One such measure is the incorporation of reportable schemes into the Mexican legal system. This reform entered into force on 1 January 2020, and reportable schemes are now part of the vast array of taxpayers' obligations. The reform also imposes obligations on the new legal concept of "Tax Advisers", which are obliged to comply with certain provisions related to reportable schemes. As of 1 January 2021, Tax Advisers are now obliged to disclose reportable schemes.

This article will guide the interested reader through this new set of rules, which are undoubtedly relevant to doing business in Mexico and to companies with third related parties abroad. In this sense, the main aim here is not to criticise the content of the reform, but rather to draw a useful map to navigate through this sea of provisions.

Origin of the Reportable Schemes Reform

As a preliminary matter, it is important to examine the incorporation of this new set of rules into the Mexican legal system.

The reform of the provisions of the Federal Tax Code (FTC) was based on the Final Report of Action 12 of the BEPS Project. It includes implementing rules like those in the United Kingdom, specifically the Disclosure of Tax Avoidance Schemes (DOTAS).

In this sense, one of the motivations of the Mexican legislative branch to include this new set of rules is that these obligations have been proved to provide pertinent information on tax elusion structures and schemes, which has led to the implementation of legislation intended to avoid the operation of these structures before they incur any significant loss of tax revenue for the State.

Similarities with the UK's DOTAS regime

The rules for the disclosure of reportable schemes in the United Kingdom depend directly on the nature of taxes – specific sets of rules are applicable for direct and indirect taxes.

There are three different disclosure regimes in the United Kingdom designed to combat tax avoidance:

- the VAT disclosure regime (VADR);
- the Disclosure of Tax Avoidance Schemes: VAT and other indirect taxes (DASVOIT); and
- Direct taxes (including Apprenticeship Levy) and National Insurance contributions (DOTAS).

The UK's legal system provides a comprehensive regime depending on the formal classification of taxes, as opposed to the generic disclosure regime provided in the FTC. Therefore, this article will refer only to the DOTAS regime, as the Mexican reportable schemes regime is predominantly related to direct taxes (Income Tax), specifically in the rules that determine the characteristics of a reportable scheme, and those related to the subjects obliged to disclose it.

Subjects obliged to disclose

There are different categories to determine whether or not a person is obliged to disclose a scheme; this is another distinctive point with respect to the Mexican FTC regime. While the FTC only recognises the categories of "Tax Adviser"" and "Obliged Tax Adviser", the DOTAS regime sets forth the classifications of "Scheme promoter", "Scheme introducer" and "Scheme designer".

Characteristics of reportable schemes

The DOTAS regime provides for several tests to determine whether a scheme should be disclosed, with the main tests being:

- the benign test;
- the non-adviser test; and
- the ignorance test.

In the definition of the "Scheme designer" – which is transposed into the Mexican legislation as the "Tax Adviser" – it is mandatory for a person to fulfil the criteria set forth by at least one of these tests.

Similarities between the DOTAS regime and the FTC
As previously noted, there are distinctive points between the DOTAS rules and the FTC. There are also certain similarities in the characterisation of a scheme that should be disclosed, and in the criteria to determine whether a person is obliged to disclose a scheme.

The three main tests provided in the DOTAS regime respond to specific hypotheses related to the residence of the person involved in the design, development or implementation of a scheme – depending on the specific circumstances in which a scheme is detected, a special test will be applicable.

Furthermore, the subsidiary responsibility for the taxpayer to disclose a scheme is a critical match point that has been adopted into the Mexican legislation in Article 198 of the FTC.

Action 12 of the OECD BEPS Project
The 2015 Final Report on Mandatory Disclosure Rules by the OECD is the most widely regarded source for States willing to implement such provisions into their domestic legislation. BEPS Action 12 provides the key pieces needed to create an effective disclosure system in order to combat and prevent aggressive tax planning, and to deter the abuse of double taxation treaties in cross-border transactions.

According to BEPS Action 12, the key design features of a mandatory disclosure regime include the following:

- who reports;
- what information to report;
- when the information has to be reported; and
- the consequences of non-reporting.

The main objective of mandatory disclosure regimes is to increase transparency by providing early information regarding potentially aggressive or abusive tax planning schemes to the tax administrations, facilitating the identification of the promoters and users of those schemes. This view is completely shared by the Mexican legislative branch in the text of the Initiative for Reform of the FTC.

Ostensibly, the Mexican legislation follows – almost by the book – the key design principles of mandatory disclosure regimes. This is clear from the ratio legis of the reform that introduced the reportable schemes obligations into the FTC and from the legal framework surrounding the subjects obliged to disclose, what needs to be disclosed and the consequences of non-disclosure.

De minimis filter
The de minimis filter is a tool that can be used as an alternative or in addition to a broader threshold test that could operate to remove smaller transactions.

There is express reference to this filter in the ratio legis of the reform that incorporates the reportable schemes regime into the FTC, but the enforceable legislative text of the FTC does not provide the content of such filter. However, on 2 February 2021, the Mexican Treasury published Ordinance 13/2021 (the Ordinance) in the Federal Official Gazette, establishing the threshold of tax benefits that must be obtained by a taxpayer in order to trigger the new obligation to disclose reportable schemes, in accordance with the FTC.

Pursuant to Article 199 of the FTC, the Treasury would publish the minimumu amounts needed for the new obligation to apply.

According to the Ordinance, personalised schemes that do or could generate a tax benefit that does not exceed MXN100 million (approximately USD49 million) need not be disclosed under the provisions of the FTC.

This is a key point to bear in mind when doing business in Mexico. For instance, if a corporate restructure is required, such schemes will be reportable if such transactions fall within the scope set forth by the Ordinance.

However, this exception is not applicable to personalised schemes that avoid the exchange of tax and financial information between foreign and Mexican authorities, regardless of the amount of tax benefit that is obtained or that is expected to be obtained.

Likewise, it is important to note that personalised schemes that involve the same taxpayer and are set to be implemented in at least one tax year in common shall be considered jointly for the purposes of calculating the MXN100 million threshold.

Legal Scope of the Reportable Schemes Regime in Mexico
The mandatory disclosure regime entered into force for taxpayers on 1 January 2020. However, as previously mentioned, as of 1 January 2021, Tax Advisers are obliged to comply with the disclosure provisions set forth in the FTC.

Additionally, pursuant to the Eighth Transitory Article Section II of the FTC, the reportable schemes to be disclosed are those that are designed, commercialised, organised or implemented from 2020, or prior to such year when any of the tax effects thereof are reflected in the fiscal years that follow 2020. In this case, taxpayers are solely responsible for disclosing such schemes.

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Subjects obliged to disclose: the Tax Adviser

The concept of "Tax Adviser" as defined in Article 197 of the FTC is relevant to understanding the subjects obliged to disclose a reportable scheme.

The following two requisites need to be fulfilled in order for a natural or legal person to be deemed a Tax Adviser:

- such person carries out activities of tax consulting in the ordinary course of its activities (although the FTC does not define the term "tax consulting"); and
- such person is responsible for – or is involved in the design, commercialisation, organisation or implementation of – the totality of a reportable scheme, or places such reportable scheme for its implementation through a third party.

Furthermore, in accordance with the first paragraph of Article 197 of the FTC, the scope of application of the obligation to disclose reportable schemes is limited to those persons that are considered Tax Advisers.

If these criteria are not met, a person cannot be considered a Tax Adviser and, consequently, would not be obliged to comply with the provisions set forth in Chapter One Title Six of the FTC (the mandatory disclosure regime).

Characteristics of reportable schemes

The reportable schemes regime defines a scheme as "any plan, project, proposal, consulting, instruction or recommendation disclosed in an express or tacit way with the object of materialising a series of juridical acts." A reportable scheme is defined as "any scheme that generates or may generate, directly or indirectly, the obtention of a fiscal benefit in Mexico" and has any of the characteristics established in Article 199 of the FTC.

In addition, there is a subsequent subdivision with respect to generalised and personalised reportable schemes.

Generalised schemes are "those intended to be commercialised in a massive way to any kind of taxpayer or to a specific group of them and, although they require a minimum or null adaptation to be suited to the specific circumstances of the taxpayer, the way to obtain the fiscal benefit is the same", whereas personalised schemes are "those which are designed, commercialised, organised, implemented or administered to the particular circumstances of a specified taxpayer."

The disclosure obligations are only applicable to the latter; therefore, there could be schemes that generate a fiscal benefit but are not deemed reportable due to lacking the characteristics provided in Article 199 of the FTC – for instance, schemes where an undue transfer of tax losses occurs, structures that avoid the settlement of a permanent establishment in Mexico, or a transfer of intangible assets that lacks a trustworthy comparison.

Thus, it does not suffice that such scheme generates a fiscal benefit in Mexico: it must also contain any of the characteristics provided in Article 199 of the FTC.

Taxpayers' subsidiary responsibility to disclose

Pursuant to Article 197 of the FTC, the first subjects obliged to disclose reportable schemes are the Tax Advisers. Nonetheless, the six hypotheses contained in Article 198 of the FTC establish a subsidiary responsibility for taxpayers to reveal such schemes, including the hypothesis in which the Tax Adviser does not provide the non-reportable certificate to the taxpayer, or when the taxpayer obtains a fiscal benefit through a reportable scheme that has been designed or implemented by a person that is not deemed a Tax Adviser in terms of Article 197 of the FTC.

Therefore, Article 198 foresees that a reportable scheme could be disclosed by the taxpayer rather than the Tax Adviser.

The non-reportable certificate

Even when a Scheme is non-reportable because it does not contain any of the characteristics listed in Article 199 of the FTC, the Tax Adviser is still obliged to issue a non-reportable certificate to the taxpayer, justifying the reasons for the scheme being non-reportable.

Pursuant to Article 198, Section I of the FTC, the legal consequence of failing to issue a non-reportable certificate is the recharacterisation of the scheme as being reportable.

Consequences of the Failure to Comply with these Provisions

In accordance with Articles 82-A, 82-B, 82-C and 82-D of the FTC, if the Tax Adviser does not disclose a reportable scheme, or if a scheme is incompletely disclosed, the fines applicable range from MXN50,000 (USD2,451) to MXN20 million (USD980,000).

If the taxpayer does not comply with these obligations, sanctions range from MXN50,000 (USD2,451) to MXN2 million (USD98,000).

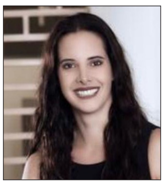
In both cases, sanctions will be applicable for each reportable scheme that was not disclosed.

Furthermore, the information obtained by the Mexican Tax Authority through the disclosure of reportable schemes cannot be used in the instigation of criminal proceedings. However, if a scheme involves the utilisation or structure of forged digital fiscal invoices (CFDI), such information can be used for criminal investigations carried out by the competent authorities in Mexico.

Finally, reportable schemes shall be disclosed online in the official website of the Mexican Revenue Service (SAT), which is currently available to the public.

SMPS Legal is a boutique law firm with regional expertise, formed by experienced and specialised lawyers who are committed to offering multidisciplinary legal counsel. SMPS Legal's Tax Practice is divided into tax consulting and tax litigation and provides all tax-related services in sophisticated and complex transactions. The team is uniquely qualified and fully integrated as a consulting and litigation tax practice, where the three head partners and eight associates help clients to take a different approach when documenting their operations and interacting with the tax authorities, to avoid unnecessary confrontations, and also provide solid litigation strategies when needed. The firm also advises on possible scenarios that might result in tax litigation. SMPS Legal has offices in Calgary, Dallas, Mexico City and Bogotá, and alliances with prominent firms in Brazil, Argentina, Costa Rica, Panama, Peru and other Latin American countries to best serve its clients.

Authors



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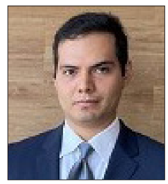

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NETHERLANDS

Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Large businesses in the Netherlands typically carry out their activities via a limited liability company (*besloten vennootschap* or BV) or – to a lesser extent, typically in the case of a listed company – via a public limited company (*naamloze vennootschap* or NV) or a no-liability co-operative (*coöperatieve UA*). Each of these legal forms has legal personality so that the entity can own assets in its own name and the shareholders (membership right-holders in the case of a co-operative) as a starting point cannot be held personally liable for corporate obligations.

A BV, NV and co-operative are separate taxpayers for Dutch corporate income tax purposes.

1.2 Transparent Entities

In the Netherlands, tax transparent entities that are typically used are a limited partnership (*commanditaire vennootschap* or CV), a general partnership (*vennootschap onder firma* or VOF) and a fund for joint account (*fonds voor gemene rekening* or FGR). Each of these legal forms lacks legal personality and should be considered as a contractual business arrangement.

As a VOF is tax transparent, it is not a taxpayer for Dutch corporate income tax purposes. Instead, the underlying participants are taxed for their participation in a VOF. Distributions by a VOF are not subject to Dutch dividend withholding tax.

With respect to a CV and an FGR, the Dutch corporate income tax treatment depends on whether it is considered open or closed. An open CV/FGR is subject to Dutch corporate income taxation as such, whereas in the case of a closed CV/FGR, the underlying participants are taxable for the income derived from their interest in the CV/FGR. A CV or FGR is closed if all limited and general/managing partners separately and upfront approve each accession, resignation or replacement of participants. Alternatively, an FGR is also considered closed if participations can exclusively be transferred to the FGR itself

Specific guidance is in place, by way of a Decree, to classify foreign vehicles (ie, non-transparent or transparent) for Dutch tax purposes. In that respect, it is, among others, also relevant whether the approval of (all the) other partners is required to transfer an interest. This guidance is currently being reviewed by the Dutch government, the results of which are expected to be published on short notice.

1.3 Determining Residence of Incorporated Businesses

For Dutch corporate income tax purposes (with the exception of certain provisions, such as the fiscal unity regime and the participation exemption), a BV, NV or co-operative is deemed to be a corporate income tax resident in the Netherlands (regardless of the place of effective management of the entity) if it is incorporated under the laws of the Netherlands (the "incorporation principle"). If a double tax convention is applicable that includes a tie-breaker rule and both treaty contracting states consider a company to be a resident of their state, typically the place of effective management of a company is conclusive for the place of residence for tax treaty purposes, which is the place where the strategic commercial and management decisions take place. Important elements for determining this place are, for example, the residency of board members and the location of board meetings.

In several treaties, the number of which is expected to increase due to the effect of the Multilateral Instrument to implement the OECD base erosion and profit shifting project (BEPS), if both treaty contracting states consider a company a resident of their state, the residency is determined on the basis of a mutual agreement procedure (MAP) between the two states.

1.4 Tax Rates

Corporate income taxpayers are subject to a corporate income tax rate of 25% (2021) with a step-up rate of 15% for the first EUR245,000 of the taxable amount. In 2022, the step-up rate is expected to be 15% for the first EUR395.000 of the taxable amount.

An individual who is a personal income tax resident of the Netherlands is liable for personal income taxation on their taxable income, including business income, at the following progressive rates (brackets and rates for 2021):

- EUR0 - EUR35,129: 9.45% tax rate, 27.65% social security rate, 37,10% combined rate;
- EUR35,129 – EUR68,507: 37.10% tax rate, 37.10% combined rate; and
- EUR68,508: 49.50% tax rate, 49.50% combined rate.

The social security rate applied to individuals who are retired is 9.75%, resulting in a combined rate of 19.20%. The official retirement age in the Netherlands will remain at 66 years and four months in 2021. From 2022, the retirement age will increase by three months and will reach 67 in 2024. After that, the retirement age will increase not by one year for every year that people live longer, but by eight months.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The business income of personal income taxpayers and corporate income taxpayers is determined on the basis of two main principles. The first is the at arm's length principle (which serves to establish the correct overall amount of profit as such, the *totaalwinst*) and the second is the sound business principle also known as sound business practice (*goed koopmansgebruik*, which serves to attribute the profit to the correct financial year, the *jaarwinst*), which have been shaped through extensive case law.

It should be noted that the Dutch fiscal concept of business income is, strictly speaking, independent of the statutory accounting rules. In practice, both regimes overlap to a certain extent.

Based on the at arm's length principle, a business income is adjusted as far as it is not in line with it. Thus, both income and expenses can be imputed in a group context for Dutch tax purposes regardless of the statutory or commercial accounting. For corporate income taxpayers this can result in informal capital or hidden dividends. A legislative proposal likely will be sent to the Dutch parliament in 2021 that will deny the deduction of at arm's length expenses, to the extent that the corresponding income is not taxed at the level of the recipient. The legislative proposal is intended to enter into force as per 1 January 2022.

2.2 Special Incentives for Technology Investments

Two main tax incentives exist.

Firstly, the innovation box that, subject to certain requirements, taxes income in relation to qualifying income from intangible assets against an effective tax rate of 9% instead of the statutory rate of 25%. The regime has been amended as of 1 January 2017 among others to reflect that only R&D activities that take place in the Netherlands are eligible for the beneficial tax treatment (eg, Nexus Approach). Qualifying intangible assets are R&D activities for which a so-called R&D certificate has been issued or that have been patented (or application to this effect has been filed). Software can also qualify as an intangible asset.

Secondly, the wage withholding tax credit, which allows employers to reduce the amount of wage withholding tax that has to be remitted to the tax authorities with 40% up to an amount of wage expenses in relation to R&D activities of EUR350,000 and 16% for the remainder (2021). The wage withholding tax credit for start-up entrepreneurs is, under certain conditions, 50% up to an amount of wage expenses in relation to R&D activities of EUR350,000 (2021).

In addition, special tax incentives apply to stimulate sustainability. For example, businesses that invest in energy-efficient assets, technologies or sustainable energy may benefit from the Energy Investment Allowance (*Energie Investerinsgaftrek* or EIA). As to environmentally sustainable investments, the Environment Investment Allowance (*Milieu Investerinsgaftrek* or MIA) and the Arbitrary Depreciation of Environmental Investments (*Willekeurige afschrijving milieubedrijfsmiddelen* or VAMIL) may apply.

2.3 Other Special Incentives

Shipping companies can apply for the so-called tonnage tax regime, whereby essentially the income from shipping activities is determined on the basis of the tonnage of the respective vessel, which should result in a low effective corporate income tax rate. Qualifying income from shipping activities is, for example, income earned with the exploitation of the vessel in relation to the transportation of persons and goods within international traffic, the transportation of persons and goods in relation to natural resources, and pipe and cable laying.

Currently, various measures haven been taken by the Dutch government in view of the COVID-19 crisis, such as a relaxation of payment of taxes and requirements to be met to apply certain tax facilities as well as the possibility to create a so-called corona tax reserve.

2.4 Basic Rules on Loss Relief

As a starting point, taxable losses can be carried back one year and carried forward six years. Losses that are incurred in years before 2019 can be carried forward for nine years. A transitional rule to regulate the effects of the changes applies to losses incurred in the years 2017-20.

Specific anti-abuse rules have to be observed. Anti-abuse rules may apply in some cases due to which losses cease to exist in the case of a substantial change of the ultimate ownership of the shares in a company that suffered the tax losses. For financial years starting on or after 1 January 2019, the so-called holding and financing losses regime has been abolished. Until that date, such losses are ring-fenced and can only be offset against holding and financing income.

From 1 January 2022, tax loss carry-forwards are expected to be limited to 50% of the taxable income exceeding EUR1 million for that year. At the same time the current six year tax loss carry forward period is expected to be abolished so that tax losses can be carried forward indefinitely (but limited to 50% of the taxable income in a financial year).

2.5 Imposed Limits on Deduction of Interest

As a starting point, at arm's length interest expenses should in principle be deductible for Dutch corporate income tax purposes. A remuneration only classifies as "interest" if the financial instrument is considered "debt" for tax law purposes. In addition, a number of interest deduction limitation rules have to be observed to determine if interest expenses are deductible in the case at hand. The most important rules are detailed below.

- If a loan agreement economically resembles equity (for example, since the loan is subordinated, the interest accrual is dependent on the profit and the term exceeds 50 years), the loan may be requalified as equity for Dutch corporate income tax purposes, due to which the interest would be requalified into dividend, which is not deductible.
- If a granted loan is considered to be a non-business like loan (*onzakelijke lening*) from a tax perspective, it may effectively result in limitation of deductible interest because of a possible (downward) adjustment of the applied interest rate for Dutch tax purposes.
- Interest expenses due on a loan taken on from a group company that is used to fund capital contributions or repayments, dividend distributions or the acquisition of a shareholding may under circumstances not be deductible. With retroactive effect to 1 January 2018, this provision applies to companies included in a fiscal unity (ie, a Dutch tax group) as if no fiscal unity has ever existed.
- Interest expenses due on loans taken on from a group company should not be deductible if the loan has no fixed maturity or a maturity of at least ten years, whilst de jure or de facto no interest remuneration or an interest remuneration that is substantially lower than the at arm's length remuneration has been agreed upon.
- For financial years starting on or after 1 January 2019, as part of the implementation of the EU Anti-Tax Avoidance Directive (ATAD) the deduction of interest expenses is limited to 30% of a taxpayers EBITDA (so-called earnings stripping rules).
- As of 1 January 2020, the so-called ATAD 2 is effective; the rule that targets reverse hybrid mismatches will be effective as from 1 January 2022. ATAD 2 aims in principle to neutralise hybrid mismatches resulting in mismatch outcomes between associated enterprises (ie, in short, situations with a double deduction or a deduction without inclusion).
- For Dutch corporate income tax purposes, interest deductions for banks and insurers are limited in case, in short, the debt financing (*vreemd vermogen*) exceeds (in 2021) more than 91% of the total assets. In other words, banks and insurers are under the proposed legislation required to have a minimum level of equity capital in place of 9% to stay out of scope of the proposed interest deduction limitation rule. The equity ratio is determined on December 31st of the preceding book year of the taxpayer.

2.6 Basic Rules on Consolidated Tax Grouping

For Dutch corporate income tax purposes, corporate taxpayers that meet certain requirements can form a so-called fiscal unity. The key benefits of forming a fiscal unity are that losses can be settled with positive results within the same year (horizontal loss compensation) and one corporate income tax return should be filed that includes the consolidated tax balance sheet and profit and loss account of the entities consolidated therein. The main requirements for forming a fiscal unity are that a parent company should own 95% of the legal and economic ownership of the shares in a given subsidiary.

Moreover, the Dutch tax legislator has newly responded to the obligations following from further EU case law to arrive at an equal tax treatment of cross-border situations when compared to domestic situations by means of limiting the positive effects of the fiscal unity in domestic situations (instead of extending those positive effects to cross-border situations). Mostly with retroactive effect to 1 January 2018, several corporate income tax regimes (ie, various interest limitation rules, elements of the participation exemption regime and anti-abuse rules in relation to the transfer of losses) are applied to companies included in a fiscal unity (ie, a Dutch tax group) as if no fiscal unity has ever existed. This emergency legislation should be followed up by a new, future-proof, Dutch tax group regime that is expected to replace the current regime in several years time.

There has been a public consultation with respect to the new, future-proof, Dutch tax group regime and the alternatives are still under review. The Dutch government has announced that they will further investigate the possible alternatives in 2021, and it is expected that the current regime will remain in place for the next couple of years.

2.7 Capital Gains Taxation

Capital gains (as well as capital losses) realised on assets of a Dutch corporate income taxpayer are considered taxable income that is taxable at the statutory tax rate, unless it concerns a capital gain on a shareholding that meets all the requirements to apply the participation exemption. Based on the participation exemption, capital gains and dividend income from qualified shareholdings are fully exempt from the Dutch corporate income tax base.

Essentially, the participation exemption applies to shareholdings that amount to at least 5% of the nominal paid-up capital of the subsidiary, whose capital is divided into shares whilst these shares are not held for portfolio investment purposes. The latter should generally be the case if a company has substantial operational activities and no group financing or group leasing activities are carried out, or a company is sufficiently taxed with a profit-based tax.

In relation to the application of the Dutch participation exemption by Dutch intermediary holding companies with no/low substance, it is being investigated by the Dutch government whether as per 2022 legislation can be introduced to enable the exchange of information with other jurisdictions.

Liquidation Loss

Under the former rules, a shareholder that held at least 5% of the shares in a Dutch company was allowed to deduct a so-called liquidation loss, upon the completion of the dissolution of such company and provided certain conditions were met. This liquidation loss broadly equals the total capital invested in that company by the shareholder minus any liquidation proceeds received. As of 1 January 2021, additional requirements (ie, on top of the existing requirements) need to be met to be able to deduct liquidation losses exceeding the threshold of EUR5 million.

These additional requirements among others relate to the residence of the liquidated company (which – in short – should be within the EU/EEA) and the fact that the Dutch shareholder of the liquidated company must have decisive control to influence the decision making of the company that is liquidated.

2.8 Other Taxes Payable by an Incorporated Business

Enterprises, be it transparent or opaque, may become subject to value added tax (VAT) when selling services or goods in the Netherlands.

Real estate transfer tax (RETT) at a rate of 8% should, in principle, be due upon the transfer of real estate or shares in real estate companies. For residential real estate a rate of 2% applies and, as of 2021, this rate can only be applied by individuals. As a result of the foregoing real estate investors no longer can apply the 2% rate. As of 2021, there is a RETT exemption for "starters"(ie, persons in the age of 18 to 35 buying their first primary residence).

2.9 Incorporated Businesses and Notable Taxes

The transfer of shares in companies that predominantly own real estate as portfolio investment may, under certain conditions, become taxable with 8% RETT.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Typically, but not always, only small businesses and self-employed entrepreneurs (partially including *zelfstandigen zonder personeel* or ZZP) operate through non-corporate forms whilst medium and large businesses operate their activities via one or more legal entities (eg, BVs).

3.2 Individual Rates and Corporate Rates

There are no particular rules that prevent individual professionals from earning business income at corporate rates. For tax purposes, an individual is free to conduct a business through a legal entity or in person. However, despite the legal and tax differences between those situations, the effective tax burden on the business income will often largely align. The combined corporate income tax rate and the personal income tax rate for substantial shareholders almost equals the personal income tax rate for individuals.

Broad Balance Between Taxation of Incorporated and Non-incorporated Business Income

Under the current substantial shareholding regime (that roughly applies to individuals holding an interest in a company of at least 5% of the share capital), dividend income (as well as capital gains) is subject to 26.90% personal income taxation (2021). The corporate income taxation on the underlying profit currently amounts to 15% for the first EUR245,000 and 25% beyond that. This leads to a combined effective tax rate of approximately 45.18% (2021).

The top personal income tax rate amounted to 49.50% at the time of writing in 2021 (and applying to a taxable income exceeding EUR68,508). Due to the application of several exemptions for individuals earning non-incorporated business income, the effective tax rate is substantially lower.

3.3 Accumulating Earnings for Investment Purposes

It is mandatory for substantial shareholders to earn a minimal salary from the BV of which they are a substantial shareholder to avoid all earnings remaining undistributed and due to which the substantial shareholder may unintendedly benefit from social security benefits. In principle, the mandatory minimum salary amounts to the highest of 75% of the salary of the most comparable job, the highest salary earned by an employee of a company or a related entity, or EUR47,000 (2021).

If it can be demonstrated that the highest amount exceeds 75% of the salary of the most comparable job, the minimum salary is set to 75% of the salary of the most comparable job, with a minimum of EUR47,000 (2021).

3.4 Sales of Shares by Individuals in Closely Held Corporations

Typically, individuals can conduct business activities in person or as a substantial shareholder of a legal entity (eg, a BV). In the case of business activities that are carried out in person (either alone or as a participant in a tax transparent partnership), the net result of the enterprise is taxed with Dutch personal income taxation at a top rate of 49.50% in 2021, to the extent the amount of taxable profits exceeds EUR68,507. Note, however, that a base-exemption of 14% (2021) applies, which lowers the effective tax rate. The gain upon the transfer of the enterprise (eg, the transfer of the assets, liabilities and goodwill) is also taxable at the same rates as regular profits.

Where business activities are carried out via a BV, the shares of which are owned by substantial shareholders, the business income is subject to corporate income taxation. To the extent that the profit after tax is distributed to a substantial shareholder in the Netherlands, 26.90% personal income taxation is due. A capital gain realised by a substantial shareholder is also taxable at the rate of 26.90% in 2021.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividend income that is not considered part of business income and is received by individuals that do not qualify as a substantial shareholder (essentially being a shareholder not being an entrepreneur and that holds at least 5% of the shares in a company) is not taxed as such. Rather, the income from portfolio investments (including portfolio dividend) is deemed to be in the range of effectively, 1.90% to 5.69% in 2021 of the fair market value of the underlying shares (and other investments held by the taxpayer) minus debts owed by it. This deemed income is taxable income at a rate of 31% to the extent net value of the underlying shares exceeds the exempt amount of EUR50,000 (2021).

For completeness sake, it has been announced that the current tax regime for income received by individuals that do not qualify as a substantial shareholder will be reformed in the near future. It has been indicated that taxing the actual return on the investment (instead of a deemed income) is the ultimate goal. Please note that no proposal has been published yet.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

The Netherlands has a withholding tax on dividends that, in principle, taxes dividends at a rate of 15%. Based on the EU Parent-Subsidiary Directive, a full exemption should be applicable for shareholders (entities) with a shareholding of at least 5%, subject to certain requirements (see also further below). If all requirements are met, under Dutch domestic law, a full exemption should also be available if the shareholder is a resident of a state with which the Netherlands has concluded a double tax treaty, even in cases where the double tax treaty would still allow the Netherlands to levy dividend withholding tax. An exemption is only available if the structure or transaction is not abusive and is entered into for valid commercial business reasons.

For completeness sake, it should be noted that in 2020 (possibly with retroactive effect to September 2020) an initiative legislative proposal for a conditional final dividend withholding tax levy emergency act has been proposed. The proposal introduces a taxable event (ie, a DWT exit levy) in case of, for example, a cross-border relocation of the (corporate) tax seat or a cross-border merger of a Dutch company, provided certain conditions are met. The proposal is not expected to cover situations in which can be relied on the domestic withholding exemption (*inhoudingsvrijstelling*) of the Dutch dividend withholding tax act. Due to the general elections to be held in 2021 it remains to been seen if, and to what extent, this proposal may become effective.

Conditional Witholding Tax

The Dutch government has the intention to introduce a conditional withholding tax (of 25%) on dividends as of 1 January 2024, which aims to prevent profit distributions to so-called low-tax-jurisdictions (in short, jurisdictions which have a statutory corporate income tax rate of less than 9% or countries which are included in the EU list of non-cooperative jurisdictions). The proposal is still pending, and it remains to be seen if, and to what extent, the proposal will be enacted after the general elections of 2021. As of 1 January 2021, a conditional withholding tax has been implemented on interest and royalty payments made to related entities in so-called "low tax jurisdictions" and in abusive situations. The low tax jurisdictions are listed in a ministerial decree, ie jurisdictions:

- with a profit tax applying a statutory rate of less than 9% (updated annually based on an assessment as per 1 October of the year prior to the tax year); or
- included on the EU list of non-cooperative jurisdictions.

The tax rate is equal to the corporate income tax rate (ie, 25%). The payer and payee of the interest and royalties are considered to be related in case of a "qualifying interest" (a qualifying interest generally being an interest that provides a controlling influence on the decision-making and activities).

4.2 Primary Tax Treaty Countries

The largest foreign investor in the Netherlands is the United States, respectively followed by the Luxembourg, the United Kingdom, Switzerland and Ireland. The Netherlands has concluded double tax treaties with all these countries.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

So far the Dutch tax authorities have not in general challenged the use of treaty country entities by non-treaty country residents. Only in the case, for example, where specific anti-conduit rules are breached will the tax authorities challenge such a structure.

Targeting Abuse

It should be noted, though, that in light of the ongoing international public debate on aggressive international tax planning in the context of the G20/OECD, the Inclusive Framework on BEPS and recent case law of the ECJ, the Dutch tax authorities are increasingly more closely monitoring structures and investments and will target those that are perceived as constituting "abuse". In this respect, the importance of business motives, commercially and economic considerations and justification and relevant substance seems to be rapidly increasing.

From 1 January 2020, the presence of substance will only play a role in the division of the burden of proof between the taxpayer and the tax authorities. If the substance requirements are met, this will lead to the presumption of "non-abuse"' which is respected, unless the tax authorities provide evidence to the contrary. If the substance requirements are not met, the taxpayer is allowed to provide proof otherwise that the structure at hand is not abusive. See **6.6 Rules Related to the Substance of Non-local Affiliates**.

Furthermore, the Netherlands, a member of the Inclusive Framework and a party to the Multilateral Instrument, agrees to the minimum standards included in Articles 6 and 7 of the Multilateral Instrument, that amongst others prohibit the use of a tax treaty by – effectively - residents of third states.

The Dutch government aims to discourage the use of so-called letterbox companies (ie, companies with no or very limited activities that add no real value to the real economy). As part of this policy, amongst others, Dutch tax authorities are increasingly more closely monitoring that companies that claim to be a resident of the Netherlands can indeed be considered as such based on their substance.

4.4 Transfer Pricing Issues

The Dutch tax authorities strictly apply the at arm's length principle as included in Dutch tax law, in Article 9 of most double tax treaties and elaborated on in the Organisation for Economic Co-operation and Development's Transfer Pricing Guidelines, as amended under BEPS. Therefore, transactions between affiliated companies should be at arm's length, whilst proper documentation should be available to substantiate the at arm's length nature of the transactions.

4.5 Related-Party Limited Risk Distribution Arrangements

The Dutch tax authorities scrutinise that, where a remuneration is based on a certain (limited risk) profile (eg, limited risk distributor), the services and risks of that company indeed match the remuneration. For example, if a limited risk distributor has in fact a stock risk, the remuneration should be increased to reflect a remuneration for that risk.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Netherlands generally follows the Organisation for Economic Co-operation and Development's Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are, in some cases, resolved through an MAP process. At the end of 2019 there were 276 MAPs outstanding, 105 of the in total 276 MAPs are international transfer pricing disputes. In 2019 179 MAPs were closed and 51 of those were international transfer pricing disputes. There is no data with respect to international transfer pricing disputes being resolved through double tax treaties. Generally, the Dutch tax authorities are open to MAPs and willing to cooperate in these procedures.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally speaking, if a transfer pricing claim is settled, the Dutch tax authorities act in accordance with the settlement. Hence, if a downward adjustment of the Dutch income has been agreed, it will in principle be allowed. A legislative proposal however likely will be sent to the Dutch parliament in 2021 that will deny the deduction of at arm's length expenses, to the extent that the corresponding income is not taxed at the level of the recipient. The legislative proposal is intended to enter into force as per 1 January 2022.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations
Local branches (permanent establishments in fiscal terms) are generally taxed on the basis of the same rules and principles as subsidiaries of non-local corporations. However, due to the fundamental difference between a permanent establishment and a legal entity, in practice differences may occur.

5.3 Capital Gains of Non-residents
Dutch tax law includes so-called substantial shareholding rules that enable taxation of capital gains on shareholdings realised by non-residents of the Netherlands in the case of abuse. Based on the current domestic tax rules, capital gains are taxable if a shareholder holds an interest of at least 5% of the capital in a Dutch BV with the main purpose, or one of the main purposes, being to avoid personal income taxation and the structure should be considered artificial, not being created for legitimate business reasons that reflect economic reality.

In the case where the shareholder is a resident in a country with which the Netherlands has concluded a double tax treaty, depending on the content of the specific treaty, the Netherlands may be prohibited from levying capital gains taxation.

5.4 Change of Control Provisions
The change of control due to the disposal of shares by a holding company at a tier higher in the corporate chain (eg, above the Netherlands) as such should not trigger corporate income taxation. However, Dutch tax law includes anti-abuse rules that lead to the cancellation of tax losses in the case of the change of control of certain companies (that broadly speaking have or are going to have limited activities). See also **5.3 Capital Gains of Non-residents** in relation to capital gains realised on the (indirect) sale of shares in a related Dutch entity.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
The Netherlands typically does not determine the income of (foreign-owned) Dutch taxpayers based on formulary apportionment. Instead, the remuneration of the rendering of services or the sale of goods between related companies is governed by the at arm's length principle.

5.6 Deductions for Payments by Local Affiliates
As to the deduction of cross charges by foreign group companies to the Netherlands, the at arm's length principle is leading. For example, head office charges should be deductible by a Dutch corporate income taxpayer, provided the expenses are at arm's length. It should be noted that in some cases a mark-up is allowed. Cross-charged shareholder costs are not deductible.

5.7 Constraints on Related-Party Borrowing
Other than the interest deduction limitations discussed in **2.5 Imposed Limits on Deduction of Interest**, there are no other/specific rules that particularly constrain borrowings of a Dutch subsidiary from a foreign subsidiary as such.

As discussed in **4.1 Withholding Taxes**, a conditional withholding tax applies on interest and royalty payments to related entities in low tax jurisdictions and in abusive situations as of 1 January 2021.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
If a permanent establishment (PE) is recognised to which the assets, risks and functions that generate the foreign income can be allocated, the foreign income should in principle be fully exempt from the Dutch corporate income tax base. It should be noted that currency translation results between the head office and the PE are not exempt.

If certain conditions are met, a loss that a PE on balance has suffered may be deductible, provided (amongst others) that the losses are not utilised in any way in the PE state by the taxpayer (eg, the head office) or a related entity of the taxpayer. As of 2021, losses resulting from the dissolution of a PE in excess of EUR5 million are generally also limited to EU/EEA situations, quite similar to the rules that apply to participations.

6.2 Non-deductible Local Expenses
As a starting point, the income that is allocated to a PE is determined based on a functional analysis, taking into account the assets, risks and functions carried out by the PE. On the basis of the outcome of the functional analysis, expenses are allocated to the PE and are as such exempt (eg, non-deductible) from the Dutch corporate income tax base. Furthermore, in some cases, expenses charged by the PE to the head office in consideration for services provided to the head office by the PE may be ignored. Other than that, there are no specific rules due to which local expenses are treated as non-deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries
Dividend income distributed to a Dutch company is fully exempt if the participation exemption is applicable. The participation exemption should, broadly speaking, be applicable to shareholdings of 5% of the paid-up capital, divided into

shares, that are not held as a portfolio investment company. A shareholding should essentially not be held as a portfolio investment if the company has operational activities and has no substantial group financing or group leasing activities, or the company is taxed at an effective tax rate of at least 10% based on Dutch standards.

As mentioned, the Dutch government is currently investigating whether with regard to intermediary holding companies with no/low substance, legislation can be introduced in 2022 to enable the exchange of information with other jurisdictions.

6.4 Use of Intangibles by Non-local Subsidiaries

Group transactions in the Netherlands adhere to the at arm's length principle (including the amendments to the transfer pricing guidelines under the BEPS project, such as in relation to hard-to-value intangibles), so the use of locally developed intangibles by non-local subsidiaries should trigger Dutch corporate income taxation.

If the intangibles would be developed under the innovation box, the qualifying income (a capital gain or a licence fee) may be taxable against an effective tax rate of 9%.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

As part of the implementation of the EU Anti-Tax Avoidance Directive, the Netherlands introduced a controlled foreign companies (CFC) regime as per 1 January 2019.

Under a somewhat CFC-like rule, in the case of shareholdings of at least 25% in foreign companies that are not taxed reasonably according to Dutch standards and in which the assets of the company are portfolio investments or assets that are not related to the operational activities of the company, the shareholding should be revalued at fair market value annually. The gain recognised as a result thereof is subject to corporate income tax at the standard rates. See also **9.1 Recommended Changes**.

Assuming that passive activities lead to the recognition of a PE, the income that can be allocated to that PE should not be exempt as the object exemption is not applicable to low-taxed passive investments.

6.6 Rules Related to the Substance of Non-local Affiliates

In general, no specific substance requirements apply to non-local affiliates (except for the CFC rules). In a broader sense, low substance of non-local affiliates could trigger anti-abuse rules (eg, non-application of the participation exemption due to which inbound dividend income may be taxable, annual mandatory revaluation of low-substance participations against fair market value).

Furthermore, under certain corporate income tax and dividend withholding tax anti-abuse rules, shareholders of Dutch intermediary holding companies, subject to certain requirements, should have so-called relevant substance, including that shareholders must use an office space for at least 24 months that is properly equipped to perform holding activities and wage expenses of at least EUR100,000 should be incurred by the shareholder.

Abuse of EU Law

It must be emphasised that following the CJEU cases of 26 February 2019 on the EU Parent-Subsidiary Directive (PSD, joined cases C-116/16 and C-117/16) and on the Interest and Royalties Directive (IRD, joined cases C-115/16, C-118/16, C-119/16 and C-299/16), the Netherlands, being an EU member state, is obligated to target "abuse of EU law". The assessment whether a structure or investment must be considered "abusive" is made based on an analysis of all relevant facts and circumstances. There are no legal safe harbour or irrefutable presumptions.

Consequently, from 1 January 2020, the presence of substance will only play a role in the division of the burden of proof between the taxpayer and the tax authorities. If the substance requirements are met, this will lead to the presumption of "non-abuse" which is respected, unless the tax authorities provide evidence to the contrary. If the substance requirements are not met, the taxpayer is allowed to provide proof otherwise that the structure at hand is not abusive.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains derived from the alienation of a qualifying shareholding in a foreign company by a Dutch company are fully exempt from Dutch corporate income tax if the participation exemption is applicable.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Apart from specific anti-abuse rules, the Dutch Supreme Court has developed the doctrine of abuse of law (fraus legis) as a general anti-abuse rule. Under this rule, transactions can be ignored or recharacterised for tax purposes if the transaction is predominantly tax-driven and not driven by commercial considerations whilst the object and purpose of the law are being breached. So far, the Supreme Court has been reluctant to apply the doctrine in cases where a tax treaty is applicable.

As part of the implementation of the EU Anti-Tax Avoidance Directive, the legislator states that the doctrine of abuse of law (fraus legis) is very similar to the general anti-abuse rule included in the directive so that effectively no additional provision has to be included in Dutch law in this respect. As a consequence, the fraus legis doctrine must be interpreted in conformity with EU law in certain cases.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Netherlands has no periodic routine audit cycle. Tax audits are typically carried out at the discretion of the tax authorities. Tax audits are extraordinary in the sense that the Dutch tax inspector, upon the filing of the corporate tax return, has the opportunity to scrutinise the filed tax return, raise questions, ask for additional information and, if necessary, make an adjustment upon issuing a final assessment.

9. BEPS

9.1 Recommended Changes

Some of the developments that have taken place since the outcomes of the BEPS Project, in chronological order, include the following.

- Following the amendment of the EU Parent-Subsidiary Directive to counter abuse, the Dutch participation exemption regime has been amended, due to which, broadly speaking, dividend income is no longer exempt from the Dutch corporate income tax base if the dividend is deductible at the level of the entity distributing the dividend.
- On 12 July 2016 the Anti-Tax Avoidance Directive (ATAD 1 or the "Directive") was adopted by the European Council, obliging member states to adopt it ultimately by 31 December 2018 (subject to certain exceptions). To adopt ATAD 1, the Netherlands implemented on 1 January 2019, a rule essentially to limit interest expense deductions to 30% of EBITDA (earnings stripping rules) and a CFC regime. The earnings stripping rules are summarised as follows:
  (a) The earnings stripping rules limit the deduction of the balance of interest amounts to the highest of 30% of the adjusted profit (*gecorrigeerde winst*) or EUR1,000,000 (the Dutch government has announced that the percentage of 30 might be lowered in the future).
  (b) The Dutch earnings stripping rules are more restrictive than required under the Directive. Thus the Dutch regime will not include a so-called group exemption (that would allow a deduction exceeding 30% of the adjusted taxable profit to the extent that the group's overall debt level exceeds 30%), includes a EUR1 million threshold as opposed to the EUR3 million threshold included in the Directive and will also apply in standalone situations (ie, where the taxpayer is not part of a group; this rule was not included in the coalition agreement).
  (c) Finally we note that the Dutch government is currently investigating whether a budget neutral introduction of a deduction on equity, accompanied by the tightening of the Dutch earnings stripping rules in order to achieve a more balanced tax treatment of capital (equity) and debt.
- The Dutch CFC regime is summarised as follows.
  (a) The benefits derived from a controlled company are included in the taxable profit of the corporate income taxpayer, taking into account the interest held and the holding period. CFC benefits are defined as interest or other benefits from financial assets; royalties or other benefits from IP; dividends and capital gains upon the alienation of shares; benefits from financial leasing; benefits from insurance, banking and other financial activities; and benefits from certain, low value-adding, factoring activities ("tainted benefits"); less related expenses.
  (b) CFC benefits are only taken into account to the extent that the balance of benefits (ie, income less expenses) results in a positive amount and that balance, by the end of the financial year, has not been distributed by the controlled company. Negative CFC benefits can be carried forward six years to offset against future positive CFC benefits.
  (c) A controlled company is defined as a company in which the taxpayer, whether or not together with related companies or a related person (see below), has an interest of more than 50% (whereby interest is defined in relation to nominal share capital, statutory voting rights and profits of the company), provided that the company is a tax resident in a low tax jurisdiction or a state included on the EU list of non-cooperative jurisdictions (unless the company is taxed as a resident of another state). A jurisdiction is considered low taxed if it does not levy a profit tax or levies a profit tax lower than 9% (the statutory rate should be at least 9%). Prior to each calendar year, an exhaustive list will be published with all designated non-cooperative and low tax jurisdictions for the next taxable period (being the next calendar year). A permanent establishment can also qualify as a CFC.
  (d) For purposes of the CFC regime, a company or person is related to the taxpayer if the taxpayer has a 25% interest in the company or the company or that person has a 25% interest in the taxpayer (whereby interest is again defined in relation to nominal share capital,

statutory voting rights and profits of the company).

(e) A company is not considered a controlled company if at least 70% of the income of the company does not consist of tainted benefits or the company is a regulated financial company as defined in Article 2(5) of the Directive and at least 70% of the benefits earned by the company are not derived from the taxpayer, a related entity or a related person.

(f) The CFC regime does not apply if the controlled company carries out material (wezenlijk) economic activities. According to the explanatory memorandum, material economic activities are considered present if the relevant substance requirements that are currently already included in the anti-abuse provisions in the Dutch Dividend Withholding Tax Act 1965 (DWT) are met. Most importantly, the controlled company will need to incur annual wage costs of at least EUR100,000 for employees and the controlled company will need to have its own office space at its disposal in the jurisdiction where it is established during a period of at least 24 months whereby this office space needs to be properly equipped and used. Furthermore, the employees must have the proper qualification and their tasks should not be merely auxiliary. Note however, that as per 1 January 2020, a different approach will apply. See **6.6 Rules Related to the Substance of Non-local Affiliates**.

- The Netherlands has signed the Multilateral Instrument that includes the BEPS measures that require amendment of (Dutch) bilateral double tax treaties. The Netherlands has taken the position that all material provisions of the MLI should be included in the Dutch double tax treaties, except for the so-called savings clause included in Article 11 of the MLI. As such, a general anti-abuse provision (in most cases, the so-called principal purpose test) should likely be included in many Dutch double tax treaties as well as a range of specific anti-abuse rules.
- The Dividend Withholding Tax Act 1965 has been amended whereby co-operatives that are mainly involved in holding and/or financing activities (and that up to now were able to distribute profits without triggering dividend withholding tax unless in cases of abuse) become subject to Dutch dividend withholding tax upon distributing profits. If the recipient of the profit distribution is a tax resident in a country with which the Netherlands has concluded a comprehensive double tax treaty, an exemption from that tax should be available provided that the relevant structure is not abusive. It remains to be seen whether the current rules in place for so-called “non-holding” co-operatives may be amended in the near future. The Corporate Income Tax Law 1969 has also been amended in relation to the above (ie, substantial shareholding rules).
- A law has been enacted to meet the obligations of the Netherlands in respect of country-by-country reporting (BEPS Action 13).
- A law has been enacted to meet the obligations of the Netherlands in respect of the automatic exchange of rulings. Furthermore, the Dutch innovation box regime has been amended to align it with BEPS Action 5 (countering harmful tax practices).
- Further enhancement of the substance requirements for interest and/or royalty conduit companies has been introduced, due to which information is automatically exchanged with the respective foreign tax authorities in the case of interest and/or royalty conduit companies not meeting these enhanced substance requirements, including a minimum of EUR100,000 salary expenses and the requirement that for at least 24 months properly equipped office space should be available.
- A conditional withholding tax on royalties and interest paid to group companies in low tax jurisdictions or in abusive situations will apply as from 1 January 2021.
- Double tax treaties have been and are being renegotiated with 23 developing countries to ensure these tax treaties can no longer be abused, potentially leading to tax budget leakage for the respective developing countries.
- The minimum substance requirements do no longer function as a safe harbor.
- The Dutch practice regarding international tax rulings has been revised as of 1 July 2019. To obtain an international tax ruling from the Dutch tax authorities, amongst other, a sufficient “economic nexus” with the Netherlands is required.
- The national definition of a permanent establishment is brought in line with the 2017-OECD Model Tax Convention (which reflect the BEPS outcomes).

Furthermore, the government has announced that it will investigate:

- the amendment of the legal privilege in order to strengthen the position of the tax authorities; and
- in 2021, a budget neutral introduction of a deduction on equity, accompanied by the tightening of the Dutch earnings stripping rules in order to achieve a more balanced tax treatment of capital (equity) and debt. No concrete legislative proposals have been announced in this respect.

9.2 Government Attitudes

The central attitude of the Dutch government is to find a balance between, on the one hand, ending international aggressive tax planning by promoting transparency and making rules abuse-proof, and, on the other hand, not harming the Dutch economy and thus seeking to take measures on an international level to avoid unilateral measures that would disproportionately harm Dutch corporations and favourable Dutch tax regimes to safeguard the attractive business and investment climate.

9.3 Profile of International Tax

International taxation, especially over the last decade, has gained a high public profile due to extensive coverage of – alleged – aggressive tax planning in leading Dutch newspapers and other media, as well as the exposure generated by NGOs such as Oxfam Novib and Tax Justice.

Over the last decade, on a regular basis Members of Parliament have raised their concerns regarding the attitude of MNCs and their supposed unwillingness to contribute their fair share. This is, for example, also reflected in the notifications made by the Dutch government for the application of the Multilateral Instrument, that reflect the Dutch position to apply nearly all anti-abuse measures included in the Multilateral Instrument.

9.4 Competitive Tax Policy Objective

The Netherlands has a competitive tax policy, driven by the fact that the Dutch economy relies for a large part on foreign markets, given that the domestic market is relatively small. In a letter from May 2020, the Dutch government sets out its (updated) international tax policy. As a starting point, domestic and cross-border entrepreneurial activities should, in principle, be treated equally for tax purposes. Thus, foreign-sourced (business) income in principle is exempt from the Dutch tax base.

At the same time, the government is aware of international corporations increasingly eroding domestic tax bases and shifting profits. It is therefore seeking to find a balance between mitigating the risk of abuse by international taxpayers whilst avoiding unnecessary hindrance of real corporate activities.

9.5 Features of the Competitive Tax System

As the Dutch government generally takes a balanced approach for each measure, consideration will be given to the pros and cons of existing practices, and the relevance for real business activities, including the accounting and legal services industry. Thus, it is difficult to say which areas are vulnerable to scrutiny, except for structures with low substance and structures that are clearly tax-driven whilst bearing little or no relevance for the real economy.

9.6 Proposals for Dealing with Hybrid Instruments

The proposals addressing hybrid instruments have been implemented by the Dutch government and as such are included in Dutch tax law and/or Dutch double tax treaties. This applies to the measures taken as part of BEPS as well as the extension of the EU Anti-Tax Avoidance Directive.

9.7 Territorial Tax Regime

The Netherlands has no territorial tax regime as it – as a starting point – taxes resident (corporate) taxpayers for their worldwide income, subject to the application of double tax treaties and unilateral rules for the relief for double taxation.

It is difficult to make a general prediction as to the impact of the interest limitation rules for Dutch taxpayers as this is to a large extent fact-driven, whilst the Netherlands already has a range of interest limitation rules and it is currently proposed to abolish two of the existing interest limitation rules.

9.8 CFC Proposals

A cornerstone of Dutch international policy for decades has been to avoid economic double (including juridical double) taxation within corporate structures, which is why the Netherlands has exempted dividend income received from foreign group companies (under the so-called participation exemption regime). Furthermore, the Netherlands so far has been advocating the principle of so-called capital import neutrality, by which a resident state should exempt foreign-sourced income from its taxation to allow its corporations to make foreign investments on a level playing field (in terms of taxation).

The Netherlands should therefore used to be reluctant to let go of its position to exempt foreign income. As a matter of fact, former proposals to include a so-called switch-over provision (whereby an exemption of taxation is basically replaced by a tax credit for certain types of income) were strongly and successfully opposed by the Dutch government. However, as part of the implementation of the EU Anti-Tax Avoidance Directive (ATAD), CFC rules have been introduced in the Netherlands as per 1 January 2019. See **9.1 Recommended Changes**.

9.9 Anti-avoidance Rules

The Netherlands favours (as reflected in the Dutch notification to Article 7 of the Multilateral Instrument) a principal purpose test as opposed to a limitation on benefits provision, mainly because the principal purpose test is considered to work out proportionately in most situations. Thus, truly business-driven structures, either inbound or outbound, should not be harmed. Nevertheless, the principal purpose test is principle-driven rather than rule-driven, which makes it less clear which structures will be affected by the principal purpose test.

In other words, there may be legal uncertainty, especially in the beginning when there is also little practical experience. Furthermore, some countries might apply the principal purpose test liberally, which might make corporations decide to avoid the Netherlands. However, this remains to be seen, especially as in other countries the same issues should come up. The potential impact of EU law in this respect is subject to debate.

9.10 Transfer Pricing Changes

Aside from the introduction of country-by-country reporting and to a lesser extent the documentation requirements (eg, master file and local file), the Netherlands has already applied the at arm's length principle as a cornerstone of its transfer pricing regime. As such, these changes should not lead to a radical change, which should also apply to intangibles.

9.11 Transparency and Country-by-country Reporting

The Netherlands is in favour of increasing transparency in international tax matters, provided an agreement can be reached on an international level as broad as possible to avoid national economies being harmed by MNCs' decisions to avoid jurisdictions that have transparency requirements.

9.12 Taxation of Digital Economy Businesses

No legislative proposals have been published in this area yet.

9.13 Digital Taxation

The Netherlands has issued several statements following the publication of the most recent public consultation documents on Pillar One and Two as published in October and November 2019 by the G20/OECD Inclusive Framework on BEPS as well as the blue prints published by the OECD end of 2020. The State Secretary for Finance favours in this respect an international, coordinated (unified) approach, instead of jurisdictions implementing domestic legislation independently. It should be noted that the Pillar Two proposal may substantially impact the sovereignty of states as regards to the taxation of business profits and their ability to employ an international tax policy based on the principle of "capital import neutrality".

9.14 Taxation of Offshore IP

The Netherlands has no specific provisions as to the taxation of offshore intellectual property. Note however that as of 1 January 2021, a conditional withholding tax applies to interest and royalty payments to states qualified as low tax jurisdictions. Furthermore, in case of passive offshore IP structures, the Dutch CFC-rules may apply.

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Trends and Developments

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Something Old, Something Borrowed, Something New

The Netherlands has been and will continue to be an attractive European jurisdiction to do business and to locate hubs for global operations. The Dutch geographical location, its well-developed financial sector, political stability and well educated and tech savvy work force, are just a few of the attractive features of the Netherlands. For many years, a dogmatic fundament of the Dutch corporate tax system has been the concept of capital import neutrality, forming the basis of the Dutch participation exemption in relation to qualifying equity interests of 5% or more. That fundament remains solid as a rock, although the public debate is glancing at the justification thereof.

The last year has been one of important changes resulting from EU and OECD initiatives and of the introduction of a novelty for the Netherlands: a withholding tax on interest and royalties. Inevitably, the COVID-19 pandemic led to some important temporary tax related rules to help businesses and the workforce to survive. The measures vary from flexible extensions from tax filings and payments combined with low (0.01%) late payment interest rate and the possibility to form a COVID-19 reserve in the 2019 tax books anticipating FY2020 losses.

Furthermore, as in recent years, the Dutch tax focus has shifted towards discouraging (abusive) tax planning by abolishing favourable tax rules and introducing anti-tax abuse measures. Prompted by public opinion, these anti-abuse measures are primarily targeting multinational enterprises. Small and medium sized enterprises – including, to a certain extent, start and scale-ups – on the other hand are stimulated through beneficial tax measures and incentives.

General election

More in general, 2021 is an important year because of the recently held general elections. The elections resulted more or less in a consolidation of the political powers. The current out-going government fell because of significant political malpractices in relation to child allowances, which also tainted the trust in the Dutch tax authorities, who administer these allowances. Following the elections, a new government must be formed. As Dutch governments are always coalitions of several parties (four parties in the current government), coalition negotiations require always many compromises. Given the various election programmes, increasing the tax burden of large companies will almost certainly be on the agenda for negotiations of several parties. How much of these wishes will actually be included in the coalition agreement and become law, is difficult to predict at the moment of finalising this contribution (25 March 2021).

Below is a bird's eye view of some of the most notable Dutch tax developments of last year. In addition, future developments are considered. This mainly circles around withholding taxes and includes the recent introduction of a conditional withholding tax on interest and royalty payments, the proposed introduction of a similar conditional withholding tax on dividends, in addition to the already existing general dividend withholding tax, and the proposed introduction of a Dutch dividend withholding tax exit charge.

Reduced Corporate Tax Rates and Other Notable Changes

The focus on SMEs is reflected, amongst others, in recent changes to the Dutch corporate income tax (CIT) rates. For 2021, the first CIT profit bracket was increased from EUR 200,000 to EUR 245,000 (2022: EUR 395,000) subject to CIT at 15%. The mainstream rate for any surplus profits remained at 25%. Partly driven by the COVID-19 pandemic, previously envisaged reductions in this mainstream rate were redressed. Other recent developments are the strict implementation of EU Directives, such as the Anti-Tax Avoidance Directive (ATAD) 1 and 2 and the mandatory disclosure obligation of the Directive on Administrative Cooperation (DAC6).

As of 2022, tax losses may be carried forward indefinitely (instead of the current six-year time bar) but offsetting is limited to 50% of the taxable profits in excess of EUR1 million. This results amongst others in a revaluation of deferred tax asset positions. The first EUR1 million of taxable profit realised in a certain year may still be set off in full against available tax losses.

Furthermore, as of 2021, the liquidation loss scheme, allowing for losses on qualifying participations which would otherwise fall in scope of the participation exemption, is (further) restricted. It has been announced that as of 2022 downward arm's length pricing adjustments may only be made if there is a corresponding taxable upward adjustment.

Since 2020, a thin capitalisation-based interest deduction limitation rule for banks and insurers applies, which restricts interest deduction in case the adjusted leverage ratio (banks) or adjusted equity ratio (insurers) is less than 9%. In 2020 this ratio was set at 8%. The reason for the increase in 2021 is mainly budgetary as the Supreme Court ruled in May 2020 in an important Dutch tax case that certain regulatory capital qualifies as debt for CIT purposes, generating tax deductible interest expenses.

Conditional Interest and Royalty Withholding Tax

Until 1 January 2021, Dutch tax law did not provide for a withholding tax on true interest and royalty payments, whereas the Netherlands did (and does) levy a 15% dividend withholding tax on certain proceeds from equity instruments. Thus, until 1 January 2021, interest payments were generally not subject to Dutch withholding tax.

This was, broadly speaking, only different in case the relevant (debt) instrument was considered as equity for Dutch tax purposes, eg, if the instrument had been issued under such conditions that the creditor to a certain extent participated in the business of the debtor (a so-called participating loan). In those cases, dividend withholding tax is due on interest payments. Until 1 January 2021, the Netherlands did not levy any withholding tax on royalty payments as well.

The absence of a withholding tax on interest and royalty payments has always been one of the main features of the Dutch tax regime, and an important promotor of foreign investments in and through the Netherlands. In recent years, there has been debate as to how the absence of a Dutch withholding tax on interest fits in the recent global objective of preventing base erosion and profit shifting. A result of this debate was the adoption of the Withholding Tax Act 2021 (*Wet bronbelasting 2021*) (WTA 2021). And, this is not the end of the debate: in February 2021 the State Secretary of Finance installed a committee which must report on so called Dutch "pass-through entities". The results of this report may be taken into account in the political negotiations after the March 2021 general elections.

Conditional withholding tax

Pursuant to the WTA 2021, a conditional withholding tax may apply on certain interest and royalties due and payable to an affiliated entity of a Dutch tax resident entity or Dutch permanent establishment if such affiliated entity:

- is considered to be resident of a jurisdiction that is listed in the yearly updated Dutch Regulation on low-taxing states and non-cooperative jurisdictions for tax purposes (the Regulation);
- has a permanent establishment located in such jurisdiction to which the interest is attributable;
- is entitled to the interest payable for the main purpose or one of the main purposes to avoid taxation of another person;
- is not considered to be the recipient of the interest in its jurisdiction of residence because such jurisdiction treats another (lower-tier) entity as the recipient of the interest (hybrid mismatch); or
- is not treated as resident anywhere (also a hybrid mismatch).

Equally, the conditional withholding tax applies if such amounts are not paid but accrued. Interest and royalties are calculated on an arm's length basis. It is not relevant whether or not the interest or royalty paying entity has substance in the Netherlands; so also interest due by a Dutch multinational with many employees on Dutch soil could, in theory, become subject to the conditional withholding tax. There is no exemption for tradeable debt (yet).

The conditional withholding tax is levied by means of withholding by the Dutch borrower (the withholding agent) at a rate of 25% (directly linked with the Dutch mainstream CIT rate). If the tax is wrongfully not withheld and paid by the Dutch withholding agent, the withholding tax assessment may also be imposed on the recipient entity. It should be noted that the withholding tax is due when the interest is due and payable, which may not align with the moment the actual payments are made.

Non-cooperative jurisdictions

Listed low-taxing states and non-cooperative jurisdictions are jurisdictions that have no corporate tax or a corporate tax rate of less than 9% and jurisdictions that were included on the EU list of non-cooperative jurisdictions for tax purposes at the end of the previous year. The 2021 list includes the American Virgin Islands, American Samoa, Anguilla, the Bahamas, Bahrain, Barbados, Bermuda, the British Virgin Islands, the Cayman Islands, Fiji, Guam, Guernsey, the Isle of Man, Jersey, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, Turkmenistan, the Turks and Caicos Islands, Vanuatu and the United Arab Emirates.

Affiliation

The concept of affiliation is quite broad and entails that, broadly:

- the recipient entity (either alone or as a part of a collaborating group) has a qualifying interest in the Dutch paying entity;
- the Dutch paying entity (either alone or as a part of a collaborating group) has a qualifying interest in the recipient entity; or
- a third party has a qualifying interest in both the payee and the recipient entity.

Qualifying interest

An interest in an entity is regarded as a "qualifying interest" if influence can be exercised directly or indirectly in the decision-making and as such the activities of an entity can be determined.

This is, for example, the case if an entity has more than 50% of the voting rights in the other entity. Considering that this conditional interest withholding tax only applies in affiliated situations, interest paid under a bank financing or note issuance or in the context of a securitisation should normally not become subject to the conditional interest withholding tax.

Conditional Dividend Withholding Tax

In its coalition agreement, the current outgoing government proposed to abolish dividend withholding tax. Thus, the government hoped gaining a level playing field with the UK, that does not levy a withholding tax on dividends, and keeping amongst others the head offices of Anglo-Dutch multinationals in the Netherlands. In direct relation to the abolition of the dividend withholding tax, the government proposed introducing a conditional dividend withholding tax as from 2020. After fierce societal and political turmoil, the Dutch dividend withholding tax was not abolished.

Notwithstanding that the dividend withholding tax is not abolished, the current government proposes to introduce, in addition to the yet existing dividend withholding tax, a conditional withholding tax on dividends in 2024.

Draft legislative proposal

A draft legislative proposal was published for consultation in September 2020. This conditional withholding tax would be implemented by expanding the Withholding Tax Act 2021 to dividends, whereas currently only interest and royalties are in scope thereof. This also means that the new conditional dividend withholding tax would only apply in case the recipient of the dividends is affiliated to the distributer of the dividends and at least one of the conditions for application of the WTA 2021 apply.

It should be noted that tax treaty benefits may reduce the withholding tax burden, though the government has indicated that it intends to renegotiate tax treaties with listed jurisdictions to allow the Netherlands to tax the dividends at the applicable rate of the WTA 2021. Currently, such dividend payments are often not subject to Dutch withholding tax because of Dutch domestic exemptions that mainly apply in relation to dividends distributed to holder of at least 5% of the nominal paid-up share capital of the distributing entity that are resident of the EU/EEA or a jurisdiction with which the Netherlands has concluded a double tax treaty.

The proposed rate for the conditional dividend withholding tax is equal to the rate for the conditional withholding tax for interest and royalties (25% in 2021) and linked to the mainstream CIT rate. The existing withholding tax on dividends would not be abolished, meaning that the Netherlands would have two different withholding taxes on dividends as from 2024.

In theory, it could be that a certain dividend distribution would both be subject to the existing 15% dividend withholding tax and the proposed 25% conditional dividend withholding tax. To avoid double (withholding) taxation, the draft legislative proposal contains a mechanism that allows dividend withholding tax payable to be credited against conditional withholding tax payable.

Dividend Withholding Tax Exit Tax Proposal

Under current law, Dutch dividend withholding tax is due in relation to certain proceeds from equity investments such as dividends, share buybacks and interest on participating loans distributed by companies that are tax resident of the Netherlands. The Dutch dividend withholding tax rate is 15% and may be reduced pursuant to applicable double tax treaties. Furthermore, certain domestic exemptions apply, in particular in relation to qualifying distributions to holders of at least 5% of the nominal paid-up share capital of the distributing entity that are resident of the EU/EEA or jurisdictions with which the Netherlands has concluded a double tax treaty.

Certain cross-border corporate reorganisations such as migrations, cross-border conversions, (de)mergers and share-for-share mergers currently do not trigger a taxable event for Dutch withholding tax purposes. This means that in these cases undistributed profit reserves of Dutch resident companies may no longer be subject to Dutch withholding tax.

The Exit Tax Proposal

In 2020, a Dutch opposition party sent a legislative proposed to Parliament which – if adopted – would introduce a new Dutch dividend withholding tax liability in relation to such cross-border reorganisations to avoid that undistributed profit reserves that accrued at the level of a Dutch entity escape the Dutch tax net. This is often referred to as the Exit Tax Proposal. The Exit Tax Proposal includes a retroactive effect to the date of its publication, ie, 18 September 2020, 12.00 CET, to avoid anticipatory behaviour.

The Exit Tax Proposal is still a legislative proposal and subject to fierce debate, both from a political, macro-economic, tax treaty, EU-law and mere tax technical perspective. The Parliamentary debate on the proposal will continue in the coming months. It is not certain if the Exit Tax Proposal will be adopted and, if it will be adopted, whether that will be in its current form or after amendments have been made.

Under the Exit Tax Proposal, a Dutch tax resident company is deemed to have distributed its net profits, insofar as these amount to more than EUR50 million, to its equity holders in cases where a Dutch resident company effectively migrates by way of migration or change of tax residency or cross-border conversion, (de)merger and share-for-share merger to a jurisdiction that:

- levies no withholding tax on dividends; or
- provides for a step-up for hidden reserves upon migration to that jurisdiction.

One of the most notable examples of a jurisdiction qualifying as such is the United Kingdom.

If no exemption applies, the deemed distribution would be subject to a 15% Dutch dividend withholding tax unless and exemption or rate reduction applies. Although the withholding tax is formally levied from the shareholders, in principle a so-called protective tax assessment is imposed at the time of the restructuring at the level of the withholding agent. In principle, the tax is not collected at the time of the restructuring as an unconditional deferral is granted, yet only once certain distributions are made by the migrated or surviving entity (in case of a merger or demerger) or when such entity is liquidated.

The Exit Tax Proposal does not introduce a new tax. It simply expands the scope of the existing Dutch withholding tax by introducing a new taxable event in the Dutch Dividend Withholding Tax Act 1965. This also means that any reduced rates and exemptions would equally apply in relation to the Dutch withholding tax due pursuant to the Exit Tax Proposal.

It is yet to be seen if the Exit Tax Proposal will be implemented in Dutch law and if so, in what form.

An Interesting Year Ahead

2020 has for many reasons been a challenging and interesting year from a Dutch tax perspective. For obvious reasons, COVID-19 has been the most relevant agenda item and this has further put the relevance of tax in a broader perspective. It is evident that the quest to end tax abusive structures will continue to be a top priority for many jurisdictions. In this context, in March 2021, the Netherlands has announced various, partly still conceptual, changes to Dutch tax law, including an important recalibration of the rules that govern the qualification of foreign legal entities as either tax opaque or tax transparent.

The Netherlands has been introducing, partly at its own initiative and party driven by broader EU and OECD developments, a set of new measures creating a robust, albeit quite complex, tax environment. Many tax related files will await the new Dutch government and some difficult policy decisions are to be made.

Allen & Overy LLP is an international legal practice with approximately 5,500 people, including some 550 partners, working in more than 40 offices worldwide. The firm has one of the select few Dutch tax teams to be part of a full-service law firm, with Tier 1 Corporate, Banking, ICM, Projects and Financial practices. The team works on a fully integrated basis with these practices. The firm has a stronger geographical footprint than most of its competitors in the Netherlands, and tax capability in more jurisdictions than most law firms. This makes A&O a strong choice for complex cross-border tax deals. International strength is valuable because most high-end tax matters have multiple cross-border elements. Clients feature all the top financial institutions and (international) corporate clients.

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Law and Practice

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Generally, a corporate form is adopted by businesses seeking long-term success, commonly the private limited liability company (ltd) corporate structure. An ltd cannot 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, from two upwards. A plc is the required form for companies listed on the stock market.

The ltd and the plc are the commonly adopted forms of corporate entities in regulated business sectors like banking and finance, insurance, oil and gas and capital markets. The unlimited liability company is also available, which features unlimited liability for shareholders, but it is rarely used. There is also the limited by guarantee corporate form, which is a non-profit sharing corporate structure used to promote charitable objects. In addition, the Companies and Allied Matters Act (CAMA) 2020 allows the registration of a limited liability partnership (LLP) (commonly adopted by private equity and hedge funds). An LLP must have at least two designated partners, one of whom must be resident in Nigeria.

Finally, there is the open-ended investment company, which is allowed to buy its own shares. Some activities can only be carried on through a corporate vehicle, including banking, insurance and crude oil exploration and production.

Many small-scale businesses and petty traders carry on business as partnerships or sole proprietorships.

A corporate entity is taxed as a separate legal entity.

1.2 Transparent Entities

The common transparent entities are general partnerships and sole proprietorships, which are often used because they are easier to set up and operate than corporate structures or are the required form for some professions, such as the legal profession. CAMA now allows limited partnerships.

1.3 Determining Residence of Incorporated Businesses

The tax residence of incorporated businesses is determined based on the place of incorporation. The income of transparent entities is taxed in the hands of their owners, and their tax liability is not affected by their place of residence.

Nigerian companies are subject to income tax on their worldwide profits. Therefore, the profits of a Nigerian company are deemed to accrue in Nigeria, regardless of where they actually arise.

A non-Nigerian incorporated business is deemed to be resident in Nigeria for tax purposes to the following extent:

- if the company or entity has a "fixed base" in Nigeria, to the extent attributable to such base;
- if the foreign company or entity 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;
- where the foreign company or entity executes a turnkey contract in Nigeria – ie, a single contract for surveys, deliveries, installation or construction;
- where the foreign company or entity does business with a connected Nigerian company, and the Federal Inland Revenue Service (FIRS) considers the business to be artificial or fictitious;
- where the foreign company directly or indirectly "transmits, emits or receives signals, sounds, messages, images or data of any kind by cable, radio, electromagnetic systems or any other electronic or wireless apparatus to Nigeria in respect of any activity, including electronic commerce, application store, high frequency trading, electronic data storage, online adverts, participative network platform, online payments", to the extent that the foreign company has a "significant economic presence" (SEP) – hereinafter referred to as Digital SEP — in Nigeria. In terms of the Companies Income Tax (Significant Economic Presence) Order issued by the Minister of Finance on 29 May 2020, a foreign company would be deemed to have Digital SEP in Nigeria where:
  - (a) its turnover from Nigeria in an accounting year is more than NGN25 million or its equivalent in any other currency;
  - (b) it uses a Nigerian domain name or registers a website in Nigeria; or
  - (c) it has a purposeful and sustained interaction with persons in Nigeria by customising its digital page or platform to target persons in Nigeria, including reflecting the prices of its products or services in Naira or providing options for billing or payment in Naira;
- a Nigerian resident paying a foreign company with Digital SEP must deduct and remit withholding tax (WHT) of 5%. The WHT is an advance payment of the ultimate companies income tax (CIT) liability of such a foreign company; and
- it provides technical, professional, management and consultancy services to a Nigerian resident.

1.4 Tax Rates

"Small" businesses (ie, those with a turnover of less than NGN25 million) are exempt from CIT, while "medium-sized" companies (turnover between NGN25 million and NGN100 million) pay CIT at the rate of 20%, and "large" companies (turnover above NGN100 million) pay CIT at 30%.

There is also a tertiary education tax of 2% on the same tax base under the Tertiary Education Trust Fund (Establishment, Etc.) Act 2011, payable by Nigerian companies.

Petroleum profits tax of between 50% and 85% (depending on the nature of operations) is payable by companies that are engaged in crude oil exploration and production.

The taxable income of non-corporate businesses and transparent entities is assessed in their owners' hands.

Individuals are allowed a consolidated relief allowance of either NGN200,000 or 1% of gross income, whichever is higher, plus 20% of gross income. The balance of the income after all deductions will be taxed in accordance with the graduated tax scale rates set out below:

- NGN300,000: 7%;
- NGN300,001-600,000: 11%;
- NGN600,001-1,100,000: 15%;
- NGN1,100,001-1,600,000: 19%;
- NGN1,600,001-3,200,000: 21%; and
- NGN3,200,001 and over: 24%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are not based on accounting profits but are arrived at by aggregating all trading income and then deducting exempt income, allowable expenses, capital allowance (at annually specified rates) and carried-forward losses. Allowable expenses are limited to expenses that are "wholly, exclusively, necessarily and reasonably" incurred in making profits. The test for deductibility does not include reasonableness for companies engaged in petroleum operations, which is defined as the exploration and production of petroleum.

Profits are taxed on an accrual basis, and tax is paid on a preceding-year basis, except for tax on profits from petroleum operations, which is paid in monthly instalments based on forecast profits, with reconciliation made at the end of the tax year to reflect actual profits.

2.2 Special Incentives for Technology Investments

There is a 20% tax credit for expenditure on research and development, in addition to capital allowance (up to 95% in the first year) instead of depreciation.

There are no special incentives for a patent box.

2.3 Other Special Incentives

Income from bonds issued by sovereign or sub-sovereign entities and corporate bodies is exempt from tax in the bondholder's hands. Proceeds from the disposal of government or corporate bonds are also exempt from VAT. These exemptions for corporate bonds will lapse in 2022.

Interest on long-term foreign loans with repayment periods above seven years (with a two-year grace period), between five and seven years (with a grace period of not less than 18 months), and between two and four years (with a grace period of not less than 12 months) enjoy 70%, 40% and 10% tax exemption, respectively.

Venture capital companies that invest in venture capital projects and provide at least 25% of the total project cost enjoy a 50% withholding tax reduction on dividends received from project companies, capital allowance on their equity investments in venture project companies, and tax exemption on gains arising from the disposal of such equity.

Companies engaged in petroleum operations enjoy an investment tax credit (ITC) or an investment tax allowance (ITA) of between 5% and 50% of their qualifying expenditure. The ITC operates as a full tax credit and does not result in a reduction of qualifying capital expenditure for the purposes of calculating capital allowances. The ITA is deductible from profits in arriving at taxable profits.

There are also special incentives available to oil companies to encourage gas utilisation or the development of gas delivery infrastructure. Under the Petroleum Profits Tax Act (PPTA), oil companies can offset their gas-related capital allowance against their oil production profits. Oil companies in downstream operations can enjoy an initial tax-free period of three years, renewable for another two years, and an additional 15% investment allowance under the Companies Income Tax Act (CITA). The shareholders also enjoy tax-free dividends during the tax-free period. Alternatively, an additional investment allowance of 35% is available to such companies. Oil companies can choose to enjoy the incentives under PPTA or CITA but not both.

These incentives have led to considerable investment in gas utilisation projects.

A company engaged in a "pioneer industry" or a "pioneer product" (as designated by the government of the day) may apply for "pioneer status" which, when granted, entitles it to:

- a three-year tax holiday, which may be extended for two further terms of one year each or one further term of two years;
- relief from WHT on dividends paid to its shareholders during the tax holiday; and
- the postponement of capital allowance until the end of the tax holiday.

Approved enterprises operating within a free trade zone are exempt from all federal, state and local government taxes, levies and rates.

2.4 Basic Rules on Loss Relief

Loss carry-back is not permitted, but all companies are entitled to carry tax losses forward indefinitely. Income losses cannot be used to offset capital gains and vice versa.

2.5 Imposed Limits on Deduction of Interest

Existing anti-avoidance provisions allow the tax authority to disallow/reduce interest charged between related parties where such interest is not reflective of the arm's-length principle.

In addition, there are thin capitalisation rules whereby the tax deductibility of interest expense on a foreign-party loan is limited to 30% of EBITDA in any given tax year. Deductible interest expense not fully utilised can be carried forward for a maximum of five years.

2.6 Basic Rules on Consolidated Tax Grouping

Nigerian law does not permit consolidated tax grouping; each company within a group is 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 can be carried forward and set off against the future profits of the company that incurred them.

2.7 Capital Gains Taxation

A 10% capital gains tax is payable on chargeable gains arising from the disposal of chargeable assets. All forms of property are chargeable assets under Nigerian law, regardless of where they are located, including foreign currency, options, debts and incorporeal property generally, but excluding private motor vehicles. Losses incurred upon the disposal of a chargeable asset are not deductible from other chargeable gains for the purposes of computing capital gains tax.

Gains arising from the disposal of the following are exempt from capital gains tax:

- securities issued by the Nigerian government;
- stocks and shares;
- decorations awarded for valour or gallant conduct;
- life assurance policies;
- chattels sold for NGN1,000 or less;
- assets acquired by way of a gift which are subsequently disposed of by way of gift;
- investment in superannuation funds, statutory provident funds and retirement benefit schemes;
- assets devolving upon death;
- securities in a unit trust scheme, provided the proceeds are re-invested;
- gains arising from the acquisition of the shares of a company as the result of a merger, takeover or acquisition, provided that no cash payment is made in respect of the shares acquired;
- gains accruing to local government councils and statutory corporations; and
- gains accruing from the disposal of chargeable assets by ecclesiastical, charitable or educational institutions of a public character, statutory or registered friendly societies and registered co-operative societies, and trade unions, provided that such gains do not arise from the disposal of assets acquired in connection with any trade or business, nor from the disposal of an interest possessed by the corporation in a trade or business carried on by some other person, and are applied purely for the purposes of the organisation, institution or society.

Where the proceeds from the disposal of an asset are used to finance the acquisition of a similar asset, the person making such disposal may apply to be treated as if the transaction has resulted in neither a gain nor a loss. Where the consideration received upon disposal of such asset exceeds the consideration paid for the acquisition of the replacement asset, the amount of that excess will be subject to capital gains tax.

2.8 Other Taxes Payable by an Incorporated Business

VAT is levied on the supply of all goods and services, with a few exceptions, at the rate of 7.5% and is collected by the supplier and remitted to the tax authority. However, oil and gas companies, including oil service companies, ministries, departments and agencies of governments, and residents receiving taxable supplies from foreign companies, must deduct VAT on the invoices from their suppliers and remit it to the FIRS.

A taxpayer can recover VAT incurred in acquiring stock-in-trade or inventory, but not VAT incurred on overheads and administration, nor capital assets. Lagos State has also introduced a 5% consumption tax on hotels, restaurants and event centres.

Stamp duty is paid on applicable instruments. The rates differ for various instruments and can be as high as 6% of the value of the underlying transaction.

2.9 Incorporated Businesses and Notable Taxes

The following taxes or levies are notable:

- an Information Technology levy of 1% of profit before tax is payable by specified companies with a turnover of NGN100 million and above. The tax, when paid, is deductible for the company's income tax purposes;
- a levy of 0.005% of the net profit of a company is payable annually to the Nigeria Police Trust Fund;
- an employer is required to make a minimum monthly contribution of 1% of its monthly payroll under the Employees' Compensation Act;
- an employer is required to deduct 2.5% of employees' monthly basic salary for remittance to the Federal Mortgage Bank of Nigeria as National Housing Fund contribution within one month after the deduction;
- an employer is also required to contribute 1% of its annual payroll cost to the Industrial Training Fund in compliance with the Industrial Training Fund Act; and
- an oil and gas company is required to pay 3% of its annual budget to the Niger Delta Development Commission for tackling ecological problems in the Niger Delta, where most of Nigeria's oil is produced.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held local businesses commonly operate in corporate form, using the structure of a private company limited by shares.

3.2 Individual Rates and Corporate Rates

The maximum corporate rate is 32% (ie, CIT of 30% plus tertiary education tax of 2%), while the maximum tax rate for individuals is 24%.

3.3 Accumulating Earnings for Investment Purposes

Where it appears to the FIRS that a Nigerian company controlled by not more than five persons has not distributed profits to its shareholders with a view to reducing the aggregate of the tax chargeable in Nigeria, the FIRS may direct the undistributed profits to be treated as distributed and taxable in the hands of the shareholders in proportion to their shares.

3.4 Sales of Shares by Individuals in Closely Held Corporations

There are no special rules on the taxation of dividends from or gain on the sale of shares in closely held corporations.

Dividends to individuals are subject to a withholding tax of 10%. The tax withheld on dividends is the final tax payable.

Gains on the sale of shares are exempt from capital gains tax.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no special rules on the taxation of dividends from or gain on the sale of shares in publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding tax of 10% applies to interest, dividends, royalties and rents. This withholding tax is treated as the final tax when the payment is due to a non-Nigerian company. The rate is reduced to 7.5% if the recipient is a resident of a country with which Nigeria has signed a double tax treaty.

Where dividends are paid to a Nigerian company, the amount deducted as withholding tax is treated as franked investment income and is not subject to further tax.

Relief in the form of withholding tax exemptions is available on outward-bound payments where:

- the payment of dividends is satisfied by an issue of shares of the company paying the dividends;
- dividends are paid by a pioneer company exempted from tax under the Industrial Development (Income Tax Relief) Act; or
- dividends are paid by an enterprise operating within a free zone.

4.2 Primary Tax Treaty Countries

Investors have primarily used vehicles set up in the United Kingdom and the Netherlands to make investments in Nigeria (local corporate stock or debt). Vehicles set up in Mauritius are increasingly being used to make investments in the local stock or debt market, even though the double taxation agreement between Nigeria and Mauritius is yet to come into force in Nigeria.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The FIRS does not challenge the use of treaty country entities by non-treaty country residents if the eligibility tests of the relevant double taxation agreements are fulfilled.

4.4 Transfer Pricing Issues

The availability of local comparables is one of the biggest transfer pricing issues for inbound investors operating through a local corporation; transfer pricing compliance requirements is another. This is because the FIRS has imposed a minimum of NGN10 million as a penalty for each failure to declare relevant group information, to disclose related party transaction(s) or to maintain contemporaneous transfer pricing documentation, where required.

4.5 Related-Party Limited Risk Distribution Arrangements

The local tax authorities challenge the use of related-party limited risk distribution arrangements for the sale of goods or the provision of services locally where they determine that the arrangement provides a tax advantage and has not been made on arm's-length terms.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The transfer pricing standards of the OECD and those of the UN apply in Nigeria, unless they conflict with the local standards. The local transfer pricing standards conflict with the OECD standards in two major regards:

- in addition to requiring the arm's-length test in respect of royalty payments, the Income Tax (Transfer Pricing) Regulations 2018 (TP Regulations) provide that, for the transfer of rights in an intangible amongst connected parties, any amount that exceeds 5% of the EBITDA derived from the commercial activity conducted using the intangible is not tax-deductible; and
- the TP Regulations also provide that, for exports, the related-party price will be the sale price for tax purposes if it is higher than the quoted price, whilst for imports the quoted price will be the sale price for tax purposes if the related party price is higher than the quoted price.

4.7 International Transfer Pricing Disputes

In 2018, the FIRS issued the Guidelines on Mutual Administrative Procedures (MAP) in Nigeria to guide Nigerian residents seeking to initiate the MAP process in respect of tax disputes, including transfer pricing disputes, involving a treaty partner. By the combined provision of these guidelines and the TP Regulations, where a Nigerian resident initiates a MAP in respect of a transfer pricing adjustment made by the tax authorities of a treaty partner, the FIRS will allow a corresponding adjustment where it agrees that the adjustment done by the tax authorities of the treaty partner is consistent with the arm's-length principle. If the FIRS does not agree that the adjustment by the tax authorities of the treaty partner is consistent with the arm's-length principle, Nigeria's competent authorities will initiate the MAP process.

There is no published data regarding the use of the MAP process by Nigeria's competent authorities to resolve international transfer pricing disputes. However, it is unlikely that Nigeria's competent authorities will often resolve international transfer pricing disputes via MAPs initiated by Nigerian residents, given Nigeria's status as an import-dependent nation and her low tax treaty network.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The TP Regulations do not make provisions for compensating adjustments. Therefore, the OECD and UN standards would apply.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Unless granted a special exemption, branch operations by non-local corporations are not permitted in Nigeria. As such, non-local corporations seeking to carry on business in Nigeria must set up a subsidiary for that purpose. There are separate rules for the taxation of local branches of non-local corporations that carry on the business of transport by sea or air and the business of transmission of messages by cable or any form of wireless apparatus.

5.3 Capital Gains of Non-residents

Gains arising on the disposal of stocks and shares by either residents or non-residents are exempt from capital gains tax.

5.4 Change of Control Provisions

There are no change of control provisions that would trigger tax or duty charges for either direct or indirect disposals of holdings.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are used to determine the income of foreign-owned local affiliates that carry on the business of transport by sea or air and the business of transmission of messages by cable or any form of wireless apparatus.

Where actual profits cannot be determined, the FIRS typically applies a deemed profit rate on turnover derived from Nigeria. In practice, profit is deemed at 20%, which is then taxed at the income tax rate of 30%, resulting in an effective tax of 6% of turnover.

5.6 Deductions for Payments by Local Affiliates

Approval is required in order to deduct management fees or expenses relating thereto. Currently, this approval is granted by the National Office for Technology Acquisition and Promotion (NOTAP). Any payment that is made under an agreement that is registered with NOTAP would be tax-deductible. In registering a management services agreement, NOTAP considers the reasonableness of the fees payable. Fees between 2% and 5% of profit before tax or where no profit is anticipated during the early years are considered reasonable, or fees ranging from 1% to 2% of net sales during the first three to five years.

Administrative expenses incurred outside Nigeria involving related parties are deductible only to the extent that such expenses are consistent with the TP Regulations.

5.7 Constraints on Related-Party Borrowing

Related-party borrowing must be at arm's length, and the thin capitalisation rules discussed under **2.5 Imposed Limits on Deduction of Interest** would apply.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The foreign income of a local corporation is not exempt from corporate tax, as a Nigerian company is taxed on its worldwide income. However, because dividends, interest, rents and royalties earned abroad and brought into Nigeria through the commercial banks are exempt from tax, the foreign income of a local corporation is effectively exempt from corporate tax.

6.2 Non-deductible Local Expenses

Expenses that are attributable to exempt foreign income would be deductible to the extent that they were incurred wholly, exclusively, necessarily and reasonably for the purposes of making a company's profits.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends earned from foreign subsidiaries of local corporations would be subject to income tax, unless they were brought into Nigeria through any of the commercial banks. Such dividends would enjoy any relief in an applicable double tax treaty where the dividends are not brought into Nigeria through any of the commercial banks.

6.4 Use of Intangibles by Non-local Subsidiaries

There are no rules imposing tax on the transfer of intangibles developed by local corporations to non-local subsidiaries for use in their business. However, the FIRS can rely on the general anti-avoidance provisions in the law to attribute a profit to the local corporation if it considers that the terms of the transfer of the intangibles do not reflect the arm's-length principle.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Nigeria does not have CFC rules.

6.6 Rules Related to the Substance of Non-local Affiliates

Rules related to the substance of non-local affiliates do not apply in Nigeria.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Local corporations are not taxed on gains on the sale of shares in non-local affiliates because of the exemption on share sales.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are anti-avoidance provisions in the various tax laws, which empower the tax authorities to make necessary adjustments to counteract any tax reduction that would result from transactions that are considered artificial. The tax authorities may deem any transaction artificial if they find that its terms have not been effected or, where it is a transaction between related parties, that its terms do not reflect the arm's-length principle.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

There is no fixed audit cycle, but large corporates are typically audited annually.

9. BEPS

9.1 Recommended Changes

In response to BEPS, Nigeria has signed the following instruments:

- the Multilateral Convention to Implement Tax Treaty-related Measures to Prevent Base Erosion and Profit Shifting;
- the Multilateral Competent Authority Agreement for the Common Reporting Standard; and
- the Multilateral Competent Authority Agreement for the Automatic Exchange of Country-by-Country Reports.

Nigeria has also put the following guidelines in place to give effect to the above instruments:

- the Income Tax (Common Reporting Standard) Regulation, 2019;
- the Income Tax (Country-by-Country Reporting) Regulations, 2018;
- the Guidelines on Country-by-Country Reporting in Nigeria, 2018;
- the Guidelines on the Appropriate Use of Country-by-Country Reports, 2018; and
- the Guidelines on the Mutual Administrative Procedure (MAP) in Nigeria.

9.2 Government Attitudes

The Nigerian government is keen on eliminating BEPS, as shown by its signing, domestication and active enforcement of anti-BEPs instruments. By implementing anti-BEPS measures, Nigeria seeks to eliminate double non-taxation, expand its revenue base and grow its economy.

The tax-to-GDP ratio of Nigeria is amongst the lowest in the world, and the government expects that the BEPS plans will increase revenue from taxation.

9.3 Profile of International Tax

International tax does not have a high public profile in Nigeria.

9.4 Competitive Tax Policy Objective

Despite its low tax-to-GDP ratio, Nigeria has competitive tax policies aimed at increasing foreign and local participation in the economy, including the exemption from all taxes granted to entities operating in the tax-free zones, the five-year income tax holiday granted to entities in several industries, and the tax exemption of all foreign-earned passive income brought into Nigeria through any of the commercial banks.

9.5 Features of the Competitive Tax System

The lack of anti-fragmentation rules and the lack of CFC rules in the domestic tax legislation are competitive features of the Nigerian tax regime that are vulnerable to the BEPS action plans.

9.6 Proposals for Dealing with Hybrid Instruments

Nigeria does not have domestic rules to deal with hybrid instruments. However, once Nigeria ratifies the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, Article 3 thereof will apply to deal with transparent entities resident in tax treaty countries.

9.7 Territorial Tax Regime

Nigerian companies are taxed on their worldwide income. However, the dividend, interest, rent and royalty income of a Nigerian company brought into Nigeria through commercial banks is exempt from tax. Other than the requirement to comply with the arm's-length principle, Nigeria does not have interest deductibility restrictions.

9.8 CFC Proposals

Nigeria does not have CFC rules, and there are no proposals to implement any.

9.9 Anti-avoidance Rules

Nigeria has anti-avoidance rules in some of its tax treaties and has indicated its intention to adopt the "principal purpose test" and the competent authority tiebreaker provisions of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS.

9.10 Transfer Pricing Changes

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and the United Nations Practical Manual on Transfer Pricing for Developing Countries, and all future updates, apply in Nigeria unless they conflict with the TP Regulations, in which case the latter will prevail.

9.11 Transparency and Country-by-country Reporting

Nigeria favours the OECD proposals for transparency and country-by-country reporting and, amongst others, has signed the Convention on Mutual Administrative Assistance in Tax Matters, the Country-by-Country Multilateral Competent Authority Agreement, and the Common Reporting Standards Multilateral Competent Authority Agreement.

9.12 Taxation of Digital Economy Businesses

Foreign companies with a digital presence in Nigeria are subject to CIT; see **1.3 Determining Residence of Incorporated Businesses**.

Payments to non-resident individuals who remotely provide technical, professional, consultancy and management services to Nigerian residents attract a final withholding tax of 10%.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

Withholding tax of 10% (which is the final tax) applies to all royalty payments for offshore IP to companies. The withholding tax is reduced to 7.5% if the IP owner is a resident of a country that has signed a double tax agreement with Nigeria. There are no special rules for IP owners in a tax haven.

ÆLEX is a full-service commercial and litigation law firm with offices in Nigeria and Ghana. It provides tax advisory and litigation services for a wide range of multinational and local companies across the oil and gas, shipping, aviation, manufacturing, and financial services sectors. The firm has been involved in a number of ground-breaking tax cases in the tax tribunal and courts in Nigeria. ÆLEX has successfully handled tax disputes on behalf of major multinational companies on various upstream tax issues, such as the deductibility of expenses, tax incentives, capital and investment allowances, and transfer pricing. In collaboration with a major African law firm, ÆLEX notably provided tax structuring advice to Africa's largest privately owned investment management company in respect of its unit trust investment scheme in Nigeria.

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NORWAY

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form, usually as a limited company (*Aksjeselskap* – AS). A limited company may have only one shareholder, and this shareholder may also be the only employee in the company. The minimum share capital is currently NOK30,000 (approximately EUR3,000). Listed businesses must be organised in the form of a public limited company (*Allmennaksjeselskap* – ASA), which requires multiple shareholders. Both the AS and the ASA are taxed as separate legal entities. The company law allows different groups of shares with different rights regarding, for example, voting power and dividends. All shares have to be issued and the identity of all the shareholders must be recorded by the company.

General partnerships are also used, and require two or more partners. General partnerships are often combined with a limited company, usually with limited companies being the partners. They are also seen in businesses otherwise organised through a personal business, when two or more persons combine resources and interact in conducting a business. A business co-operation involving shared upside and downside may be deemed a partnership for tax purposes, regardless of any formal partnership agreement. Limited partnerships may be used in some cases, but are less common after changes were made in the tax rules. Partnerships are transparent for tax purposes.

Personal business may also be conducted without a corporate form. Personal businesses outweigh the other forms of business in sheer numbers, but the personal business is usually used when there are very few or no employees besides the owner. Some business activities may only take the form of a personal business, including that of farming. A person may transfer their personal business to a fully owned limited company without immediate taxation.

There are also other varieties, but the limited company is most common. Norwegian law does not recognise trusts with the settlor or the settlor's relatives as beneficiaries. If a trust is used for business purposes (eg, as the top unit owning a group of companies), the settlors will have to abandon their economic interest. A trust is taxed as a separate entity. There are a few such trusts in Norway, controlling fairly sizeable businesses.

1.2 Transparent Entities

The most common transparent entities are general partnerships. They may be used in all types of businesses, but are often used in shipping, and also in service businesses where the personal partners play a significant role, such as law firms. Being transparent entities, partnerships allow for an immediate use of taxable individual deductions by the partners. Therefore, they are more flexible than limited companies when it comes to the distribution of proceeds and tax consolidation with other business activities of the partners.

Limited liability partnerships were popular until a few years ago, when the tax rules were tightened. A limited partner may now only carry forward any tax loss against future income from the partnership, and not use it as a deduction against other taxable income. This made limited liability partnerships less attractive for investment groups. Any proceeds from such investments will normally be exempt from taxation for partners other than individuals, thus not resulting in any future taxable income.

1.3 Determining Residence of Incorporated Businesses

The determination of the residency of a company or partnership will depend on its country of registration, or if its effective management is in Norway. A company registered in Norway will be resident there, unless its effective management is abroad. A company resident in another country according to a double tax agreement will not be considered resident in Norway according to internal rules either.

1.4 Tax Rates

The corporate tax rate is 22%. There are reduced rates for shipping, which is taxed under a tonnage tax regime, and increased rates for some financial services (25%, in addition to increased payroll tax), for upstream activities on the Norwegian Continental shelf (78%) and for the production of hydroelectric power (59% – this does not apply to wind-generated power).

Dividends from limited companies and distributions from partnerships to an individual are multiplied by a factor of 1.44, and then taxed, resulting in an effective tax rate of 31.68%. This gives a total taxation of 46.7% for the company and owner in total.

Salaries are taxed at a progressive rate, reaching 46.4% from approximately NOK1 million. Income from a personal business is also taxed at a progressive rate, reaching 49.6% from approximately NOK1 million.

Income from a personal business is subject to a slightly higher contribution to the national social security scheme than employees' salaries, thus topping out at a higher rate than salaries and distributions/dividends. However, salaries are subject to a payroll tax of 14.1% (19.1% for some financial services), which is reduced in the rural and northern parts of Norway. In the most northern parts, the payroll tax is 0%.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are calculated according to the General Tax Act on an accruals basis, not according to accounting profits. The most notable differences are the taxation of capital gains from equity investments, which are tax exempt for corporate shareholders, and depreciations of assets, which are calculated according to special tax rules. The values of assets for tax purposes are usually based on initial cost (minus accumulated tax depreciation, if applicable), not market value. Unrealised exchange gains on long-term debt and receivables may be deferred, while unrealised exchange losses may be deducted as incurred. Regarding timing issues, the taxation of financial instruments may also differ between accounting and tax purposes.

2.2 Special Incentives for Technology Investments

There are limited incentives for technology investments, but there is a possibility to claim a tax refund – the so-called *Skatte-Funn* (Tax Discovery) – for costs related to development projects approved by the Norwegian Research Council. This is intended to be a direct economic incentive, but is capped at NOK25 million. There is also a wider opportunity to deduct costs related to R&D directly, rather than capitalising such costs.

2.3 Other Special Incentives

There are not many special incentives applicable to particular industries:

- shipping has a tonnage tax regime (see **1.4 Tax Rates**);
- there are some incentives given to wind power through accelerated depreciations; and
- payroll costs are reduced in the rural and northern parts of Norway.

A separate deduction for investments into new entrepreneur businesses was introduced in 2017, but is capped at NOK1 million. Certain temporary incentives have been introduced during the COVID-19 pandemic, with the most notable being direct deduction and uplift against the Special Tax basis (56%) on investments in upstream activities within the frame of the Norwegian Petroleum Tax Act.

2.4 Basic Rules on Loss Relief

Losses may be carried forward indefinitely, and may be offset against business income, capital gains or other income. There are some limitations when it comes to losses and income from inside/outside the Special Tax regimes, like the tonnage tax regime and the resource rent regimes on petroleum income and income from hydroelectric power generation. If a business ceases activity, it is possible to carry back losses against the two previous years' income. A relief of debt (debt forgiveness) will normally reduce a carry forward loss equally, but a conversion of debt into equity (share capital) is not regarded as a relief of debt.

2.5 Imposed Limits on Deduction of Interest

There are limitations on the deductibility of interest, which are applicable to all companies except those subject to Special Tax in the Petroleum Tax regime. The present rules include limitations on interest deduction on both external debt and debt to related parties. Interest costs exceeding 25% of EBITDA are not deductible, but there is a threshold of NOK25 million on net interest for the Norwegian part of the group before the rules apply. The EBITDA is calculated on the taxable result.

There is an escape clause if the Norwegian entities (or the Norwegian part of the group) have a debt/equity ratio similar to the group as a whole. The escape clause enables fully Norwegian groups to deduct the full interest on external debt, whilst groups with companies outside Norway may not always deduct full interest costs.

There is also a restriction on interest on debt to related parties, where the debtor is not part of the group. The threshold is then reduced to NOK5 million.

Neither of the restrictions apply to companies that are subject to Special Tax for petroleum activity (exploration, exploitation and pipeline transportation on the Norwegian Continental Shelf).

Disallowed interest costs may be carried forward and deducted within the 25% of EBITDA in the following ten years.

2.6 Basic Rules on Consolidated Tax Grouping

Within each legal entity of a group, losses and profits/gains are generally tax consolidated, except for limitations regarding consolidation between the ordinary tax regimes and the Special Tax regimes (see **2.4 Basic Rules on Loss Relief**).

There is a wide opportunity to consolidate taxable results between companies within the Norwegian part of a group, conditioned upon more than 90% common ownership/control. Consolidation is performed through group contributions, which may be given in any direction and to any Norwegian company within the group. The group contribution is deductible for the contributing company, and taxable for the receiving company. It may also be applied for (to or from) permanent establishments that are taxable to Norway. In some cases, group contributions may also be contributed without a tax consequence, making it possible to refinance companies without using debt or equity from the top company. Based on strict conditions, cross-border group contributions may be allowed if the receiving company is resident within the EU/EEA and risks losing a carry forward loss. Group contributions may not be applied for income that is subject to Special Petroleum Tax or Hydropower Tax.

2.7 Capital Gains Taxation

There is a wide exemption when it comes to company and partnership taxes on capital gains from equity investments. The participation exemption applies to all investments, in both listed and unlisted companies, and also for minority ownership shares. If the ownership share is less than 90%, 3% of received dividends are taxed at a rate of 22%. The participation exemption does not apply to investments in companies that are resident in low-tax jurisdictions outside the EU/EEA, and it only applies to holdings above 10%, that are held for more than two years, if resident in normal tax jurisdictions outside the EU/EEA. There are a few conditions, and investments in company structures that are not familiar to or recognised by Norwegian company law have proved especially challenging. However, investments in other limited companies, also abroad, are almost without exception taxed according to the above stated general rules.

2.8 Other Taxes Payable by an Incorporated Business

There are no stamp duty or other taxes payable on an equity transaction, but there is stamp duty (2.5%) on real estate transactions. However, most business-to-business real estate transactions are executed as a sale of shares in a company owning the real estate, thus not triggering any stamp duty.

2.9 Incorporated Businesses and Notable Taxes

Most local communities in Norway impose real estate taxes, of up to 0.7% of the market value of the real estate. The VAT rate is 25% but does not apply on transfers of real estate and enterprises. There are no other notable taxes, but there are various customs taxes. Norway also tends to tax commodities that are deemed not healthy or harmful to the environment, such as alcohol, tobacco, sugar, petrol, cars, emissions, etc.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses (fewer than four employees) operate as personal businesses, in non-corporate form, at least when it comes to sheer numbers. Included in this category is a number of farmers and businesses that do not constitute a full-time occupation. However, the government has eased the requirements contained within the company law, in order to make the limited company more attractive for closely held businesses.

3.2 Individual Rates and Corporate Rates

The tax rates are set out so that there should not be much tax incentive to transform earnings into corporate income (see also **1.4 Tax Rates**). To a large extent, the capital gains taxation of individuals has been increased, giving a combined total tax payable by the company and the individual owner that is quite close to the tax rates on salary. There is some case law concerning whether the company (corporate income) or the owner (salary) is the correct recipient of the payment, but this issue will usually be avoided by entering into agreements that make it clear that the services provided are rendered from the company to the third-party buyer, and do not constitute an employer-employee relationship between the owner and the third-party buyer.

3.3 Accumulating Earnings for Investment Purposes

The participation exemption rules were made with the intention of accumulating earnings for reinvestment purposes. The tax authorities have stated that they will not challenge whether a distribution of dividends should (partly) be reclassified as salary, nor any non-distribution, even though the owner performs activities for the company that would otherwise call for remuneration.

3.4 Sales of Shares by Individuals in Closely Held Corporations

The ordinary capital gains taxation applies, bringing the effective tax rate up to 31.68% (see **1.4 Tax Rates**).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

There are no differences between the taxation of capital gains from closely held corporations or publicly traded corporations (see **3.4 Sales of Shares by Individuals in Closely Held Corporations** and **1.4 Tax Rates**).

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Norway is not part of the EU, but is a part of the EEA Agreement with the EU. Within the EU/EEA, discrimination on grounds of nationality and restrictions on the freedom of establishment are generally not permitted. A company resident in another EU/EEA country will therefore be treated as a Norwegian company, including not being taxed on capital gains from companies resident in Norway.

For individuals and companies outside the EU/EEA, Norway imposes a 25% withholding tax on dividends. A lower rate may follow from a relevant tax treaty.

A withholding tax on interest and royalties will be introduced on 1 July 2021. A withholding tax on rent on certain material assets, like ships, vessels, helicopters and planes, will be introduced on 1 October 2021. The withholding tax applies to payments to related parties that are resident in a low-tax jurisdiction. "Low tax" is less than two thirds of Norway's tax rate, which will be about 14.7% under Norway's current tax rate of 22%. The withholding tax will not apply if the receiving related party is established within the EU/EEA, unless the establishment is deemed wholly artificial. Dividends from companies that are subject to Special Tax on petroleum activity in Norway are exempt from withholding tax, subject to certain conditions being met.

4.2 Primary Tax Treaty Countries

In order to obtain double protection from both the EEA Agreement and the applicable double tax agreement, many investors use companies that are resident in the EEA for investments in local corporate stock. Norway, however, does not recognise wholly artificial holding companies and generally applies a strict "substance over form" approach.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

There is quite a lot of attention in Norway regarding the use and misuse of tax treaties, although there have not been many cases. Norwegian authorities are anxious to see results from the BEPS initiative, including the limitation of benefits (LOB) and principle purpose test (PPT) introduced to many treaties as a result of BEPS. Norway has ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (the MLI), which entered into force for Norway on 1 November 2019. The MLI became effective for withholding taxes from 2020 and for other treaty regulations (eg, permanent establishments) from 2021.

4.4 Transfer Pricing Issues

The biggest transfer pricing issues for inbound investors have concerned the use of debt, and whether the interest rate and the debt to equity ratios are at arm's length. This has not been as important in the last few years for companies not subject to the Petroleum Tax regime, after the introduction of a limitation on the deductibility of interest paid to related parties (see **2.5 Imposed Limits on Deduction of Interest**). Transfer pricing issues seem to have taken a turn, and more cases now involve payment for the use and ownership of intangibles, and also the re-evaluation of transactions, including business restructurings.

4.5 Related-Party Limited Risk Distribution Arrangements

The Norwegian tax authorities accept the use of related party limited risk distribution arrangements for the sale of goods or the provision of services, but look closely into the actual risks being taken, and the actual remuneration.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The Norwegian arm's-length principle has a direct reference to the OECD standards and, as such, should follow the OECD standards. However, taxpayers and the tax authorities do not always agree on how the OECD standards should be understood, and some may think that the Norwegian authorities are somewhat aggressive in their approach.

4.7 International Transfer Pricing Disputes

The Norwegian tax authorities use and accept the use of mutual agreement procedures and double tax treaties. The tax authorities have a dedicated workforce that deals with such cases, and has issued guidelines on when and how such procedures are conducted. To some extent, the tax authorities also allow for advance pricing agreements, when possible according to the double tax agreements. However, reaching a unified conclusion may be difficult, and very few tax treaties to which Norway is a party contain arbitration provisions.

Local authorities do not have the ability to give one-sided advance pricing rulings if they are outside the mutual agreements under the double tax agreements. There have been some discussions on the long duration of the mutual agreement processes, but such discussions do not seem to be exclusive to Norway.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are normally allowed when a transfer pricing claim is settled. There are special provisions in the tax administration act to make sure that the tax authorities make compensating adjustments. If a unified conclusion can be reached in a mutual agreement procedure (MAP), the conclusion is usually followed.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches of non-local corporations are not taxed any differently to local subsidiaries of Norwegian groups. A local branch is taxed according to the same rules as local limited companies, including the participation exemption regarding equity investments. If the branch belongs to a company that is resident within the EU/EEA, the EEA Agreement provides a legal framework protecting against any discrimination towards a branch compared to a local subsidiary. Most tax treaties to which Norway is a party include non-discrimination clauses that will provide a similar type of protection.

5.3 Capital Gains of Non-residents

Capital gains of non-residents are not taxed. A non-resident might, however, own the stock through a Norwegian branch. The sale of stock in other Norwegian corporations will then potentially be taxable, but the participation exemption will make any capital gains from the sale of stocks in Norwegian companies exempt from Norwegian tax in most cases.

5.4 Change of Control Provisions

There are no change of control provisions that could trigger tax directly. However, a change of control higher up in the group could indirectly affect the Norwegian entity through a change in which other companies are regarded as related parties. In addition, a change of ownership in a Norwegian company may affect the applicability of withholding tax (see **4.1 Withholding Taxes**).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Formulas are not used as a method of determining income as such, but income accrued by a foreign-owned local affiliate will typically be compared against other companies in similar businesses/markets in order to seek indications of the improper use of transfer pricing.

5.6 Deductions for Payments by Local Affiliates

The local affiliate needs to justify the payment for a service or goods having been provided for the benefit of the local affiliate, and that the price for such service or goods is at arm's length.

5.7 Constraints on Related-Party Borrowing

There are rules limiting the deductibility of interest paid to a related party. The limitation applies to both internal payments and cross-border payments (see **2.5 Imposed Limits on Deduction of Interest**). For companies that are subject to Special Petroleum Tax, the maximum interest deduction in the Special Tax base is capped as a calculated portion of the written down tax value of the company's facilities at the end of the year compared to the company's average interest-bearing debt during the income year. However, this limitation is general and does not only apply to loans from related parties. Hydroelectric power producers are not allowed interest deductions at all in the resource rent tax (37%), but are granted an uplift based on a calculated risk-free cost on investments.

A withholding tax on interest paid to related parties will be introduced on 1 July 2021 (see **4.1 Withholding Taxes**).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Norway imposes a full, global tax liability on resident companies on all income earned inside and outside of Norway. Foreign income is only exempt when a treaty calls for an exemption, with a few exceptions. Income from foreign petroleum exploration and production is tax exempt.

6.2 Non-deductible Local Expenses

If foreign income is exempt due to either a treaty or the few internal exceptions, neither local nor global-related expenses related to such income are deductible.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries are taxed under the participation exemption scheme. The participation exemption will normally apply to any subsidiary, except subsidiaries in low-tax countries. If capital gains are not exempted, they are taxed at 22%. There are also rules allowing for the underlying tax paid by the subsidiary to be offset against Norwegian taxation of the dividends. With the broad participation exemption, such offset is less practical than before the participation exemption was introduced (in 2004).

A subsidiary in a low-tax jurisdiction might be subject to Norwegian CFC taxation. Dividends from a CFC-taxed subsidiary qualify under the participation exemption.

6.4 Use of Intangibles by Non-local Subsidiaries

The transfer or use of intangibles developed by a Norwegian entity is taxed based on an arm's-length remuneration.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Norway has quite strict CFC rules. Income earned by a subsidiary is subject to taxation as if the subsidiary was Norwegian, conditioned upon the subsidiary being controlled or owned more than 50% by Norwegian entities. The entities do not need to be part of the same group.

All income from a non-local branch is taxed according to Norwegian rules. Norway taxes resident companies on their worldwide income, including all income from foreign branches, subject to limitations in any relevant tax treaties.

6.6 Rules Related to the Substance of Non-local Affiliates

Elements of the "substance over form doctrine" applied by Norway as a general anti-avoidance rule, which was previously based on case law, were formalised in a new Section 13-2 of the General Tax Act on 1 January 2020. The tax treatment of foreign companies using a corporate form that differs from the forms recognised in Norwegian company law tends to create practical problems.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

The sale of shares in non-local affiliates is usually covered by the participation exemption (see **6.3 Taxation on Dividends from Foreign Subsidiaries**).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Anti-avoidance provisions include a statutory general anti-avoidance rule, a general provision in the General Tax Act aimed at reduced income due to community of interest between parties/companies involved in a transaction, and more specific anti-avoidance rules, including CFC regulations, a provision for limiting use of loss carried forward and other tax positions after reorganisations and business transactions and regulations limiting the deductibility of interest.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Norwegian tax period is usually 1 January to 31 December. A tax return is due before 31 May in the year following the taxable period. A statement of taxable income is presented to the company mid-October in the year after the year of income. Taxes are due in three instalments during the year following the year of income, with the last instalment, later than October, settling the balance.

Controls and audits may be conducted during the income year and before the tax return is submitted, but audits are usually performed after October in the year following the income year. The company may change its taxable income within three years after the end of the year of income, and the Norwegian tax authorities may reassess the taxable income if the taxpayer has been notified of such reassessment within five years following the year of income. In the event of deliberate tax fraud, the tax authorities may reassess within ten years.

9. BEPS

9.1 Recommended Changes

Norway is a high-tax jurisdiction by tradition, in which inbound investments have made up a large part of the private economy. Furthermore, the general legal system is largely based on a doctrine of "substance over form" compared to many (most) other comparable legal systems. This is also the case with respect to Norwegian tax law. The concept of taxation based on economic substance and reality rather than formalities has been recognised for a long time. There is even a separate expression for this in Norwegian: "Taxation based on looking through the formalities" (*Gjennomskjæring* in Norwegian). Hence, despite the fact that most of the transfer pricing legislation is contained in one general section in the General Tax Law 1999, which also includes a reference to the OECD Transfer Pricing Guidelines, many of the BEPS recommendations have been deemed part of Norwegian tax legislation for a long time. To some extent, the recommendations have been used to tighten up the Norwegian tax legislation, but there are also elements that have been inspired by the BEPS recommendations, including the following.

- General interest limitation rules related to loans between related parties have been effective since 2014. This should be assessed against the background that interest costs are generally deductible, regardless of whether or not they are related to any income-generating activity or business activity. General interest limitations rules also for loans from third parties were implemented in 2019. Furthermore, petroleum activity has been subject to interest limitation rules with respect to Special Tax for many years.
- For hybrid mismatch situations, dividends are not tax exempted for the shareholder if the distributing company is entitled to a tax deduction for such distribution.
- Changes in the definition of when a company is resident in Norway were made in 2019, in order to prevent companies from having dual residencies or no residency.
- To a limited extent, Norway is party to the MLI (see **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**). The limited participation is not because Norway does not want to impose changes to its double taxation conventions, but rather because Norway prefers direct negotiations as the basis for direct amendments to double tax conventions, in many situations. Also, with respect to the Nordic countries, there is already a multilateral double taxation convention in place, in which Norway prefers to include the necessary amendments directly.

9.2 Government Attitudes

The general governmental attitude towards BEPS in Norway is clearly favourable. This is partly because the Norwegian fiscal authorities welcome international support for principles that have for a long time been either formal legislation or a general position of the authorities. For example, the BEPS recommendations also represent a source of support for even tighter specific regulations related to interest limitations.

9.3 Profile of International Tax

International tax has a high public profile in terms of individual histories being presented by the press (eg, "Panama papers" and specific cases), but it is probably fair to say that the general public does not really seem to be very concerned about the concept of international tax, nor challenges related to it. Politically, there is clear attention on issues related to multinationals and the digital economy as a potential threat to the Norwegian tax base.

9.4 Competitive Tax Policy Objective

Norwegian governments (being coalitions from either the conservative/centre side or the labour/left side) do not appear to be that interested in making the Norwegian tax system competitive, beyond trying to avoid it becoming uncompetitive. Accordingly, Norway will remain a high-tax jurisdiction with very few tax incentives. The general postulate is "a broad tax base and a low, but not (among) the lowest tax rate". Consequently, in 2019 the Norwegian corporate tax rate was reduced from 28% to 22%.

9.5 Features of the Competitive Tax System

The tonnage tax system was introduced to deter the Norwegian shipping industry leaving Norway. This is formally a system with limited duration, but it is difficult to see the system being abolished.

Furthermore, there are time-limited depreciation rules for certain investments into wind power generation. Apparently, the Norwegian authorities do not intend these rules to become permanent.

Presumably, a fair statement is that investments into or from Norway are normally made despite the tax system and not because of it.

9.6 Proposals for Dealing with Hybrid Instruments

Because Norwegian tax legislation and practice are largely based on realities rather than formalities, the use of hybrid instruments to achieve tax objectives has probably been limited. The reasoning presented by the BEPS initiative appears to be in line with the general view of the Norwegian tax authorities. Accordingly, legislation stating that dividends are not tax exempted for the shareholder in Norway if the distributing company is entitled to tax deduction for such distribution has already been implemented. In addition, changes in the definition of when a company is resident in Norway were implemented in 2019, preventing companies from having dual residencies or no residency. It is also expected that the Norwegian authorities will pursue this issue actively when negotiating new or amended double taxation conventions.

9.7 Territorial Tax Regime

Primarily, Norway has a tax system that is based on global income, although there are certain elements that are territorial in scope. Typically, interest costs related to property or activity abroad that is exempted from Norwegian taxation under either domestic legislation or double taxation conventions are not deductible against income subject to Norwegian tax. Allocation rules – or more often principles – are important in this respect, but these rules are not part of the general interest limitation rules referred to under **5.7 Constraints on Related-Party Borrowing** and **9.1 Recommended Changes**; they are more a result of symmetry and neutrality considerations, which have for a long time been important principles on which the Norwegian tax legislation has been developed. The interest limitation rules have not had any significant effect on the level of investments in and from Norway, but rather on how they are structured.

9.8 CFC Proposals

Norway has had comprehensive CFC rules for decades. In general, the rules apply if 50% or more of a foreign company is directly or indirectly owned or controlled by Norwegian residents and the company in question is subject to taxes which are less than two thirds of the taxes the company would have been subject to if it was resident in Norway. Hence, the BEPS proposals in this respect represent very little change.

These rules apply regardless of substance in the CFC. Hence, the idea of having a sweeper CFC rule that could make offshore subsidiaries whose profits are taxed at a "low rate" vulnerable to CFC apportionment, regardless of the substance located in a particular jurisdiction, was implemented a long time ago. Finally, based on the concept of "taxation based on looking through the formalities", CFCs with little or no substance would be vulnerable to Norwegian taxation, as if the company had been resident in Norway. There are examples of case law for this dating back to the early twentieth century.

9.9 Anti-avoidance Rules

Due to the general concepts with respect to substance over form (see **9.1 Recommended Changes**) and the rather aggressive transfer pricing approach regularly seen from the Norwegian tax authorities, it is difficult to see the BEPS initiatives on double taxation convention limitation of benefit or anti-avoidance rules having any significant impact on taxation in Norway.

9.10 Transfer Pricing Changes

As noted previously, it is difficult to see the proposed transfer pricing changes initiating any radical changes in Norway. Norwegian tax authorities already refer to the proposals as being in line with their understanding of the present situation in Norway.

9.11 Transparency and Country-by-country Reporting

Norway has a long tradition of transparency. In addition, the companies in question have since long been required under the Norwegian tax legislation to report their direct activity abroad. In addition, comprehensive CFC regulations have been in place for a long time. Hence, country-by-country reporting has already been introduced and does not represent anything fundamentally new.

9.12 Taxation of Digital Economy Businesses

There has been a lot of discussion on this topic in Norway, but very little (if anything) has been presented as firm proposals by the authorities. Partly due to the fact that Norway is a small country with a small but very open economy, Norwegian authorities seem to await EU initiatives and will not implement unilateral rules on this. Many of the issues and problems discussed with respect to digital economy businesses operating largely from outside the Norwegian jurisdiction are not necessarily fundamentally new to a country that has a long history of inbound investments.

9.13 Digital Taxation

See **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP

There are no special provisions dealing with the taxation of offshore intellectual property in particular. Ordinary rules apply, relying on Norwegian CFC rules and general transfer pricing measures such as the arm's-length principle.

Harboe & Co is an Oslo-based law firm that specialises in taxation and has specialist competence in Norwegian special tax regimes (oil and gas, finance and hydropower) and litigation/dispute resolution in transfer pricing matters. It assists with income tax, value added tax (VAT), real estate tax and customs duties in industry sectors such as investment companies, venture/private equity, real estate, oil and gas, renewables, utilities, chemicals, banking and insurance, and individuals. The key types of work undertaken are assistance in tax litigation and disputes, transaction structuring and support, transfer pricing issues and structuring, investment structuring, due diligence, advice on tax incentives and reporting to tax authorities.

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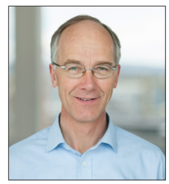

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PHILIPPINES

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Business organisations in the Philippines are generally formed as incorporated entities or corporations, although business firms may also be organised as partnerships or sole proprietorships.

Corporations

Corporations are either formed under the Revised Corporation Code of the Philippines (RCC) or created under special law.

Corporations formed or organised under the RCC may be stock or non-stock corporations. Stock corporations are those with capital stock divided into shares and authorised to distribute to the shareholders dividends on the basis of the shares held. All other corporations are non-stock corporations. Under the RCC, corporations may be organised with a sole shareholder (a "one-person corporation").

Corporations have the powers provided under the RCC, and may exercise such other powers as may be essential or necessary to carry out the business purposes stated in their articles of incorporation. Corporations may exist perpetually.

Corporations are taxed as separate legal entities. For income tax purposes, entities that are not corporations as defined under the RCC – such as joint-stock companies, joint accounts, associations, insurance companies, or partnerships – are treated as corporations. However, general professional partnerships (GPPs) and joint ventures or consortiums formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating or consortium agreement under a service contract with the Philippine government are not taxed as separate corporations and the income tax is imposed on the partners and/or consortium members.

The Corporate Recovery and Tax Incentives for Enterprises Act (the "CREATE Law"), which became law on 26 March 2021, lowered the corporate income tax from 30% to 25%, which shall apply retroactively beginning 1 July 2020, and the imposition of MCIT was reduced from 2% to 1% from 1 July 2020 to 30 June 2023. The CREATE Law also provides a lower corporate income tax of 20% for corporations with net taxable income not exceeding PHP5 million and with total assets not exceeding PHP100 million, excluding land on which the corporation's office, plant and equipment are situated during the taxable year for which the tax is imposed.

When corporations declare dividends to their shareholders, or profits to their partners, in the case of partnerships that are considered corporations, these dividends and profits are again taxed at the shareholder – or partner – level. Individual shareholders and partners are generally subject to a 10% final tax on dividends. Dividends declared by a domestic corporation to another domestic corporation or to a resident foreign corporation are not subject to income tax.

Sole Proprietorships

Sole proprietorships, on the other hand, have no separate juridical personality. Proprietors are taxed as individuals, and the income tax rates range from 0%–35%.

1.2 Transparent Entities

The transparent entities commonly used in the Philippines, GPPs and unincorporated joint ventures or consortiums, are exempt from income tax. The income tax is imposed on their partners or consortium members.

GPPs are formed by persons for the sole purpose of exercising their common profession, while non-taxable unincorporated joint ventures or consortiums are those formed for the purpose of undertaking construction projects or engaging in petroleum, coal, geothermal and other energy operations pursuant to an operating or consortium agreement under a service contract with the Philippine government.

1.3 Determining Residence of Incorporated Businesses

The incorporation test is used in determining the residence of incorporated businesses for Philippine taxation purposes.

A corporation organised under Philippine laws is a domestic corporation, while a corporation organised under the laws of a foreign country is a foreign corporation. A foreign corporation doing business in the Philippines (for example, through a branch) is considered a resident foreign corporation. A non-resident foreign corporation refers to a foreign corporation not engaged in trade or business within the Philippines.

For income tax purposes, domestic corporations are taxed on their worldwide income; foreign corporations are taxed only on their Philippine-sourced income.

Income tax of domestic and resident foreign corporations is based on their taxable income, or gross income less allowable deductions, while non-resident foreign corporations are taxed on their gross income, without deductions.

The residence of transparent entities is generally not material since they are exempt from income tax. However, the determination of the residence of the individuals or corporations composing the transparent entity is relevant, as they are the ones directly subject to income tax.

1.4 Tax Rates

Corporations are generally subject to the following taxes.

- 25% (or 20%) corporate income tax based on taxable income or 2% MCIT (reduced to 1% until 30 June 2023) based on gross income, whichever is higher. The MCIT is imposed beginning on the fourth taxable year following the taxable year the corporation commenced its business operations. The taxpayer may ask the Commissioner of Internal Revenue (CIR) to suspend the MCIT under certain circumstances. Any excess MCIT over the regular corporate income tax (RCIT) may be carried forward and credited against the RCIT for the three immediately succeeding taxable years.
- 12% value added tax (VAT).
- Local taxes, the rates of which vary depending on the type and location of the business.

Transparent entities (ie, GPPs and certain types of unincorporated joint ventures or consortiums) are exempt from income tax but are generally subject to the following taxes:

- 12% VAT; and
- local taxes, the rates of which vary depending on the type and location of the business.

Individuals engaged directly in business or through transparent entities are generally subject to the following taxes:

- 0%–35% graduated income tax;
- 12% VAT; and
- local taxes, the rates of which vary depending on the type and location of the business.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable income is defined as gross income less deductions allowed under the Philippine Tax Code or other special laws.

Taxable income is not entirely based on accounting profits. Certain items are income for accounting purposes but are not taxable under the Tax Code. Certain deductions are allowable for accounting purposes but not under the Tax Code, and vice versa.

For instance, accounting income should be adjusted to exclude from taxable income any income that has been subject to final tax, and to add back expenses that are not deductible under tax laws (eg, provisions for bad debts since, under the Tax Code, bad debts must be actually written off to be deductible).

Taxable income is generally computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, but if no such method of accounting has been so employed, or if such method does not clearly reflect the income, the computation will be made in accordance with such method as, in the opinion of the CIR, clearly reflects the income. In the Philippines, the accounting method is generally based on the Philippine Financial Reporting Standards (PFRS), but in a case of conflict between the PFRS and tax law and regulations, the latter shall prevail for purposes of income taxation.

2.2 Special Incentives for Technology Investments

Income earned by an alien or a foreign corporation from the use of intellectual property in the Philippines is considered as Philippine-sourced income and is subject to Philippine income tax. Income earned by a resident citizen or a domestic corporation from the use of intellectual property within or outside the Philippines will be subject to Philippine income tax.

Businesses conducting research and development (R&D) activities may be granted fiscal incentives such as the income tax holiday (ITH) for a certain period. Under the 2020 Investment Priorities Plan of the Philippine government, "innovation drivers" such as R&D activities have been identified as preferred activities for investment subject to incentives. Innovation drivers also cover the commercialisation of new and emerging technologies, uncommercialised patents on products and services, and products of locally undertaken R&D activities, such as agricultural biotechnology tools, photonics and nanotechnology, and natural health products.

A taxpayer may treat R&D expenditures, which are paid or incurred during the taxable year in connection with the taxpayer's business as ordinary and necessary expenses, as deductible expenses during the taxable year when they were paid or incurred.

However, subject to the relevant rules and regulations, the taxpayer may opt to treat as deferred expenses R&D expenditures that are:

- paid or incurred by the taxpayer in connection with his business;
- not treated as deductible expenses; and
- chargeable to capital account but not chargeable to property subject to depreciation or depletion.

Such deferred expenses shall be amortised over a period of not less than 60 months, as may be elected by the taxpayer beginning with the month in which the taxpayer first realises benefits from such expenditures.

2.3 Other Special Incentives

The general investment incentives laws are the Special Economic Zone Act of 1995 (the "PEZA Law") for businesses located in designated economic zones ("ecozones"), the Omnibus Investments Code of 1987 (OIC) for entities engaged in preferred activities and registered eith the Board of Investments, and the Bases Conversion and Development Act of 1992 (the "BCDA Law") for business enterprises that are located within former military bases that were converted into ecozones or freeport zones. The fiscal incentives under these laws were amended by the CREATE Law.

Under the CREATE Law, a uniform set of incentives may be granted to qualified enterprises whose activities are listed in the strategic investment priority plan, among other conditions. The fiscal incentives that may be granted to qualified, registered enterprises under the CREATE Law are:

- ITH of four to seven years;
- special corporate income tax of 5% on gross income earned in lieu of all national and local taxes or enhanced deductions for five to ten years;
- duty exemption on importation of capital equipment, raw materials, spare parts or accessories; and
- VAT exemption on importation and VAT zero-rating on local purchases.

There are other special laws that provide fiscal incentives to certain sectors or undertakings such as co-operatives and, renewable energy developers in order to promote economic development.

Additionally, under the CREATE Law, the grant of a preferential tax rate to existing registered enterprises will have a sunset period of ten years from effectiveness of the law if the existing registered enterprise is availing of the 5% gross income tax incentives. Existing registered enterprises availing of the ITH may continue to enjoy such incentive for the period granted under the terms of their registration.

Further, the Fiscal Incentives Review Board (FIRB) is tasked to grant appropriate tax incentives to registered projects or activities with investment capital of more than PHP1 billion. The grant of tax incentives to registered projects or activities with investment capital of PHP1 billion and below is delegated by the FIRB to the concerned investment promotion agencies to the extent of their approved registered project or activity under the strategic investment priority plan.

The president is also given the power to modify the period or manner of availing incentives in the interest of national economic development and upon recommendation of the FIRB, provided that the grant of ITH shall not exceed eight years and, thereafter, a special corporate income tax rate of 5% may be granted. However, the cumulative period of incentive availment for incentives granted by the president shall not exceed 40 years.

2.4 Basic Rules on Loss Relief

The Philippine Tax Code provides that the net operating loss (NOL) of an enterprise (ie, the excess of allowable deductions over the gross income) for any taxable year immediately preceding the current taxable year, which had not been previously offset as deduction from gross income, may be carried over as a deduction from gross income for the next three consecutive taxable years immediately following the year of such loss. However, any net loss incurred in a taxable year when the taxpayer was exempt from income tax is not allowed as a deduction. Additionally, a net operating loss carry-over (NOLCO) shall be allowed only if there has been no substantial change in the ownership of the business in that:

- not less than 75% in the nominal value of outstanding issued shares, if the business is in the name of a corporation, is held by or on behalf of the same persons; or
- not less than 75% of the paid-up capital of the corporation, if the business is in the name of a corporation, is held by or on behalf of the same persons,

where such substantial change resulted from the said taxpayer's merger, consolidation or business combination with another person, and not through a sale by a shareholder.

Ordinary loss is deductible against ordinary gain and capital gain, while capital loss is deductible only against capital gain.

Individual taxpayers sustaining a net capital loss in any taxable year are also allowed to deduct such loss against capital gain in the succeeding taxable year but only in an amount not exceeding net income in the said taxable year.

Under the CREATE Law, registered enterprises granted tax incentives are entitled to an enhanced NOLCO, which means that the net operating loss of a registered project or activity during the first three years from the start of commercial operations that had not been offset as deduction from gross income may be carried over as deduction from gross income within the next five consecutive taxable years immediately following the year of such loss.

2.5 Imposed Limits on Deduction of Interest

Interest paid or incurred by a taxpayer within a taxable year on indebtedness in connection with his or her business is generally allowed as a deduction from his or her gross income, but such allowable deduction for interest expense shall be reduced by 20% of the interest income of the taxpayer subject to final tax. An example of interest income subject to final tax is interest income from peso bank accounts, which is subject to 20% final tax.

No deduction is allowed in respect of interest:

- if within the taxable year an individual taxpayer reporting income on the cash basis incurs an indebtedness on which an interest is paid in advance through discount or otherwise;
- if both the taxpayer and the person to whom the payment has been made or is to be made are related parties as specified under the Philippine Tax Code; or
- if the indebtedness is incurred to finance petroleum exploration.

The taxpayer may opt to treat interest incurred to acquire property used in business as a deduction or as a capital expenditure.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is not permitted under Philippine law. Losses incurred by one company in a group may not be utilised by another company.

Nonetheless, when a taxpayer merges, consolidates or combines with another person, that taxpayer's NOL may be transferred or assigned to the surviving or new corporation or entity if the shareholders of the transferor/assignor gain control of at least 75% or more in nominal value of the outstanding issued shares or paid-up capital of the transferee/assignee (if the surviving entity is a corporation) or 75% or more interest in the business of the transferee/assignee (if the transferee/assignee is not a corporation).

Additionally, in a merger, the NOLCO shall be allowed as a deduction from gross income of the surviving entity if the taxpayer who sustained and accumulated the NOL is the surviving entity.

2.7 Capital Gains Taxation

Net capital gains realised by domestic corporations and foreign corporations on the sale or exchange of shares in a domestic corporation not traded on the Philippine stock exchange are subject to a final tax of 15%.

The sale of shares listed and traded on the Philippine stock exchange is subject to a stock transaction tax of 6/10 of 1% based on the gross selling price or gross value in money of the shares of stock sold.

If the corporation is a non-resident foreign corporation, it may avail itself of tax treaty relief on capital gains derived from the alienation of property in the Philippines.

2.8 Other Taxes Payable by an Incorporated Business

A corporation that, in the course of trade or business, sells, barters, exchanges, leases goods or properties, or renders services, is subject to VAT at the rate of 12% on the sale of goods or service, barter or exchange. The importation of goods is likewise subject to VAT.

Depending on the transaction, corporations may be subject to documentary stamp tax (DST), which is a tax on documents, instruments, loan agreements and papers, and upon acceptances, assignments, sales and transfers of obligations, rights or properties.

Certain goods manufactured or produced (eg, distilled spirits, tobacco products, mineral products, petroleum products, sweetened beverages) in the Philippines for domestic sales or consumption or for any other disposition, or which are imported, are subject to excise tax. Cosmetic surgery services performed in the Philippines are also subject to excise tax. Excise taxes are imposed in addition to VAT, and VAT is computed on the gross selling price or gross receipt plus the excise tax.

2.9 Incorporated Businesses and Notable Taxes

Certain income payments are subject to final or creditable withholding taxes. Incorporated businesses (ie, domestic corporations) may be constituted as withholding agents when they make payments that are subject to final or creditable withholding tax.

Passive income that is subject to final withholding tax (FWT) is no longer included in the computation of the taxable income. The following types of passive income earned by incorporated businesses are subject to the following FWT:

- 20% final tax on the amount of interest on currency bank deposit and yield or any other monetary benefit from deposit substitutes and from trust funds and similar arrangements, and royalties derived from Philippine sources; or
- 15% final tax on interest income from a depository bank under the expanded foreign currency deposit system.

The sale, exchange or disposition of lands and/or buildings that are not actually used in the business of a corporation and are treated as capital assets is subject to 6% capital gains tax (CGT) based on the gross selling price or fair market value of the property, whichever is higher.

The sale of shares of stock in a domestic corporation that are held as capital assets is subject to a separate tax – CGT or stock transaction tax.

The CREATE Law repealed the improperly accumulated earnings tax (IAET) equal to 10% of improperly accumulated taxable income.

Incorporated businesses (ie, employers) are also required to pay a 35% fringe benefits tax on the grossed-up monetary value of fringe benefits furnished or granted to their employees, except rank and file employees, unless the fringe benefit is required by the nature of, or necessary to, the trade or business of the employer, or when the fringe benefit is for the convenience or advantage of the employer.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Following the general way business is done in the Philippines, closely held businesses would usually operate in corporate form.

The RCC has its own definition of a "close" corporation. A close corporation is one whose articles of incorporation provides that:

- all the corporation's issued stock of all classes, exclusive of treasury shares, is held of record by not more than 20 persons;
- all the issued stock of all classes is subject to specified restrictions on transfer; and
- the corporation is not listed on any stock exchange or has not made any public offering of its stocks of any class.

The concept of a one-person corporation was recently introduced in the RCC.

3.2 Individual Rates and Corporate Rates

As a rule, corporate practice of a profession is not sanctioned under Philippine law. According to the Philippine Supreme Court, this rule is hinged on the idea that "the ethics of any profession is based on individual responsibility, personal accountability and independence, which are all lost where one verily acts as a mere agent, or alter ego, of unlicensed persons or corporations."

3.3 Accumulating Earnings for Investment Purposes

The Philippine Tax Code provision imposing an IAET at the rate of 10% based on improperly accumulated taxable income was repealed by the CREATE Law.

The RCC prohibits stock corporations from retaining surplus profits in excess of 100% of their paid-in capital stock subject to certain exceptions.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Cash and property dividends received by citizens or resident aliens from their shares in domestic corporations (including closely held corporations) are subject to a final tax of 10%, while those received by non-resident aliens engaged in trade or business in the Philippines and non-resident aliens not engaged in trade or business in the Philippines are subject to a final tax of 20% and 25%, respectively.

Stock dividends are not subject to income tax if the number of shares received is in proportion to the existing shareholding of the stockholder. However, the issuance of shares through the declaration of a stock dividend is subject to DST at the rate of PHP2 for every PHP200 of the par value of the shares issued.

Net capital gains realised by individuals on the sale or exchange of shares in domestic corporations (including closely held corporations) not traded on the Philippine stock exchange are subject to a final tax of 15%. The sale of shares in domestic corporations outside the stock exchange is subject to DST at the rate of PHP1.75 for every PHP200 of the par value of the shares issued.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Cash and property dividends received by individuals (citizens and resident aliens) from their shares in publicly traded corporations are subject to a final tax of 10%, while those received by non-resident aliens engaged in trade or business in the Philippines and non-resident aliens not engaged in trade or business in the Philippines are subject to a final tax of 20% and 25%, respectively.

Stock dividends declared by publicly traded corporations are likewise not subject to income tax if the number of shares received is in proportion to the existing shareholding of the stockholder. However, the issuance of shares through the declaration of a stock dividend is subject to DST at the rate of PHP2 for every PHP200 of the par value of the shares issued.

Sale of shares listed and traded on the Philippine stock exchange is subject to a stock transaction tax of 6/10 of 1% based on the gross selling price or gross value in money of the shares of stock sold.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Interests, dividends and royalties earned by non-resident aliens not doing business in the Philippines are subject to FWT of 25%.

Interests and royalties earned by non-resident foreign corporations are subject to FWT of 25%.

Interest on foreign loans received by non-resident foreign corporations is subject to FWT of 20%.

Dividends earned by non-resident foreign corporations are generally subject to FWT of 25%. Effective 1 July 2021, this rate is reduced to 15% if the country of domicile of the non-resident foreign corporation allows a credit against the tax due from the non-resident foreign corporation taxes deemed to have been paid in the Philippines equivalent to 10%, which represents the difference between the RCIT rate of 25% and the 15% tax rate on dividends. This is referred to as tax sparing credit.

4.2 Primary Tax Treaty Countries

The Philippines is a party to tax treaties with 43 countries. There is no public data available showing which tax treaty countries are primarily used by investors to make investments in Philippine corporate stock or debt.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The Philippine Bureau of Internal Revenue (BIR) requires the submission of documents to ascertain whether an entity applying for a tax treaty relief is entitled to the preferential tax rates under an applicable tax treaty.

For interest, dividends and royalties, no tax treaty relief application (TTRA) is required but the non-resident must submit a certificate of residence for tax treaty relief (CORTT) form to the payor of the income or the withholding agent in order to avail of the preferential treaty rates for these incomes. Such preferential tax treaty rates or exemptions shall be applied and used outright by the withholding agents upon submission of CORTT forms by the non-resident, subject to a compliance check and post-reporting validation during the regular tax audit by the BIR on the payor or withholding agent. Non-compliance with the regulations prescribing the procedures to avail of the tax treaty benefits on dividends, interests and royalties is a ground for denial of the non-resident's claim for preferential tax treatment, as well as the disallowance of the relevant expense on the part of the payor or withholding agent.

For other types of income, the availment of tax treaty relief must be preceded by a TTRA filed with the BIR. If the BIR finds that the entity is not qualified, then the TTRA will be denied.

4.4 Transfer Pricing Issues

Based on the BIR's transfer pricing guidelines, intra-firm or inter-related transactions account for a substantial portion of the transfer of goods and services in the Philippines, but the revenue collection from related-party groups continues to decrease. The BIR has attributed this to the fact that related companies are more interested in their net income as a whole rather than as separate entities. Accordingly, the transfer pricing regulations prescribed the guidelines in determining the appropriate revenues and taxable income of the parties in controlled transactions by providing the methods for establishing an arm's-length price. The regulations also require taxpayers to maintain or keep documents necessary for the taxpayer to prove that efforts were exerted to determine the arm's-length price or standard in measuring transactions among associated enterprises.

To provide a framework and guide for transfer pricing examinations by the BIR, the BIR issued transfer pricing audit guidelines, which are applicable to controlled transactions between related/associated parties where at least one party is subject to tax in the Philippines and to transactions between a permanent establishment and its head office or other related branches.

The BIR also issued regulations to ensure that proper disclosures of a related-party transaction are made and that these transactions are conducted at arm's length. The BIR recently amended these regulations to streamline the procedure for submission of the disclosure form, transfer pricing documentation and other supporting documents by providing safe harbours and materiality thresholds.

4.5 Related-Party Limited Risk Distribution Arrangements

The transfer pricing regulations recognise that an appraisal of the risk is important in determining arm's-length prices or margins. Only those risks that are economically significant in determining the value of transactions or margins of entities will be identified and used in the comparability analysis to be conducted in applying the arm's-length principle.

Under the audit guidelines, the BIR must conduct a functional, asset and risk analysis in order to determine the nature of the taxpayer's business. Functional analysis is performed to obtain accurate identification on the characteristics of the taxpayer's business as well of its counterparts, and, consequently, the level of the risks borne and the remuneration or profit (which must be proportional with the risks borne) can be predicted.

However, this firm has not yet seen and is not aware whether the BIR has already applied these audit guidelines and specifically challenged the use of related-party limited risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

While the Philippines is not a member of the OECD, the transfer pricing regulations issued by the BIR are largely based on the OECD Transfer Pricing Guidelines.

4.7 International Transfer Pricing Disputes

International transfer pricing disputes are not prevalent in the Philippines. Transfer pricing issues have been recognised by the BIR in prior issuances, but the BIR has not yet issued guidelines on mutual agreement procedures (MAPs).

While specific guidelines have not yet been released, the BIR has signified that taxpayers may avail of advance pricing arrangements (APAs) to reduce the risk of transfer pricing examination and double taxation. An APA may be unilateral, which is an agreement between the taxpayer and the BIR, or bilateral or multilateral, which is an agreement involving the Philippines and one or more of its treaty partners. If a taxpayer does not choose to enter into an APA, it may still invoke the article on MAPs in Philippine tax treaties to resolve double taxation issues.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The Philippine Tax Code authorises the CIR to distribute, apportion or allocate gross income or deductions between or among two or more organisations, trades or businesses, whether or not incorporated and organised in the Philippines, owned or controlled directly or indirectly by the same interests, if necessary, in order to prevent evasion of taxes or clearly reflect the income of any such organisation, trade or business.

Thus, transfer pricing adjustments made by the BIR are to ensure that taxpayers clearly reflect income attributable to controlled transactions and to prevent tax evasion in such transactions.

Under the transfer pricing audit guidelines, upon finding that the price or rate is not at arm's length, the BIR will propose adjustments by imputing the arm's-length margin (eg, the discrepancy between the price or profit of the affiliated transactions and the arm's-length price or profit). The primary adjustments may also lead to secondary adjustments.

The BIR will discuss their findings with the taxpayer and the latter may contest the facts and issues identified. Thereafter, the regular tax audit process and remedies (eg, protest, administrative and judicial appeal) will be applicable.

The transfer pricing regulations granted the taxpayers the option to avail of the APA and the MAP relief. However, difficulties in the actual implementation have yet to be seen since, to date, the BIR has not yet issued APA or MAP guidelines.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

The term "non-local corporation" used here shall refer to a foreign corporation, defined under the Philippine Tax Code as a corporation not created or organised in the Philippines or under its laws.

Local branches of non-local corporations are taxed differently from local subsidiaries of such non-local corporations. Local branches of non-local corporations are subject to income tax only on their Philippine-sourced income, while local subsidiaries of non-local corporations are considered domestic corporations and subject to income tax on their worldwide income.

With respect to their taxable income (Philippine-sourced or worldwide as applicable), local branches and local subsidiaries of non-local corporations are subject to the same tax rates:

- 25% corporate income tax based on taxable income; or
- 2% MCIT (reduced to 1% until 20 June 2023) based on gross income.

Regional operating headquarters (ROHQs) of non-local corporations whose income is currently taxed at 10% are now subject to the RCIT, effective 1 January 2022, due to the CREATE Law.

However, the local branch's remittance of branch profits to the foreign head office is subject to branch profit remittance tax of 15%, while remittance of dividends by the local subsidiary to the foreign head office is subject to FWT of 30% (reduced to 25% under the CREATE Bill) subject to the tax sparing credit and tax treaty.

5.3 Capital Gains of Non-residents

Net capital gains from the sale of stock in local corporations are always subject to Philippine income tax, except if there is an applicable tax treaty that grants CGT exemption.

Net capital gains of non-resident individuals and non-resident foreign corporations arising from the sale of stock in local corporations not traded on the local stock exchange are subject to CGT of 15%.

The gain from the sale of shares of a non-local holding company will be considered income from sources outside the Philippines and will not be subject to Philippine income tax unless the seller is a resident Philippine citizen or a domestic corporation.

Treaties eliminate CGT under certain conditions. For instance, there are tax treaties that exempt the net capital gains arising from the sale of shares in a local corporation from CGT if the assets of the local corporation do not consist principally of real property.

5.4 Change of Control Provisions

In general, there is no change of control provision that by itself would trigger tax and duty charges unless the change in control arises from the disposition of shares in a domestic corporation. However, change of control may affect deductibility of certain expenses, such as the NOLCO, which is deductible from gross income only if there has been no substantial change in the ownership of a business or enterprise.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The BIR's Revenue Audit Memorandum Order No 1-95, which contains the audit guidelines and procedures for the proper determination of the income tax liability of Philippine branches and liaison offices of multinational enterprises selling goods or providing services, prescribes a formula whereby a portion of the income derived from Philippine sources by the foreign entity is attributed and taxed to the branch or the liaison office.

5.6 Deductions for Payments by Local Affiliates

There is no specific standard applied in allowing a deduction for payments by local affiliates for management and administrative expenses incurred by a non-local affiliate. As a rule, an expense may be allowed as a deduction from the gross income of the local affiliate if the same is an ordinary and necessary expense paid or incurred during the taxable year in carrying on, or which is directly attributable to, the development, management, operation and/or conduct of the trade or business of the local affiliate. The transfer pricing guidelines issued by the BIR also require that the payment should be consistent with the arm's-length principle. In the case of payment to a non-local affiliate, the payor must withhold any applicable withholding taxes and remit the same to the BIR.

5.7 Constraints on Related-Party Borrowing

In addition to the usual requirements of the deductibility of interest expense, the interest agreed upon by and between affiliates should be in accordance with the arm's-length principle adopted by the BIR, and the necessary withholding taxes withheld and paid to the BIR.

In determining whether the interest payment transactions are at arm's length, the BIR, under the transfer pricing audit guidelines, will look into various factors, such as the nature and purpose of the debt, market conditions at the time the loan is extended, amount of principal and period of the loan, security offered and guarantees, and the amount of debt already held by the borrower.

Additionally, no interest expense deduction is allowed if both the taxpayer and the person to whom the interest is paid or payable are related parties as specified under the Philippine Tax Code.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The term "local corporation" used here shall refer to a domestic corporation, defined under the Philippine Tax Code as a corporation created or organised in the Philippines or under its laws.

Foreign income of local corporations is not exempt from corporate tax as they are taxed on worldwide income.

Philippine-sourced income and foreign-sourced income together constitute the local corporation's gross income. The local corporation pays the higher of RCIT of 25% (or 20%) based on gross income less the allowable deductions provided under the Tax Code, or MCIT of 2% (reduced to 1% until 3 June 2023) based on gross income.

6.2 Non-deductible Local Expenses

Foreign-sourced income is not exempt from Philippine income tax. Hence, local expenses attributable to such foreign-sourced income are deductible, subject to the rules on allowable deductions provided in the Philippine Tax Code.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by local corporations from foreign subsidiaries are included in the local corporations' gross income, which, after taking into account the allowable deductions provided under the Philippine Tax Code, is subject to an RCIT rate of 25% (or 20%), or MCIT of 2% (reduced to 1% until 30 June 2023). Under the CREATE Law, dividends from foreign subsidiaries may be exempt from tax provided the following conditions are met:

- the dividends actually received or remitted into the Philippines are reinvested in the business operations of the domestic corporation in the Philippines within the next taxable year from the time the foreign-sourced dividends are received;
- the dividends received are used to fund the working capital requirements, capital expenditures, dividend payments, investment in domestic subsidiaries and infrastructure projects of the domestic corporation; and
- the domestic corporation holds directly at least 20% of the outstanding shares of the foreign corporation and has held the shareholding for at least two years at the time of dividend distribution.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations may not be used by their non-local subsidiaries in their business without the former incurring local corporate tax. Local corporations should enter into a sale or licensing agreement with non-local subsidiaries pursuant to which the local corporations should receive compensation in accordance with the arm's-length principle. Any income derived by the local corporation should be included in its gross income, and after subtracting the allowable deductions, the taxable income shall be subject to RCIT of 25% (or 20%).

If local corporations do not recognise income for the use of their intangibles by non-local subsidiaries, transfer pricing issues may arise.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

There are no controlled foreign corporation (CFC) rules in the Philippines. As a rule, Philippine tax law does not tax a local parent company on the CFC's taxable income unless the CFC distributes dividends to the parent company.

6.6 Rules Related to the Substance of Non-local Affiliates

Following the concept of separate legal personality and piercing the veil of corporate entity, a non-local affiliate will be considered a resident of the Philippines if circumstances show that the affiliate is just an extension of the juridical personality of the local corporation. However, this is largely a fact-driven exercise.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

The gain realised by local corporations on the sale of shares in non-local affiliates is included in the local corporations' gross income, which is subject to RCIT of 25% (or 20%) after taking into account the allowable deductions provided under the Philippine Tax Code or to MCIT of 2% (reduced to 1% until 20 June 2023).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

The Philippines' anti-avoidance rules are based on jurisprudence. The Supreme Court makes a distinction between tax avoidance and tax evasion. Tax avoidance is recognised as a tax-saving device using means sanctioned by law. Nonetheless, the Supreme Court has ruled that a transaction that is prompted more by the mitigation of tax liabilities than for legitimate business purposes constitutes tax evasion, which is subject to both criminal and civil penalties.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

In general, all taxpayers are considered possible candidates for audit, but certain transactions or taxpayers are considered mandatory or priority audit cases by the BIR. The mandatory audit cases include claims for tax refund/credit on erroneous/double payment of taxes, regardless of amount or requests for tax clearance of taxpayers undergoing corporate reorganisations.

Priority audit cases include issue-oriented audits (eg, transfer pricing, BEPS, industry issues), taxpayers deriving their revenue/income exclusively or substantially from their parent company/subsidiaries/affiliates, taxpayers with shared expenses and other interrelated charges being imputed by a parent company to its affiliates and likewise an affiliate to other affiliates in a conglomerate, and controlled corporations.

If a taxpayer is subject to an audit, the BIR will issue a letter of authority to examine the taxpayer's books, accounts and other records for a specific taxable year. The taxpayer has the opportunity to contest the BIR's findings through administrative or judicial process. The BIR has three years from the prescribed date for filing or actual filing of the taxpayer's income tax return, whichever is later, to assess deficiency taxes, except in cases of non-filing, false returns or fraudulent returns with intent to evade tax, where the BIR has a right to assess within ten years from discovery.

9. BEPS

9.1 Recommended Changes

The recommended changes under the BEPS Action Plan have not yet been incorporated in local tax laws and regulations.

In January 2013, the Philippines put in place transfer pricing regulations based on OECD guidelines to provide guidance in applying the arm's-length principle for cross-border and domestic transactions between related enterprises.

In August 2019, the BIR issued the transfer pricing audit guidelines, which provide standardised audit procedures and techniques applicable to taxpayers with related-party or intra-company transactions. The audit guidelines specify the audit procedures to be applied to common transfer pricing issues relating to intra-group services, intangible assets and interest payments.

The transfer pricing regulations implement the authority of the CIR to allocate income or deductions between two or more organisations owned or controlled directly or indirectly by the same interests, and also include the requirement for taxpayers to keep adequate documentation that will demonstrate the taxpayer's compliance with the "arm's-length" principle. The transfer pricing regulations further state that additional regulations relating to the application of APA and MAP processes will be issued, but these have yet to be released.

9.2 Government Attitudes

The Philippines is not a member of the OECD but the Philippine government supports OECD initiatives against BEPS. The Philippines participated in meetings of the OECD Committee on Fiscal Affairs and its former CIR served as one of the vice-chairs of the ad hoc group that worked on the development of the multilateral instrument to implement the tax treaty-related BEPS Action Plan.

One of the government's principal objectives in tax administration is to attain its collection targets. The government's first tax reform package took effect in January 2018. The second tax reform package proposed by the administration of President Rodrigo Duterte, the CREATE Law, was signed into law on 26 March 2021. Among the amendments under the CREATE Law is the provision of a sunset period for the preferential tax rate enjoyed by ROHQs of non-resident foreign corporations, which, according to the Department of Finance, will "address the potentially harmful tax features flagged by the OECD". Under the CREATE Law, starting 1 January 2022, ROHQs will be subject to the RCIT rate.

9.3 Profile of International Tax

Traditionally, international tax does not have a very high public profile in the Philippines, although there is now more consciousness about it due to the number of foreign investors in the Philippines and increasing outward investments of Philippine companies. Transfer pricing concerns arising from related-party transactions of local subsidiaries with their foreign parent companies or affiliates continue to drive the discourse on developing more comprehensive guidelines for the implementation and enforcement of regulations on transfer pricing. The transfer pricing guidelines were released by the BIR in 2013, which allow taxpayers to enter into APAs with the BIR, but the separate guidelines on APAs are not yet in place.

In August 2019, the BIR issued transfer pricing audit guidelines prescribing standardised audit procedures and techniques in auditing taxpayers with related-party or intra-group transactions. While these guidelines serve as an internal manual for BIR examiners in the conduct of their tax audit, the guidelines contain the application of arm's-length principles in specific common transfer pricing issues (eg, intra-group services, intangible assets), transfer pricing methods and various factors to consider that the taxpayer may find valuable in its preparation of transfer pricing documentation. In July 2020, the BIR issued regulations for the proper disclosure of related-party transactions that were intended to improve the BIR's transfer pricing risk assessment and audit functions.

9.4 Competitive Tax Policy Objective

Currently, the Philippines has a competitive tax policy and grants generous fiscal and non-fiscal incentives to inward investments, although it has the highest corporate income tax rate compared to other Association of Southeast Asian Nations (ASEAN) countries. The second tax reform package reduces the corporate income tax rate and rationalises tax incentives to make the incentive system performance-based, targeted, time-bound and transparent.

The principal objective of the current administration's tax reform policy is to promote inclusive growth and to raise revenues to support the administration's ten-point socio-economic agenda, which includes a massive infrastructure programme.

9.5 Features of the Competitive Tax System

The actions recommended by BEPS may have a more significant impact on transfer pricing provisions and tax avoidance rules, especially if applied to transactions between related parties where the local affiliate enjoys income tax incentives (eg, enterprises located at ecozones and freeport zones).

9.6 Proposals for Dealing with Hybrid Instruments

The Philippines has not adopted hybrid mismatch rules in response to BEPS. The fourth proposed tax reform package provides for a unified income tax rate for passive income such as interests, dividends and capital gains.

Generally, the current policy of the Philippine government is to develop a capital market by providing an efficient regulatory framework, and in terms of taxation, harmonising taxes on capital transactions to become simpler, fairer and more efficient.

9.7 Territorial Tax Regime

The Philippines has primarily a territorial tax regime, although resident citizens and domestic corporations are taxed on worldwide income. Consistent with territoriality, non-residents are taxed only on Philippine-source income. Interest income is considered Philippine-sourced if it arises from loans extended to residents.

The Philippines applies a tax arbitrage rule on deductible interest that reduces the allowable deduction for interest expenses by 20% of the interest income subject to final tax. This is intended to bridge the gap between the ordinary corporate income tax rate of 25% and the final tax rate on interest income, which is generally 20%.

Also, interest expense deduction will not be allowed if the interest payment is between two corporations, more than 50% of the stock of which is owned directly or indirectly by or for the same individual, if either one of the corporations is a personal holding company. A personal holding company is one that meets the stock ownership and gross income requirements under the tax regulations. Under the stock ownership requirement, more than 50% in value of the personal holding company's outstanding stock must be owned, directly or indirectly, by not more than five individuals. Under the gross income requirement, 70% or more of the gross income of the corporation must be classified as personal holding company income.

9.8 CFC Proposals

Sweeper CFC rules may not necessarily achieve the purpose of preventing the shifting of income to lower tax jurisdictions since there may be other reasons for locating offshore subsidiaries in low-tax rate jurisdictions. However, if sweeper CFC rules are adopted, they need to be carefully crafted to ensure that they target only activities that were entered into for tax avoidance purposes and do not unnecessarily affect economic activity adversely.

9.9 Anti-avoidance Rules

The Philippines' general anti-avoidance rules are largely based on principles arising from Supreme Court decisions, which made a distinction between tax avoidance and tax evasion. Tax avoidance is "the tax-saving device within the means sanctioned by law. This method should be used by the taxpayer in good faith and at arm's length." What the law clearly prohibits is tax evasion, which is considered the wilful attempt, in any manner, to evade or defeat any tax imposed under the Philippine Tax Code. The Supreme Court nonetheless considers transactions that are prompted more by the mitigation of tax liabilities than for legitimate business purposes as entered into for tax evasion purposes.

The Philippines' tax treaties with certain countries have taken into account double taxation convention (DTC) limitation of benefits.

9.10 Transfer Pricing Changes

The proposed transfer pricing changes may cause changes in the reporting regime in the Philippines. The current transfer pricing regulations already require taxpayers to keep adequate documentation to show that transfer prices are consistent with the arm's-length principle, but such documents are not required to be submitted with tax returns, unless the tax authority requires or requests the taxpayer to do so. Taxpayers may resist the recommended transfer pricing documentation and treat it as an unduly burdensome process given that the three-tiered documentation approach requires more comprehensive information than that currently required under the transfer pricing regulations.

The taxation of profits from intellectual property is not a particularly controversial issue in the Philippines. The Philippines' transfer pricing regulations apply to two major categories of intangible properties or assets: manufacturing intangibles and marketing intangibles.

Manufacturing intangibles are generally created through R&D activities, which are risky and entail expenses.

Marketing intangibles include trade marks or trade names that help increase the marketing of goods and services and have important promotional value for the products.

To determine arm's-length transactions, the existence of intangible assets must be considered as it necessarily entails a higher profitability level than the average for the industry. Thus, the owner will necessarily require and should be compensated with more than a mere return to recover the costs incurred for the development of such intangible assets.

The Philippines also imposes FWT on the gross income earned by non-resident foreign corporations from Philippine sources. Gross income includes income derived from rents or royalties, which are considered to be Philippine-sourced if the income arises from property located in the Philippines or from any interest in such property, or the use of, or the right or privilege to use in the Philippines, any intellectual property. If the intellectual property is owned by a domestic corporation, royalties earned on such intellectual property from sources outside the Philippines will form part of its gross income for purposes of computing taxable income.

9.11 Transparency and Country-by-country Reporting

Transparency may be necessary to enable tax authorities to determine taxpayers' compliance. However, taxpayers may be reluctant to share information on their transactions unless sufficient mechanisms are in place to ensure the confidentiality of the information made available under the reporting requirements.

The Philippines enacted the Exchange of Information on Tax Matters Act of 2009 to comply with or commit to the internationally agreed tax standards required for the exchange of tax information with its tax treaty partners to help combat international tax evasion and avoidance. Under the law, information received by the foreign tax authority from the BIR pursuant to an international convention or agreement on tax matters is considered absolutely confidential, and disclosure of such information shall be limited to the assessment or collection, enforcement or prosecution of the taxes covered under such international conventions or agreements.

9.12 Taxation of Digital Economy Businesses

The BIR has issued regulations requiring persons engaged in online transactions and apps-based businesses – including payment gateways, delivery channels and internet service providers – to register their business, issue receipts, file returns and pay the taxes due on their income. The BIR also recently issued a circular clarifying that Philippine Offshore Gaming Operations licensees, whether foreign-based or Philippine-based, conducting offshore gaming operations are required to register with the BIR before they commence business. The tax authority, however, has recognised that enforcement of the regulations remains difficult due to the nature of online businesses, especially those that do not have any local presence in the Philippines.

9.13 Digital Taxation

This firm is not aware of any specific plans to revise the tax laws in response to BEPS proposals for digital taxation There is also no current proposal to amend the concept of "permanent establishment" for income tax purposes to cope with the digital economy.

Under the current rules on situs of taxation, income from services performed in the Philippines are considered Philippine-sourced income subject to income tax; thus, services performed offshore by non-residents should not be taxable under the current tax laws. This holds true until the current situs rules are amended, or unless there is a provision to the effect that digital services are considered performed within the Philippines, despite the service provider being located offshore.

Currently, the Philippine consumption tax (ie, VAT) on e-commerce transactions seems to apply to local players only. In a regular service transaction, the local taxpayer is constituted as a withholding agent who withholds the VAT from its income payments to non-residents who render services in the Philippines, and remits the VAT to the BIR.

However, House Bill No 7425 filed in the House of Representatives (HOR) sought to impose VAT on the sale of goods and services conducted via electronic and digital platforms, make non-resident digital service providers liable for collecting and remitting the VAT on their transactions and require covered non-resident digital service providers to register with the BIR. The bill is still being considered by the HOR.

9.14 Taxation of Offshore IP

Revenues earned by offshore companies from licensing IP in the Philippines are subject to FWT of 25% (royalty withholding tax regime) . The FWT is withheld and remitted to the BIR by the local income payors.

IP owners who are residents in countries that have tax treaties with the Philippines may avail a preferential tax rate on royalties derived from the licensing of IP in the Philippines.

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SyCip Salazar Hernandez & Gatmaitan has a tax department that comprises 13 partners, one of counsel and 17 associates. Fourteen of them are lawyers and certified public accountants. The firm's tax lawyers are also experts in other practice areas, such as the firm's Special Projects Group, the Banking Finance and Securities Group and the Litigation Group. The department provides the entire range of tax services, from advising on and structuring the tax aspects of corporate transactions to administrative and judicial litigation in relation to tax refunds and defending clients against assessments for national taxes, local taxes, customs duties and safeguard measures. The department also assists corporate clients in obtaining rulings and in compliance requirements. To a great extent, it draws its work from the extensive client base of the firm and assists the firm's corporate departments in the tax aspects of their transactions. The firm's depth of experience in corporate work – including acquisitions and divestments in various industries, such as power, telecommunications, natural resources, infrastructure, transportation, manufacturing and gaming – sets it apart from other tax advisers.

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In general, businesses in Poland tend to adopt a corporate form. This tendency is mostly driven by factors such as the size of the business activity and the desire to limit liability. The Polish legal system features two types of corporate forms, namely limited liability companies and joint-stock companies; as of 1 July 2021, another corporate form will come into play, a simplified joint-stock company as a hybrid between the two existing forms. Both forms offer limited liability for their shareholders.

The limited liability company is most frequently used for doing business in Poland due to its relative simplicity in terms of corporate governance and compliance obligations. Shares issued by a limited liability company are not deemed securities; as a result, such a company cannot be listed on a stock exchange. Conversely, shares of a joint-stock company can be floated on a stock exchange.

Joint-stock companies also feature more advanced corporate instruments, such as convertible bonds, authorised but not issued capital, founders' certificates and non-voting shares. Their operations and management are subject to more stringent requirements than the operations of a limited liability company.

Both forms are taxed as separate legal entities. This will also be the case for a simplified joint-stock company once it becomes available.

1.2 Transparent Entities

Local and foreign investors may conduct business activities through a partnership. In general, this may take one of the following forms:

- a civil law partnership;
- a general partnership;
- a professional partnership;
- a limited partnership; or
- a limited partnership issuing shares (limited-stock partnership).

General and limited partnerships have been the most commonly used. However, this may no longer be the case as since 1 January 2021 limited partnerships are separate taxable entities (with some tax credit reliefs for general partners). Limited partnerships issuing shares also used to be popular when they were transparent entities and were used mostly by real estate investors. However, this is also no longer the case, since they are now taxed as separate legal entities and are rarely used. Civil law partnerships are established for small businesses only.

All types of partnerships, other than limited partnerships and 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. Private equity and hedge funds rarely adopt any of the transparent forms and gravitate towards corporate forms or different forms of investment funds.

1.3 Determining Residence of Incorporated Businesses

Incorporated businesses that have their corporate seat or their place of effective management in Poland are deemed Polish tax residents. To determine the place of effective management, it is necessary to establish where important management decisions of the company are taken and prepared. Most of the double tax treaties concluded by Poland determine residence using the effective place of management as a tie-breaker rule.

Transparent entities are disregarded for income tax purposes. As a consequence, there is no need to determine their tax residence and no such rules exist.

1.4 Tax Rates

Corporate income tax (CIT) is chargeable at the rate of 19% or, with respect to small taxpayers, 9%. In addition, outbound dividends are subject to local withholding tax at the rate of 19%, and outbound royalty and interest payments to non-residents are subject to local withholding tax at the rate of 20%, unless a pertinent double taxation treaty (DTT) sets out a lower rate. There is no proposed legislation aimed at changing CIT rates after 2020.

As a rule, individuals conducting business directly or through transparent entities are subject to progressive taxation, with rates of 17% and 32%. However, it is also possible to choose taxation at the 19% flat rate.

Income generated through the exploitation of intellectual property (IP) rights may be taxed at 5% subject to certain additional conditions and formal requirements (the "Innovation Box" or "IP Box" tax regime).

On 1 January 2021, Poland introduced so-called Estonian CIT. Taxpayers who meet certain conditions will only pay CIT once they decide to distribute profits. The tax rates in this regime vary from 10 to 25%. The conditions for applying the Estonian CIT regime are quite strict, therefore it is difficult to assess whether it will become a popular tool among CIT payers.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

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 the 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 such company.

In principle, income from business activities is taxable on an accrual basis (with the significant exception of interest). Expenses incurred to derive taxable income are deductible unless they are expressly listed in the Polish CIT Act as non-deductible costs.

2.2 Special Incentives for Technology Investments

The Innovation (IP) Box

On 1 January 2019, the Innovation (IP) Box, a new tax incentive scheme, came into force in Poland. The Innovation Box incentive includes a preferential tax rate of 5% (applicable to CIT and personal income tax, or PIT) on qualified IP income, where the taxpayer is deemed to be an owner, co-owner or user of IP rights under a licence agreement. The 5% rate is applied only to qualified IP rights that have been created, developed or improved by the taxpayer. The intellectual property rights that qualify for the Innovation Box tax incentive cover, for example, patent rights, protection rights for utility models and rights to computer software.

R&D Tax Relief

Both CIT and PIT payers may make an additional deduction of eligible costs incurred for research and development activities (R&D) from the tax base. Starting from 2018, the attractiveness of the R&D tax relief increased since the deduction level has been raised to 100% of eligible costs incurred – and even 150% of costs incurred by certain types of taxpayers that possess the status of research and development centres.

2.3 Other Special Incentives

State aid is provided to investors in the form of an exemption from personal and corporate income taxes for the implementation of a new eligible investment.

Since 30 June 2018, income tax exemptions are available for eligible investments located anywhere in Poland and the investment does not have to be located in the area covered by special economic zone status. Tax exemptions are granted upon the administrative decision of the respective minister for the period of 10 to 15 years.

To be eligible for this state aid, each new investment has to satisfy quantitative and qualitative criteria.

2.4 Basic Rules on Loss Relief

Where costs of ordinary income exceed total taxable ordinary income, in a given tax year, the difference represents a tax loss.

The taxpayer has the opportunity to deduct such a loss. The provisions provide that the loss may be carried forward against ordinary income derived in the following five consecutive tax years. However, in any of those five years, the loss from a given year may be deducted in part, not exceeding 50% of that loss. Alternatively, a tax loss not exceeding PLN5 million may be set off against the profits of one year; a not deducted amount may be carried forward to the remaining five years, but it may not exceed 50% of the loss per year.

It is not possible to carry losses back, offsetting them against prior-year income. Such possibility was only given to taxpayers temporarily during the COVID-19 pandemic. Tax losses are linked to the legal entity that incurred them. The possibility of offsetting losses resulting from restructuring operations such as mergers, acquisitions or transfers of going concern are limited.

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 vice versa.

2.5 Imposed Limits on Deduction of Interest

Interest is deductible when it is 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 tax authorities. The deductibility of interest is expressly excluded in debt push-down structures, where a special-purpose vehicle (SPV) that incurred debt to acquire an operating company is subsequently merged with the latter to reduce operating income by interest on the incurred debt.

From 2018, CIT payers, including local branches of foreign enterprises, are obliged 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% of their earnings before interest, tax, depreciation and amortisation (EBITDA) in a given fiscal year. The limitation of tax-deductible costs also refers to the costs of financing payable to both related and unrelated entities. 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. This interest-limitation rule features a safe harbour of PLN3 million.

2.6 Basic Rules on Consolidated Tax Grouping

Poland provides for a tax consolidation regime, known as a "tax capital group".

Taxable income for the group is calculated by combining the incomes and losses of all the companies forming the group.

A tax capital group under the Polish CIT Act may be formed only by limited liability companies and joint-stock companies based in Poland and under certain conditions. Some of the requirements for establishing a capital group are as follows:

- having a registered office in Poland;
- average capital of each group company of no less than PLN500,000 (approximately EUR125,000);
- minimum share in subsidiaries by the parent company – 75%;
- minimum share of income in the revenue of the tax group – 2% (under special anti-COVID crisis regulation, this requirement is deemed to be fulfilled in 2020 and 2021 even when the share is lower, if the tax capital group incurred negative consequences because of the COVID-19 pandemic); and
- minimum term of the agreement – three years.

2.7 Capital Gains Taxation

There is no separate capital gains tax in Poland as it forms part of the general CIT regime. However, certain capital gains from the disposal or redemption of shares in corporations 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.

Capital gains are generally treated as regular income and are subject to the standard 19% CIT. Exemptions may apply under DTTs or under domestic rules (such as the CIT exemption for dividends paid to entities holding at least 10% of shares in the paying entity for an uninterrupted period of at least two years, even if this minimum holding period expires after the dividends were paid). There is no participation exemption for selling shares in other corporation.

2.8 Other Taxes Payable by an Incorporated Business

The 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 the related goods are situated or 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 value added tax (VAT), even though it is VAT exempt.

Civil law transaction tax rates are fixed or ad valorem. The ad valorem rates vary from 0.5% to 2% depending on the type of civil law transaction.

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 declared capital of a local capital company, as well as to mergers or transformations of such local capital companies.

2.9 Incorporated Businesses and Notable Taxes

Apart from general corporate income tax, incorporated businesses may be subject to the following notable taxes.

VAT

Polish regulations on VAT are based on EU legislation, which means that the principles of VAT in Poland are in many cases the same as in other EU member states.

The basic VAT rate applicable to most goods and services is 23%.

A rate of 8% applies to pharmaceuticals and medical products, most foodstuffs, restaurants and hotel services, magazines and newspapers, as well as transportation services and residential housing.

A rate of 5% applies to supplies of certain foodstuffs (eg, bread, dairy products, meats) and certain kinds of printed books.

A zero VAT rate applies to the intra-Community supply of goods, exports of goods, some international transportation services and related services.

Excise Tax
Similarly, as with VAT, excise tax 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:

- import, intra-Community acquisition and first domestic sale of passenger cars that are not registered in Poland; and
- 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 plants or goods exempted from excise tax because of their intended use if they are used contrary to their intended use.

Excise tax is calculated as a percentage of the value of the taxable goods (or their customs duty value) or as a flat fee per quantity basis (fee per unit).

Tax on Civil Law Transactions
For more information, please refer to **2.8 Other Taxes Payable by an Incorporated Business**.

Real Estate Tax and Other Local Taxes
Local taxes include:

- real estate tax;
- transportation tax (imposed only on lorries and trucks);
- marketplace tax;
- agricultural tax;
- forestry tax;
- dog-owner tax; and
- sanatorium tax.

Autonomous local 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 2021 are PLN24.84 per square metre for buildings connected with business and PLN0.99 per square metre of land. In addition to statutorily defined exemptions, local 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.

Tax on Certain Financial Institutions
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 PLN4 billion for banks and PLN2 billion for insurance companies. 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% monthly.

Tax on Retail Sales
The tax on retail sales was firstly introduced to Polish tax law in 2016. However, due to the position of the European Commission aimed at challenging the tax before the Court of Justice of the EU, its collection was suspended. The new tax eventually entered into force on 1 January 2021.

The tax on retail sales is levied on the biggest stores, earning monthly revenues exceeding PLN17 million. The tax is levied on the monthly surplus of revenues from retail sales over PLN17 million. A tax rate of 0.8% applies to revenues not exceeding PLN170 million and a 1.4% tax rate applies to the part of revenues exceeding PLN170 million.

Other, less notable, taxes include:

- stamp duty;
- tonnage tax;
- gambling tax;
- tax on mines;
- sugary drink tax; and
- tax on alcoholic beverages with a volume up to 300 ml.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses
Most closely held local businesses operate in Poland as limited liability companies (*spółka z ograniczoną odpowiedzialnością*) or sole proprietorships (*jednoosobowa działalność gospodarcza*). Partnerships are popular forms among professionals such as lawyers, auditors and business consultants. However, due to a change of the rules regarding the taxation of limited partnerships starting from 1 January 2021, the popularity of this legal form may decrease.

3.2 Individual Rates and Corporate Rates
In Poland, individual professionals (eg, architects, engineers, consultants, accountants) working under employment contracts

or civil law contracts are subject to PIT, calculated, as a rule, according to a progressive tax scale between 17% and 32%. Employees under the age of 26 can benefit from a tax exemption.

Individual professionals conducting business activity are also taxed according to the tax scale. However, such individuals may elect for the 19% flat-rate PIT, taking into account restrictions on services for former/current employers and an exclusion of management services from that rate. Additionally, as of 1 January 2021, a lower 15% lump-sum taxation may apply to a broader group of professionals (eg, lawyers, architects, accountants) conducting business activity. Engineers and other professionals whose work involves the creation of IP rights can also benefit from the IP Box regime, thus being subject to 5% tax on the income derived from certain IP rights.

Except for attorneys-at-law, advocates and certain other legal professionals, other professionals may conduct their activity through a limited liability company, thereby being subject to the general rules of Polish corporate income taxation.

3.3 Accumulating Earnings for Investment Purposes

There are no rules that could prevent closely held corporations from accumulating earnings for investment purposes, especially since there is no wealth tax in Poland.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends payable to individuals are subject to withholding tax (WHT) at the rate of 19%. DTTs may stipulate a lower rate or a tax exemption.

Income on the sale of shares is subject to 19% PIT.

No participation exemptions apply.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

As with the case of closely held corporations, dividends payable to individuals are subject to WHT at the rate of 19%. DTTs may stipulate a lower rate.

Income on the sale of shares by an individual is subject to 19% PIT.

No participation exemptions apply.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of income tax treaties, WHT applies at the rate of 19% to dividends and at the rate of 20% to interest and royalties.

Payments of dividends are exempt from corporate withholding taxation provided that:

- the recipient of the payment is a company that is a tax resident of any EU member state, Switzerland or a European Economic Area (EEA) member state and is not entirely tax exempt with regard to its worldwide income;
- the recipient of dividends holds at least 10% (25% in the case of Switzerland) 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;
- the recipient of the dividend is the beneficial owner of the dividend and runs actual business activity in the country of its residence; and
- prior to the payment of dividends, a tax certificate is delivered by the recipient of the income to the Polish subsidiary.

Payments of interest and royalties are exempt from withholding taxation as long as:

- the recipient and payer of interest or royalties are associated companies where one company holds directly at least 25% of the shares of the other company, or another company holds directly at least 25% of the shares of both the payer and the recipient;
- the above minimum 25% holding of the shares lasts for an uninterrupted period of two years, even if this minimum holding period ends after the payment of interest or royalties;
- 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 with regard to its worldwide income;
- the recipient of the interest and/or royalties is their beneficial owner and runs actual business activity in the country of its residence; and
- prior to the payment, the recipient of income delivers its tax residence certificate issued by its pertinent foreign tax authority.

Both the above-mentioned exemptions may not apply if they stem from a transaction lacking business reasons and aimed solely or mainly at obtaining a tax benefit.

As of 2019, Poland has introduced new compliance rules for the collection of withholding taxes on payments of dividends, interest, royalties and intangible services. The new rules provide for some restrictions that impact the application of exemptions and reduced rates to payments of WHT, including:

- maintaining, in principle, the existing rules for the collection of the tax for payments not exceeding PLN2 million with respect to one taxpayer in a given fiscal year; however, the WHT agent is, in each case, obliged to scrutinise with due diligence if tax regulatory conditions for the application of a tax exemption or a local or treaty reduced tax rate are satisfied;
- an obligation to collect the tax in the full amount from payments over PLN2 million, without applying any exemptions or reduced rates; in such cases, the taxpayer or WHT agent will, however, be able to receive a refund of tax withheld on the condition that it proves fulfilment of the requirements for the reduction of WHT; and
- exceptions to the above full WHT at the domestic rate will apply only if a taxpayer receives a special opinion issued by the tax authority, or the WHT agent declares that it is in possession of the appropriate documents to prove grounds for non-collection of the tax or collection of the tax in a reduced amount.

Entry into force of these new compliance rules has been postponed until 1 July 2021. The Ministry of Finance is also working on modifications to these new WHT rules aimed at making them less burdensome for WHT agents.

4.2 Primary Tax Treaty Countries

In general, Poland has an extensive double tax treaty network with more than 90 countries reducing or eliminating withholding taxes.

The primary tax treaty countries used to make investments in local corporate stock or debt are Luxembourg, the Netherlands, Sweden, Switzerland, Ireland, Cyprus and Malta. This is mostly due to relatively low domestic corporate taxation in these countries, and participation exemptions provided in the domestic tax systems of these countries or in the double tax treaties between Poland and the countries in question. The choice of tax treaty countries can change in time due to amendments in double tax treaties that will proceed due to ratification of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) by Poland.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The Ministry of Finance has identified cases of abuse of tax exemption for dividends by distributing dividends through intermediary companies. In this regard, the Minister of Finance has issued a general warning letter concerning the acquisition of shares in Polish companies by an investor from a non-treaty country outside the EU and the EEA via a subsidiary company from the EU or the EEA in order to exempt dividends paid by Polish companies from Polish withholding taxation pursuant to the EU Parent–Subsidiary Directive. Such exempt dividends are further exempt under DTTs concluded by intermediary countries and benefit from preferential tax treatment in non-treaty countries.

The purpose of the letter is to draw the attention of subordinate tax offices to the risk of tax avoidance and to challenge these harmful practices.

4.4 Transfer Pricing Issues

The biggest transfer pricing (TP) issues presented for inbound investors operating through a local corporation are:

- pricing transactions between related entities at arm's length;
- the obligation to prepare TP documentation in cases when the value of the transaction exceeds, in a tax year, certain thresholds (PLN10 million for transactions on goods and financial transactions, PLN2 million for service and other transactions and PLN100,000 for transactions with entities located in a country that engages in harmful tax practices);
- the obligation to prepare master file documentation that contains additional information about the whole related-party group in case the related companies are subject to full or proportional consolidation, whose consolidated revenues exceeded PLN200 million in the previous financial year;
- the obligation to provide the Head of the National Revenue Administration with country-by-country reporting (CbCR) for the largest Polish capital groups, whose consolidated revenues exceeded the equivalent of EUR750 million; and
- since January 2021, the obligation to prepare TP documentation for transactions with entities (even non-related) whose beneficial owners are located in low-tax jurisdictions (the threshold for such transactions is PLN500,000).

4.5 Related-Party Limited Risk Distribution Arrangements

The Polish tax authorities are increasingly interested in scrutinising local and cross-border transfer pricing issues, with more emphasis being placed on the verification of the arm's-length pricing in transactions between related parties. Tax officers may audit limited risk distribution (LRD) arrangements for the sale of goods or provision of services locally, especially when such arrangements do not correspond to the functional profile of the local distributor.

LRDs should reflect the economic reality, so if the local company is a fully fledged distributor, tax authorities may challenge such arrangements. Therefore, it is essential to gather evidence confirming the real functions performed by the distributor. Nonetheless, there exists no general fiscal approach or fiscal policy of local tax authorities aimed at challenging the use of related-party limited risk distribution arrangements for the sale of goods or provision of services locally.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

For a few years, the Polish government's tax policy, including transfer pricing rules, has conformed with global trends and is focused on closing any remaining loopholes in the Polish tax system by changing the existing provisions and introducing various regulations, such as exit tax, or other measures; for example, more stringent controlled foreign corporation (CFC) rules, new transfer pricing documentation requirements or reporting tax schemes (under the Mandatory Disclosure Regime, or MDR). These measures are taken to prevent base erosion and profit shifting, aggressive tax optimisation, indirect tax fraud and tax leakage caused by all the above.

4.7 International Transfer Pricing Disputes

The mutual agreement procedures (MAPs) have not been popular in Poland in recent years. The main reason seems to be the long waiting time for the application to be processed by the tax authorities. However, at the end of 2019, a new domestic legislation entered into force as an implementation of EU Directive 2017/1852 that clearly defined the timeframe within which a MAP should be completed by the local authorities. This should shorten the process and may increase the popularity of MAPs.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

The effect of non-recognition of a transfer price between related parties is the primary adjustment, which leads to an increase in the tax income of the entity whose transfer pricing has been adjusted. In such cases, a compensating adjustment would be allowed, at the level of the counterparty of the adjusted transaction, reducing its tax income. Such adjustments are not made automatically, which leads to at least temporary double taxation of profits. However, it is general practice that a compensating adjustment will be made to eliminate double taxation, when a mutual agreement is reached with the counterparty country following an application for a MAP. Moreover, Poland has recently implemented EU Directive 2017/1852, which provides for the shortening of the MAP.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

A non-local corporation is a taxpayer on income received by its branch in Poland. Tax is levied on the income attributable to the activities of the local branch; proper formulas should be applied to make the cost/revenue allocation. Such income may also be taxed in the country of which the non-local corporation is a tax resident; however, taxation on that level is usually eliminated on the basis of applicable DTTs.

In turn, subsidiaries of non-local corporations established in Poland are subject to taxation in Poland on their worldwide income. This income is not taxable at the level of the non-local corporation.

5.3 Capital Gains of Non-residents

Under Polish income tax regulations, capital gains on the sale of stock in a corporation are taxable in Poland provided that at least 50% of the assets of the local corporation consist of real estate located in the territory of Poland.

Additionally, from 1 January 2021, a separate definition of a real estate company has been introduced in CIT and PIT laws. Under this definition, a real estate company is an entity whose balance sheet asset value consists of at least 50% of the rights to real estate worth more than PLN10 million. The provisions apply irrespective of whether the real estate or the right to such real estate is held directly or indirectly by the entity whose shares are being sold. Thus, if an investor sells shares in a non-local holding, which in turn owns stock in a local corporation whose assets consist mostly of real estate or fulfils the definition of a real estate company, such a transaction is deemed taxable in Poland. In the event of a sale of shares in the real estate company, the real estate company will be obligated to withhold the tax from the sale. Also, the sale of shares in a local corporation admitted to public trading on a regulated stock exchange by a non-resident is a taxable event. Conversely, if a non-resident sells the shares of a non-local holding company owning the shares of a listed company, such a transaction should generally not be taxable in Poland.

The above-mentioned provisions may be modified by applicable DTTs concluded by Poland, which, in general, provide for capital gains taxation only in the residence country, unless there is a real estate clause in a given DTT. The use of real estate clauses in DTTs concluded by Poland will be broadened in the coming years due to implementation of the MLI.

5.4 Change of Control Provisions
A change of control, including the disposal of an indirect holding much higher up in the overseas group, may result in tax duties in Poland if the assets of the holding consist mainly of real property in Poland; for more information, please refer to **5.3 Capital Gains of Non-residents**.

A change of control encompassing the sale of stock in a local corporation results in taxation of 1% on civil law transactions levied on the market value of disposed shares, with the exception of sales of shares on the regulated stock market via local licensed intermediary companies. There is no transfer tax on civil law transactions if the change of control encompasses the sale of shares in a non-local corporation, unless a buyer is a local entity and a share sale agreement is signed in Poland.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
There are no specific formulas used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates
In principle, any cost of a local affiliate is tax deductible under the condition that:

- it was incurred by the local affiliate – ie, in the final analysis, it must be covered by the taxpayer's assets;
- it is definitive (real) – ie, the value of the expense incurred has not been reimbursed to the local affiliate in any way;
- it is connected with the local affiliate's business activity;
- it was incurred in order to obtain, preserve or secure income, or may affect the amount of income earned; and
- it was not included in the group of expenses that are not regarded as tax-deductible costs.

If a local affiliate pays management and administrative fees to a non-local affiliate, such payments are particularly prone to scrutiny by the tax authorities. In such cases, the tax authorities tend to verify most closely if management and administration services were actually performed (ie, are not fictitious), whether they were performed to the benefit of a local affiliate and whether the fees paid were at arm's length.

In addition, under the CIT Act, tax deductibility of expenses incurred to purchase certain intangible services (including management services) from related entities (within the meaning of TP rules) is limited. Under the limitation rule, expenses incurred for such services that exceed in a given tax year 5% of tax EBITDA and PLN3 million combined are not tax deductible.

5.7 Constraints on Related-Party Borrowing
There are several constraints that should be taken into consideration for related-party borrowing, namely:

- the obligation to exclude from tax-deductible costs a surplus of all debt financing costs over the interest income (if any), to the extent to which such surplus exceeds 30% of their tax EBITDA in a given fiscal year;
- determination of the interest rate should be in line with the arm's-length principle;
- the obligation to collect the WHT in the full amount from interest payments over PLN2 million, without applying any exemptions or reduced rates at source, unless the taxpayer receives a special opinion issued by the tax authority or the WHT agent declares that it is in possession of the appropriate documents to prove grounds for non-collection of the tax or collection of the tax in the reduced amount; and
- local WHT exemption on interest payments may not apply if they stem from a transaction lacking business reasons and aimed solely or mainly at obtaining a tax benefit (ie, specific anti-avoidance rule).

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Domestic tax law does not provide for a general exemption of foreign income. Foreign income of corporate taxpayers is subject to 19% (or 9%) CIT on all income derived from whichever source of income and on all capital gains derived from certain sources, subject to certain exemptions. The 9% rate applies to small taxpayers (with revenues not exceeding EUR2 million in a tax year), with the exception of new taxpayers created via the restructuring of existing businesses; this rate does not apply to capital gains.

However, Polish companies receiving foreign (inbound) income in Poland may credit against Polish CIT taxes withheld in the country of source. Such credit may not exceed the Polish income tax on the same income.

Foreign income of local corporations is exempt from corporate tax in Poland if such exemption is expressly provided for in an applicable DTT.

6.2 Non-deductible Local Expenses
As a rule, to determine taxable income, the taxpayer should group tax expenses into (i) costs related to the taxable income

and (ii) expenses related to non-taxable (exempt) income. The latter are non-deductible.

However, where a taxpayer incurs tax-deductible expenses to earn revenue from sources generating income subject to income taxation and expenses related to revenue from sources generating income not subject to income tax or exempt from income tax, and where it is not possible to classify expenses under their respective revenue sources, such expenses shall be deductible pro rata to the ratio of the revenue earned from the former sources to the total amount of revenue in a given year.

6.3 Taxation on Dividends from Foreign Subsidiaries

As a rule, inbound dividends are included in the general CIT base and taxed accordingly at 19%. However, 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) 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 Polish inbound dividend tax exemption.

This dividend tax exemption may not apply to dividends and other income from participation in corporate profits if they result from a transaction or a series of transactions lacking business reasons and aimed solely or mainly at obtaining tax exemption rather than avoiding double taxation of corporate profits.

Any inbound dividend 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. Such a credit, however, may not exceed the Polish income tax on the same income.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations and used by foreign subsidiaries in their business activity are not subject to CIT in Poland for the foreign subsidiaries.

From the perspective of local corporations, licence fees for the use of intangibles paid by foreign subsidiaries are subject to 19% CIT in Poland. However, local corporations may credit taxes withheld in the country of the foreign subsidiary against Polish CIT resulting from received licence fees. This credit may not exceed the Polish income tax due on such fees.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Polish CFC rules apply both to corporate CIT and PIT payers shifting profits (ie, in the form of royalties, dividends and other passive income) to a foreign company, other entity or permanent establishment (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 Polish CIT and PIT laws.

Since 2019, the notion of a CFC has been broadened to include any entity with or without 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 performs substantial business activity in that state.

6.6 Rules Related to the Substance of Non-local Affiliates

There are no explicit requirements related to the substance of non-local affiliates. However, substance is of importance for outbound payments subject to WHT in Poland and in the case of CFC taxation. In the former case, benefiting from a WHT exemption or reduced tax rate (either as a relief at source or as a tax refund) is essentially only possible if a receiving entity runs "actual business operations" in its country of residence. The term is a Polish equivalent of "business substance" since the Polish CIT Act features an open catalogue of exemplary substance requirements that, if present, demonstrate that actual business operations are conducted (eg, premises, qualified personnel, equipment, business justification). In the latter case, there is no CFC taxation if a foreign entity runs actual business operations in its country of residence, provided that such operations are "substantial".

There are no substance rules that would relate to situations where local corporations receive payments from non-local affiliates.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

According to the general rule provided for in the CIT Act, companies that are Polish tax residents are taxed on their entire income regardless of where it is earned. This means that the income of a Polish taxpayer from the sale of shares in a Polish or foreign company is, in principle, taxed in Poland with 19% CIT. DTTs may provide for different taxation, particularly if they feature the real estate clause.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

In July 2016, Poland introduced a general anti-avoidance rule, according to which, tax authorities may disregard tax benefits resulting from a transaction or a series of transactions of a taxpayer if such 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, there is no reasonable business or economic rationale behind the 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 an artificial manner mainly or solely for the purposes of achieving tax benefits, and that the general anti-avoidance rule does not apply to that transaction.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Polish tax authorities do not carry out audits in a regular routine cycle.

9. BEPS

9.1 Recommended Changes

Poland has already implemented various Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting (BEPS) recommendations, such as:

- CFC rules;
- CbCR rules;
- new TP documentation rules;
- limitation on deductibility of interest;
- Innovation (IP) Box;
- MDR; and
- anti-hybrid rules.

On 7 June 2017, Poland signed the MLI Convention, as stipulated in BEPS Action 15, which entered into force in Poland on 1 July 2018.

The MLI Convention is already applicable to more than 30 DTTs concluded by Poland.

9.2 Government Attitudes

The Polish government's tax policy conforms with current global trends and is focused on closing the remaining loopholes (see **4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards**).

The Polish tax administration is more focused on TP issues than in the past, by challenging the arm's-length character of transactions. Furthermore, large multinational corporations are under scrutiny of the Polish tax authorities since they are believed to be involved in aggressive tax planning schemes. The BEPS project does have a substantial impact on the Polish government's tax policies. The current government's policy aimed at closing the remaining tax loopholes seems to be even more intensive during the COVID-19 pandemic, as the government seeks additional revenue that could supplement the strained state budget.

9.3 Profile of International Tax

International tax is very important in transactions that trigger various issues with international tax aspects, in public debate and in legislation that is being enacted. This is due to the fact that not only customers but also Polish tax authorities are becoming more focused on closing the loopholes in income taxation, and they are aware that the bulk of base erosion and profit shifting takes place across borders.

As part of this strategy, during the period from 2012 to 2015, Poland concluded seven new DTTs, eight protocols amending double tax conventions and 15 agreements on the exchange of information on tax matters. Additionally, in 2017, Poland signed the MLI Convention, which already applies to more than 30 DTTs concluded by Poland.

9.4 Competitive Tax Policy Objective

Apart from a relatively low CIT rate, Polish corporate taxation is not particularly competitive compared to jurisdictions such as Luxembourg or the Netherlands. It is in line with EU and OECD standards and already features most BEPS developments. Nonetheless, it offers taxpayers certain favourable preferences – such as the Innovation (IP) Box, R&D relief, Estonian CIT or notional interest deduction – but those should not be compromised by further implementation of anti-avoidance measures.

9.5 Features of the Competitive Tax System

The Polish tax system does not have any competitive features that would differ from the standard of other OECD jurisdictions. Poland has relatively low tax rates – 9% CIT for the smallest taxpayers (since 2021, up to EUR2 million revenue) and 19% CIT for others – nonetheless, the CIT rate is outside the scope of BEPS regulations.

9.6 Proposals for Dealing with Hybrid Instruments

In January 2021, a new regulation concerning, inter alia, hybrid instruments entered into force. The primary objective of the proposed new law is to continue the process of the implementation of the EU Anti- Tax Avoidance Directive (ATAD 2).

Specifically, anti-hybrid rules provide for non-deductibility of payments resulting in double deductions of costs or deductions of costs without inclusion of corresponding revenue in other country. The following hybrid mismatch arrangements are, in particular, covered by the Polish anti-hybrid rules:

- hybrid entity mismatches;
- hybrid transactions;
- hybrid PE mismatches; and
- tax residency mismatches.

This introduces to the Polish CIT Act measures that prevent companies from artificially shifting profits to minimise the effective tax rate through making use of discrepancies (mismatches) between different tax jurisdictions in the assessment of the same category of payment.

According to the explanatory memorandum accompanying the new law, the proposed regulations will substantially contribute to the elimination of hybrid mismatches. The key objective of the proposed changes is to counter double deductions or a deduction without inclusion of taxable revenues.

9.7 Territorial Tax Regime

Taxpayers with 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.

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.

From 2018, CIT payers, including local branches of foreign enterprises, are obliged 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% of their 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 parts 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 "repo" transactions, regardless of who is a beneficiary of financing costs.

The limitation of tax-deductible costs refers to costs of financing, irrespective of whether they are payable to related entities or unrelated entities. 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 specific years.

The interest-limitation rule in place may encourage investors to rethink their financing structures, which may eventually result in the greater importance of equity financing.

9.8 CFC Proposals

Until 2019, in essence, only corporations could qualify as CFCs. Polish entities with a sufficient percentage of shares in a CFC had to increase their taxable base by income earned by the CFC and tax it at 19%. However, they were entitled to reduce their taxable CFC basis by dividends paid out by the CFC (as long as they were not tax exempt) and by capital gains from sales of shares in that CFC in order to prevent double taxation.

Since 2019, the notion of a CFC has been broadened to include any entity with or without legal capacity, a foreign foundation, trust, any nominee relationship or direct or indirect representative. Yet, it is still the case that only dividends may be deducted from the taxable CFC basis, due to which, payments received from foreign foundations or trusts that do not qualify for dividends are taxed twice. This is a major defect of the current CFC rules.

The introduction of CFC rules to the Polish tax system revolutionised international tax planning. The Polish legislator's aim was to tax income derived by Polish tax residents from foreign companies when the income is not taxed in the company's country of residence or the tax is too low.

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 performs substantial business activity in that state. Foreign entities that are tax residents of other countries may be considered CFCs despite performing substantial business activity.

9.9 Anti-avoidance Rules

Poland has ratified the MLI Convention, due to which, a general principal purpose test (PPT) clause has already been or eventually will be introduced to all agreements covered.

In addition, Poland does not preclude the possibility of introducing the limitation of benefits (LOB) clause through bilateral negotiation to those DTTs that currently lack it. Some of the DTTs to which Poland is a party already feature the LOB clause but its practical application has been limited thus far.

It is hard to predict if the PPT and the LOB clauses are likely to impact investors in the future. It seems that the Polish tax authorities still have a long way to go to learn how to effectively harness international anti-avoidance rules as a weapon in the fight against aggressive tax planning. So far, they are more focused on exploiting domestic anti-avoidance rules, with the general anti-abuse rule (GAAR) serving as a prime example.

9.10 Transfer Pricing Changes

Cross-border transactions within an international group are targeted by the Polish tax authorities with respect to TP compliance.

Taxpayers conducting transactions (including the transfer of intangible assets) with related entities, or transactions involving 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, the 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.

The Polish TP rules generally follow the OECD guidelines. CIT payers' TP reporting obligations increased significantly, and TP 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.

On 1 January 2019, Poland introduced significant changes to its TP regulations. From that moment, TP documentation is generally not applicable to domestic transactions (with certain exceptions). TP documentation must be prepared for related-party transactions exceeding the following thresholds in a tax year:

- PLN10 million for transactions on goods and financial transactions;
- PLN2 million for services and other transactions; and
- PLN100,000 for transactions with entities located in a country that engages in harmful tax practices.

The changes were adopted in order to achieve a high level of transparency of related-party transactions (eg, intellectual property as a subject matter of the transaction).

Additionally, from 2021, the scope of transactions with unrelated entities established in low-tax jurisdictions that should be subject to the arm's length principle and TP documentation is extended to cover transactions with pass-through unrelated entities where the ultimate beneficiaries are established in low-tax jurisdictions.

Transactions between related parties involving intellectual property are the source of particular concern of the tax authorities with respect to their conformity to the arm's-length principle, in particular with respect to proper determining of economic owner of such property. DEMPE (development, enhancement, maintenance, protection and exploitation) analysis, especially with regard to intellectual property, is more frequently used by Polish tax authorities during tax controls these days.

9.11 Transparency and Country-by-country Reporting

The regulations concerning CbCR were introduced in Poland in 2015 and were amended a number of times afterwards. In 2017, Poland adopted the Act on the Automatic Exchange of Tax Information with Other Countries.

CbCR provides the tax authorities with a fair view of operations performed by multinationals and helps identify possible areas of aggressive tax planning through the use of strategic cross-border TP policies. The automatic exchange of tax information aims at combating tax evasion and profit shifting to offshore companies. While both measures create a certain additional compliance burden for the taxpayers, it seems that the burden is justified by the objectives the measures try to achieve; ie, greater transparency and tax fairness.

9.12 Taxation of Digital Economy Businesses

The Polish government announces from time to time that it plans to introduce a digital services tax to the Polish tax system but at the same time, it was recently declared that the adoption of a digital tax had been suspended until new rules on taxation in the digital economy were proposed at EU and OECD forums in which Poland takes an active part. The first step in taxation of digital businesses in Poland was the introduction of an additional 1.5% tax imposed on video-on-demand platforms in July 2020. Additionally, at the beginning of February 2021, a draft law was introduced on tax that is to be levied on revenues derived from, inter alia, internet advertising.

9.13 Digital Taxation

Poland has suspended its work on digital taxation as the government is waiting for EU and OECD initiatives to be finalised. However, in February 2021, a proposal of a draft law regarding a digital services tax was introduced by the Ministry of Finance. The proposed draft provides for the taxation of certain digital services rendered on the territory of Poland, such as internet advertising.

The draft law provides for a number of exemptions from the digital tax and is to apply only to companies with a significant digital presence in Poland. The tax would be imposed on companies that derive revenues of more than EUR5 million from internet advertising in Poland and derive revenues of more than EUR750 million worldwide, on an annual basis. The rate of the digital tax is to be 5%.

9.14 Taxation of Offshore IP

As a rule, royalties paid to non-residents are subject to 20% WHT in Poland. The local royalty withholding taxation may be reduced or even eliminated if so stipulated by a relevant DTT.

Poland has implemented Council Directive 2003/49/EC on a common system of taxation applicable to royalty payments made between associated companies of different member states. In particular, payments of outbound royalties are exempt from withholding taxation if certain conditions are met.

The aforementioned withholding tax exemption of outbound royalties is limited to recipients from the EU, the EEA and Switzerland. Payments to other countries (including tax havens) do not qualify for the exemption.

Royalty payments made to entities from countries perceived as tax havens that have not concluded a DTT with Poland are subject to the general 20% WHT rate.

With regard to the taxation of offshore IP, the Polish CFC rules may be applicable. This may take place when the intellectual property is assigned to a controlled entity in a low-tax jurisdiction and income arising from the exploitation of the intellectual property in Poland is transferred to the jurisdiction in the form of royalty payments.

Additionally, use of IP rights between related parties is more frequently challenged by Polish tax authorities under TP rules aiming at determining the real beneficial owner of IP rights to which the income from the IP rights should be assigned.

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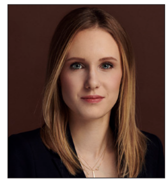

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Trends and Developments

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Tax Highlights of 2020

2020 was dominated by the fight with the COVID-19 pandemic. Therefore, many legislative measures have been taken to prevent a negative impact from the economic breakdown. In particular, deadlines for multiple statutory obligations have been postponed until the end of the state of epidemic that was declared and temporary tax preferences were introduced throughout the year in order to minimise COVID-19's impact on the business activity of taxpayers. Those were, in particular, the following.

Exemption from commercial property tax

An exemption from commercial property tax has been introduced in corporate income tax (CIT) law for the period from 1 March 2020 to 31 December 2020 and further extended after 31 December 2020 until the state of epidemic is over.

Bad debt relief

Creditors whose businesses had been adversely affected by COVID-19 can reduce their revenues derived during the state of epidemic by applying a relief for bad debts under personal income tax (PIT) and CIT regimes within a shorter period of 30 days instead of 90 days after their accounts receivable became overdue.

Carry back of a tax loss

Taxpayers who incurred a loss in tax year 2020 because of the COVID-19 outbreak and, as a consequence, derived revenues at least 50% lower than the revenues generated on the same operations in tax year 2019 were granted a possibility of a one-off reduction of the income generated in 2019 by the loss incurred in 2020 (up to the maximum amount of PLN5 million).

Tax capital groups

Tax capital groups that in 2020 suffered adverse economic effects of the COVID-19 outbreak and, for that reason, failed to meet the profitability and no-tax-arrears conditions, which triggers a dissolution of the group, nevertheless could retain the status of a tax capital group, until the end of the original period that is determined when the given tax group is established and may not be shorter than three years.

Tax residency certificates

Tax residency certificates whose validity period of 12 months expired during the state of epidemic can be used when collecting WHT until the lapse of two months after the state of epidemic has been cancelled. In addition, tax residency certificates issued for 2019 may also be used if the tax remitter holds the taxpayer's statement on the validity of the data contained therein.

Extensions of deadlines

Multiple statutory deadlines have been extended or suspended during the COVID-19 pandemic. For instance, the deadlines for fulfilling the transfer pricing (TP) obligations have been significantly extended, allowing taxpayers to submit relevant statements much later than usual. Additionally, the deadlines for filing the annual CIT and PIT returns and for payments of respective taxes were deferred.

Changes in law also concerned the reporting of tax arrangements and resulted in a suspension of all statutory deadlines in this respect. First, deadlines regarding cross-border arrangements that were implemented as of February 2020 started to run only at the beginning of 2021. Additionally, improper implementation of the DAC 6 EU directive resulted in another change in mandatory disclosure rules, imposing an obligation on intermediaries and relevant taxpayers to report again already notified cross-border arrangements.

New Developments in 2021

From 2021, a number of amendments to CIT law entered into force, partially as a response to the COVID-19 crisis.

The government has visibly intensified its policy aimed at closing tax loopholes in order to supply the strained state budget with additional resources. Therefore, the tendency to quickly introduce the OECD's recommended tools preventing base erosion and profit shifting is likely be continued in the coming years. As part of this policy, the following taxation rules have been introduced in 2021.

CIT on partnerships

Limited partnerships with a registered office or place of management located in Poland that until the end of 2020 were classified as tax-transparent entities became CIT payers subject to a 19% CIT rate levied on their income starting from 1 January 2021. General partners are allowed to deduct a percentage of a limited partnership's CIT liability proportionally to their profit participation from their CIT/PIT liability once a limited partnership distributes profits.

Additionally, in certain cases, general partnerships may also become CIT payers. This applies to general partnerships whose partners are not only individuals and that did not submit the information on the participation of particular partners within the statutory deadline. If a general partnership fails to comply with this requirement, its income will be subject to 19% CIT and its partners will be liable to CIT/PIT upon the distribution of profits by the general partnership.

Tax strategy reporting obligation

Tax capital groups and taxpayers whose revenues exceed EUR50 million annually are required to prepare and disclose to the public a report on their tax strategy for a given tax year, starting from 2021.

The report on tax strategy should take into account the nature, type and size of a taxpayer's business and should include, in particular, the following information:

- a description of the taxpayer's approach as to processes and procedures for managing the settlement of tax law obligations;
- information on voluntary forms of co-operation with the tax administration;
- information on significant transactions with related parties (the value threshold is 5% of the balance sheet value of assets);
- information on the tax arrangements in low-tax jurisdictions;
- information on planned and undertaken restructuring activities that may affect the tax liabilities of the taxpayer or its related parties; and
- information on submitted applications for tax rulings (both individual and general), binding VAT rate information or binding excise tax information.

Anti-hybrid rules

According to the new anti-hybrid rules, taxpayers, including local branches of foreign enterprises, are obliged to deny deductions of expenses or tax exemptions or other tax incentives relating to income if such expenses or income results from using the following hybrid measures:

- (debt and equity) instruments; ie, instruments qualified differently for taxation in countries of a recipient and an issuer of such instrument;
- entities; ie, entities that are qualified for taxation purposes as tax transparent in one jurisdiction and as non-transparent in another jurisdiction;
- permanent establishments (PEs); ie, actions that are deemed as creating a PE under the provisions of one jurisdiction and as not creating a PE under the provisions of another jurisdiction; and
- transactions; ie, transactions concerning the transfer of a financial instrument that results in taxable income derived by more than one taxpayer.

Transfer pricing changes

The scope of transactions with unrelated entities established in low-tax jurisdictions subject to the arm's-length principle has been extended since 1 January 2021 and now covers transactions with pass-through entities whose ultimate beneficiaries are operating in low-tax jurisdictions. This may have a significant impact on taxpayers' due diligence procedures as there is now a requirement to determine the place of establishment of ultimate beneficiaries of all unrelated counterparties.

Taxpayers will be obliged to prepare transfer pricing documentation covering such transactions if the value of transactions in a tax year exceeds PLN500,000.

Real estate companies

The definition of a real estate company has been introduced to Polish PIT and CIT laws. Under this definition, a real estate company is an entity meeting jointly the following conditions:

- its balance sheet assets consist of at least 50% of real estate;
- such real estate is worth at least PLN10 million; and
- owned real estate is mainly used for lease, tenancy or a similar activity (at least 60% of tax revenue should be derived from such activity).

In the case of a disposal of at least 5% of the shares in a Polish real estate company, the obligation to settle Polish tax liability will be imposed on the real estate company whose shares are sold if at least one of the transacting parties is a Polish non-resident.

Additionally, with respect to real estate companies having their seat or place of management in foreign countries, an obligation was imposed to appoint a tax representative in Poland.

All the above measures are aimed at closing tax loopholes and increasing the Polish tax base. However, it should be noted that next to solutions aiming at imposing additional tax obligations on taxpayers, preferential tools are also being introduced in Polish income tax law. In 2021, these were, in particular, the following.

Estonian CIT

As of 2021, a so-called Estonian CIT has been implemented in Poland. In general, this new regime allows businesses eligible for this new form of taxation to pay tax only on part of the income paid out to shareholders in the form of dividends (also in other forms of hidden profit distribution). The Estonian CIT is dedicated for small and medium joint-stock and limited liability companies deriving income no higher than PLN100 million. The conditions for qualifying for this new regime are rather strict and comprise:

- holding no shares in other businesses;
- employment of at least three persons, excluding a shareholder;
- deriving operating income at least as high as income from interest, IP rights, financial instruments, guarantees and certain related-party transactions; and
- incurring of investment costs.

Taxpayers that qualify for Estonian CIT should be able to apply this regime for four years if they record 15% investment costs growth. If the taxpayer meets all the criteria, it may be taxed this way for the next four years. The tax rates in this regime vary from 10 to 25%. The strict application conditions mean it is difficult to assess whether it will become a popular tool among CIT payers.

Increase of the income limit qualifying for the 9% CIT rate

Since 1 January 2021, the annual revenue threshold to apply the preferential 9% CIT rate instead of the standard 19% CIT rate has been increased from EUR1.2 million to EUR2 million. However, the lower rate still may not be applied to capital gains.

Strict WHT regime postponed again

Additionally, a new strict WHT regime that limits the use of domestic tax exemptions and double tax treaty benefits has been postponed again and is to apply from July 2021.

Even though the new regime does not apply yet, the Polish Ministry of Finance has already announced that it is working on an amendment of the WHT regime in order to address at least some of the concerns raised by withholding tax agents with regard to potential difficulties in the application of the new regime in its current wording.

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PORTUGAL

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses generally adopt a corporate form, with the most commonly used being joint-stock companies (*Sociedades Anónimas,* or S.A.) and limited liability companies (*Sociedades por Quotas*, or Lda). Portuguese company law also establishes other forms, used less commonly. In general, joint-stock companies and limited liability companies are taxed according to similar rules, with both being treated for legal purposes (including tax) as separate entities, unless the tax transparency regime applies.

Joint-stock companies are subject to a minimum share capital of EUR50,000, represented by shares. The capital is divided into shares and the shareholders' liability is limited to the value of the shares subscribed.

Limited liability companies are formed by at least two shareholders (although limited liability companies with a single shareholder are also admitted). There is no minimum share capital required. Shareholders may be jointly responsible up to the amount of initial paid-in capital agreed in the articles of incorporation. Limited liability companies may be held by a single shareholder (*Sociedade Unipessoal por Quotas*), either upon formation or upon the redemption of the interest held in the company by other shareholders. In general, the same rules apply as for limited liability companies.

1.2 Transparent Entities

Partnerships – whether de facto or in the form of limited partnerships or limited liability partnerships – have not been recognised as such or established in either the company laws or the tax laws of Portugal. Accordingly, Portuguese tax law does not provide a comprehensive set of rules establishing how resident or non-resident partnerships/partners are taxed. Furthermore, no clear guidance is provided regarding how foreign partnerships should be respected as such or taxed as separate entities.

Notwithstanding, the Portuguese Corporate Income Tax Code (the "CIT Code") establishes a transparency regime that applies, inter alia, to certain family-owned companies dedicated to asset management, to certain companies that fall into the definition of Professional Services Firms, and to certain joint venture entities such as complementary groups of companies (*Agrupamento Complementar de Empresas*) and European Economic Interest Groups (*Agrupamento Europeu de Interesse Económico*).

Complementary groups of companies can be formed by a group of corporate entities/individuals, generally to facilitate collaboration between members in a specific business venture. A complementary group of companies has separate legal personality from its members. These entities are not subject to minimum registration capital, and members are jointly liable for the entity's debts.

European Economic Interest Groups are meant to facilitate or develop the economic activities of their members via a pooling of resources, activities or skills, and can be formed by legal entities governed by public or private law that have been formed in accordance with the laws of an EU country and have their registered office in the EU, as well as by individuals developing an industrial, commercial, craft or agricultural activity, or providing professional or other services in the EU. They must have at least two members from different EU countries. Each member of a European Economic Interest Group has unlimited joint and several liability for the entity's debts.

In addition, Portuguese Collective Investment Vehicles apply taxation schemes that privilege investor-level income taxation to fund-level income taxation (see **2.3 Other Special Incentives**).

1.3 Determining Residence of Incorporated Businesses

Portuguese tax residency of corporate entities is determined based on the location of the head office or place of effective management.

1.4 Tax Rates

The general CIT rate applicable on the Portuguese mainland is 21%, while the applicable tax rate in the Madeira Archipelago is 14.7% and in the Azores Archipelago it is 16.8%.

On the Portuguese mainland, entities qualifying as small and medium enterprises (SMEs) are subject to a 17% rate, which applies to the first EUR25,000 of taxable profit. The remaining profit is subject to the applicable general rates.

A state surtax applies to taxable profits exceeding EUR1.5 million, as follows:

- from EUR1.5 million up to EUR7.5 million – 3%;
- from EUR7.5 million up to EUR35 million – 5%; and
- profits exceeding EUR35 million – 9%.

Local surtax up to 1.5% of taxable profits is levied by municipalities.

Certain expenditures incurred by entities subject to CIT are separately subject to Autonomous Taxation (*Tributação Autónoma*) at varied rates, such as undocumented expenses, entertainment expenses and expenses incurred with vehicles.

Generally, taxable income derived from businesses operated directly by individuals is subject to personal income tax (PIT) and taxed as business income (Schedule B income) at progressive rates ranging from 14.5% to 48% and to a solidarity surcharge, also levied at progressive rates (2.5% to 5%), applicable to taxpayers with taxable income over EUR80,000. (See **3.2 Individual Rates and Corporate Rates**).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are defined in the CIT Code as the sum of profits and losses (p&l) as well as the net variations in equity not reflected in p&l, as accrued and determined for accounting purposes, subject to the adjustments set forth in the CIT Code. These adjustments include:

- cancellation of the equity and the proportional consolidation methods;
- correction of fair value accruals/deductions;
- correction of amounts deducted as provisions and impairments in excess of deductible amounts as determined in the CIT Code;
- correction of amounts deducted with CIT, autonomous taxation and other taxes levied on profits paid by the taxpayer, penalties, fines, late payment and other compensatory interests paid and taxes levied on third parties that the taxpayer is not legally authorised to bear;
- deferred taxes;
- undocumented expenses;
- amounts paid or owed to entities subject to a privileged tax regime as defined in Portuguese tax laws;
- excessive depreciation and amortisation;
- bad debt deductions above the limits established in the CIT Code;
- unrealised capital gains and losses, as well as adjustments in connection with the capital gains rollover relief mechanism;
- gains or losses registered for accounting purposes with respect to derivative instruments;
- transfer pricing adjustments;
- interest deductibility limitations and excessive deduction carry-forwards;
- excessive deductions taken with respect to gifts and donations;
- tax regimes based on territoriality, including the deductions for dividends received and capital gains realised from the sale of certain securities as well as the application of the exemption method to foreign permanent establishments (PEs); and
- the patent box regime and tax depreciation for certain assets, including intangibles.

2.2 Special Incentives for Technology Investments

Patent Box

The Portuguese patent box grants a deduction corresponding to 50% of the income derived as consideration from the disposal or temporary use of certain industrial property rights (patents, industrial models and copyright on computer software), including income from the violation of such rights ("qualifying income"). Qualifying income is defined as the net positive balance between the revenues and gains derived in a given taxable year as consideration from the disposal or use of qualifying industrial property rights and the research and development (R&D) expenses or losses incurred or borne in the same period by the taxpayer in connection with the industrial property right from which the gain is obtained.

This regime does not apply to any services supplied that are ancillary to a qualifying disposal or temporary use of industrial property.

2.3 Other Special Incentives

Portuguese tax law establishes several tax incentives aimed at promoting certain behaviour (eg, savings) or stimulating certain activities, industries and sectors. Notable sector-specific incentives include those granted to capital markets and to the financial sector in general, to real estate development and rehabilitation, to the shipping industry, wine production, sports and cultural activities, cinema, forestry management, patronage, philanthropic activities and the co-operative sector.

Pension Funds

Generally, pension funds established according to Portuguese law are exempt from Portuguese CIT and the municipal transfer tax applicable to the sale of real estate. This tax treatment may be extended to pension funds established under the law of another EU/EEA jurisdiction, provided the latter is bound by administrative co-operation or mutual assistance in taxation matters, when the following requirements are met:

- the pension fund should provide exclusively for retirement benefits in relation to ageing, incapacity, survival, pre-retirement or anticipated retirement, health benefits post-employment, and, when accessory to the referred benefits, death grants;
- the pension fund should be managed and supervised by an entity to which Directive 2003/41/EC of the European Parliament and of the Council applies;
- the pension fund should be the beneficial owner of the income; and

- if the income to be received by the pension fund is a profit distribution, the corresponding shareholdings must be held, uninterrupted, for at least one year.

Collective Investment Vehicles (CIVs)

Investment funds in securities, real estate investment funds, investment companies in securities and real estate investment companies established according to Portuguese law are technically subject to CIT on their taxable income; however, income typically derived by CIVs – including interest, dividends, capital gains and rents, as well as certain fees and commissions – is generally excluded from CIT. This exemption does not apply when the income is paid by an entity resident in a blacklisted jurisdiction. CIVs are exempt from municipal and state surcharges.

In addition, stamp duty applies on the net asset value of these funds on a quarterly base (at a rate of 0.0025% or 0.0125%, depending on the investment policy pursued).

Investors resident in Portugal are subject to tax on distributions, redemptions and the disposal of units or shares issued by CIVs (at different rates). Non-resident investors are exempt, except with respect to investments in real estate investment funds and companies, in which case a 10% rate applies.

Portuguese REITs and their shareholders have an income tax regime similar to real estate investment funds and companies, with the particularity that income from the sale of real estate is only excluded from tax when the immovable property has been held for renting purposes for at least three years.

Exemptions Applicable to Foreign Financial Entities

Interest payments made by resident financial institutions towards Portuguese resident financial institutions without a PE in Portugal are generally exempt from CIT (blacklisted entities as well as non-resident financial institutions substantially held by resident entities are excluded). Also, gains realised by non-resident financial institutions, in the context of swap transactions entered into with a resident financial entity, are also generally exempt from CIT (similar exclusions apply).

Exemption Applicable to Debt Instruments

Non-resident entities and individuals (except those that are resident in blacklisted Jurisdictions) are exempt from CIT and PIT otherwise due on interest and capital gains derived in connection with qualifying debt instruments that benefit from the regime set forth in Decree Law 193/2005.

Debt instruments qualifying for this regime include bonds issued by public and private sector entities, money market instruments (namely treasury bills and commercial paper), perpetual bonds, convertible bonds, other convertible securities, and tier 1 and tier 2 capital instruments, regardless of the currency of issue. Qualifying instruments must be integrated in a centralised system managed by a Portuguese resident entity or by an entity established in the EU/EEA that manages an international clearing system (in the latter case, provided that the state of establishment is bound to administrative co-operation for tax purposes equivalent to the rules in force in the EU).

The beneficiaries of this exemption include central banks and government agencies, international organisations recognised by Portugal, and entities resident in a country or jurisdiction that has entered into a double tax treaty or an exchange of information agreement with other entities that are not resident in a blacklisted jurisdiction.

Tonnage Tax and Seafarer Schemes

Following approval by the European Commission, two new schemes have been implemented:

- a special tax regime based on the amount of tonnage operated by ship-owners, applicable to eligible maritime transport activities, exempting the companies concerned from the general obligation to pay CIT irrespective of the companies' actual profits or loss (the "Tonnage Tax Scheme"); and
- a special tax and social contributions regime applicable to seafarers involved in eligible maritime transport activities, partially exempting them and their employers from the general obligation to pay income tax and social contributions (the "Seafarer Scheme").

2.4 Basic Rules on Loss Relief

For resident entities, there is no distinction between ordinary income/capital gains and ordinary losses/capital losses. The carry-forward of losses is available for five years, unless the entity is a certified SME, in which case the carry-forward of losses is available for 12 years. For each year, the deduction of tax losses is limited to 70% of the taxable profit. Carry-back is not allowed.

Portuguese law establishes a general anti-loss trafficking rule, under which, loss carry-forward is not allowed if more than 50% of the entity's ownership (share capital or voting rights) has changed between the taxable year in which such losses were generated and the end of the taxable year in which the deduction is claimed. However, several exceptions apply to the general rule (eg, when the ownership is converted from direct into indirect or from indirect into direct, and when an interest is exchanged between entities whose share capital or voting rights are held directly or indirectly by a common entity).

When no exception applies, the Minister of Finance may approve the transfer of losses to the extent that a motion is filed with the tax authorities and it is considered that there is a recognised economic interest in authorising such transfer.

In the case of non-resident entities, no carry-forward of losses is available for business income unless such entities have a PE in Portugal. Non-residents that derive Portuguese-source capital gains and do not have a PE in Portuguese territory to which such gains are attributable are subject to tax on the balance of Portuguese-source capital gains and losses. In the case of securities, exemptions may apply (see **7. Anti-avoidance** for more details).

2.5 Imposed Limits on Deduction of Interest

In general, business expenses, including interest, are deductible for tax purposes to the extent they are necessary to obtain or guarantee income subject to CIT. There are, however, certain limitations that are applicable to interest expenses deductibility.

Interest Barrier Rule

Net interest expenses may be deducted up to the greater of the following limits:

- EUR1 million; or
- 30% of EBITDA as determined by accounting rules and corrected for tax purposes.

It is possible to carry forward excess interest deductions and unutilised limits for five taxable years. Excess interest deductions and unutilised carry-forwards are applied on a first-in, first-out basis, after the current year's interest is deducted. Rules similar to the anti-loss trafficking rules detailed above also apply to excess interest deductions and unutilised limits.

Companies taxable under the Special Regime of Group Taxation (*Regime Especial de Tributação dos Grupos de Sociedades*, or RETGS) may elect to apply these rules on a group basis. Likewise, certain rules limit the deductibility of interest as well as the application of excess limits pertaining to pre-grouping or post-grouping taxable years.

Transfer Pricing and Shareholder Loans

In addition to the above, transfer pricing rules may limit the deductibility of interest in the case of debt arrangements entered into between related parties, as defined for tax purposes, to the extent such interest is not established according to the arm's-length principle.

Unless transfer pricing rules apply, interest and other forms of compensation agreed under financial arrangements, qualified as shareholder loans (*suprimentos*), cannot be deducted in excess of the rate established in a ministerial decree issued by the Minister of Finance.

2.6 Basic Rules on Consolidated Tax Grouping

The RETGS is not a consolidation regime, but rather an optional tax regime under which the "Dominant Company" of a "Group of Companies" may elect to aggregate the taxable profits and losses of any other company pertaining to the same group of companies ("Member Companies").

Under the RETGS, a Group of Companies exists when a company (the Dominant Company) directly or indirectly holds 75% of the share capital of another company or companies (the Member Companies), as long as such interest provides the Dominant Company with the majority of the voting rights in each of the Member Companies.

An election to apply the RETGS can only be filed when certain conditions applicable to the Dominant Company and to the Member Companies are cumulatively fulfilled.

The RETGS ceases to apply when any of the mandatory requirements concerning the Dominant Company are no longer fulfilled, or when the taxable profits of any of the entities forming the Group of Companies are determined according to an indirect assessment. When a Dominant Company becomes controlled by another Portuguese company that fulfils the requirement to be considered a Dominant Company (other than the requirement with respect to losses during the three previous tax periods) during the application of the RETGS, the latter may elect to continue to apply the RETGS.

Specific and strict rules apply to the carry-forward of losses during the application of the RETGS, including in cases where a non-recognition transaction occurred. Also, pre and post-RETGS loss carry-forward is limited.

2.7 Capital Gains Taxation

In general, capital gains are considered taxable profits and are taxed at the general CIT rate. Capital losses may be deducted if the general deductibility rules are fulfilled, but not to the extent such losses correspond to profits or reserves distributed in previous years or capital gains realised on the disposal of shares that benefited from the participation exemption or from the foreign (indirect) tax credit.

The participation exemption regime exempts capital gains and losses realised by Portuguese-resident companies with share transfers, provided that the following requirements are met.

- The company disposing of the interest must hold – directly and/or indirectly – at least 10% of the share capital or voting rights of an entity.
- Such interest must be held for a minimum period of one year.
- The entity disposing of the interest must not be taxed under the tax transparency rules.
- The company whose shares are disposed of must either:
  (a) be liable to CIT in Portugal without being exempt;
  (b) if resident in the EU, be liable to a tax mentioned in Article 2 of Directive 2011/96/UE without benefiting from an exemption; or
  (c) if resident outside the EU, be liable to a tax that is similar to the CIT, where the applicable rate is not below 60% of the Portuguese CIT rate (this condition may be waived under certain circumstances).
- The entity whose shares are being disposed of should not be a resident of a blacklisted jurisdiction.
- No more than 50% of the value of the subsidiary's total assets is comprised of real estate located in Portugal, unless such properties are used in connection with an agricultural, industrial or commercial activity (other than a real estate buy and sell activity).

Additionally, a rollover relief mechanism may be used to exclude 50% of the positive balance of capital gains and losses realised on the sale of tangible fixed assets, intangible assets and non-consumable biological assets, held for at least one year, from taxable income, to the extent the realisation value of such assets is wholly or partially reinvested in the acquisition, production or construction of similar assets during a four-year reinvestment period that corresponds to the two years before and the two years after the taxable period in which the realisation occurs. The law establishes specific rules to be observed, including regarding the type of assets qualifying for this regime.

When the reinvestment is not wholly or fully made until the end of the reinvestment period, the income that was not previously recognised for tax purposes must be subject to taxation in that period, increased by 15%.

Non-resident taxpayers who do not have a Portuguese-situs PE may be subject to Portuguese-source capital gain taxation on the disposal of the following assets:

- Portuguese-situs real estate;
- the disposal of shares in real estate-rich companies (whether or not such companies are resident for tax purposes in Portugal); or
- the disposal of shares in Portuguese companies.

There is an exemption that applies to non-resident entities or individuals deriving Portuguese-source capital gains from the disposal of shares and other securities issued by Portuguese entities, but this exemption does not apply in the following cases.

- To non-resident entities domiciled in a blacklisted jurisdiction.
- To non-resident entities that are directly or indirectly held, at more than 25%, by resident entities, except when:
  (a) the non-resident entity is liable to a tax mentioned in Article 2 of Directive 2011/96/UE without benefiting from an exemption, or, if resident outside the EU, to a tax that is similar to the CIT, where the applicable rate is not below 60% of the Portuguese CIT rate;
  (b) the non-resident disposing of the interest has held directly and/or indirectly at least 10% of the share capital or voting rights of the Portuguese issuer for a minimum period of one year prior to the disposal; and
  (c) the non-resident entity is not part of an artificial arrangement, or a series of artificial arrangements, put in place with the main purpose of obtaining a tax advantage.
- When more than 50% of the total assets of the Portuguese entity whose shares are being disposed of consists of immovable property located in Portugal.
- When the entity whose shares are disposed of actively manages or passively holds control in other Portuguese resident companies, whose assets, in turn, are made up by more than 50% of immovable property located in Portugal.

2.8 Other Taxes Payable by an Incorporated Business

Other taxes may apply to specific transactions, namely:

- value added tax (VAT), generally levied on the supply of goods and services;
- stamp duty, which may apply to contracts, acts, documents, titles, books and other items occurring or deemed to be occurring within Portuguese territory listed in the General Table that are not subject to, or exempt from, VAT, such as the acquisition of real estate, the use of credit and guarantees; and
- property transfer tax (IMT), which may be levied on the transfer of real estate located in Portugal.

2.9 Incorporated Businesses and Notable Taxes

Other than the taxes mentioned in **2.8 Other Taxes Payable by an Incorporated Business**, a company owning real estate in Portugal is generally subject to property tax (IMI), levied at a rate ranging from 0.3% to 0.45% (urban properties) of the tax registration value. An addition to the property tax, called AIMI, may also apply.

Also, industry-specific levies may apply to companies operating in certain sectors.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Generally, most closely held local businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

The CIT Code comprises a tax transparency regime that applies to the following entities in specific situations:

- companies incorporated under the form of civil companies with commercial capacity;
- "professional services firms" ("*Sociedade de Profissionais*"); and
- companies established for the passive administration of certain assets, values or goods held for the fruition of their shareholders.

A "professional services firm" is defined as a company in which all the shareholders undertake the same type of professional activities listed in a ministerial order – doctors, dentists, lawyers, etc – and more than 75% of the income is derived from at least one qualifying professional activity, as long as its shares are held by not more than five shareholders for more than 183 days per tax year, with none of them being a public company, and at least 75% of the share capital is held by professionals who carry out such activities, totally or partially through the company.

The taxable profits are computed at a corporate level but are attributable to the shareholders and taxed as business (Schedule B) income. If the shareholder receives payments on account of future dividends during a given tax period, and such payments are in excess of the income attributed via the tax transparency regime, then the total amount of such payments should be taxed as self-employment/business income (*Categoria B*) for PIT purposes.

3.3 Accumulating Earnings for Investment Purposes

If a closely held corporation is domiciled in a blacklisted jurisdiction, it may be considered a controlled foreign company (CFC), in which case, anti-deferral rules could apply. In this case, the CFC profits or income may be attributable to the individuals holding an interest in the CFC, in the proportion of such interest. Income so attributed is characterised as business (Schedule B) income if the interest is used in a business activity, or as investment (Schedule E) income in all other cases.

If the tax transparency regime applies, the taxable profits of the tax transparent entity are directly attributable to the shareholder, and are taxed as business income for PIT purposes. If the shareholder receives payments on account of future dividends during a given tax period, and such payments are in excess of the income attributed via the tax transparency regime, then the total amount of such payments should be taxed as self-employment/business income (*Categoria B*) for PIT purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Capital gains realised on the sale of shares by resident individuals are taxed at a special 28% rate (Schedule G income), unless the taxpayer chooses to include this income and submit it to the progressive rate structure and the solidarity surcharge, or unless it is shares from a non-listed micro or small-sized company that are taxed at the effective rate of 14%.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

The rules that apply to the taxation of dividends and capital gains derived by individuals from publicly traded corporations do not differ from those applicable to income derived from privately traded corporations.

Dividends received by resident individuals are taxed at a 28% flat rate unless the taxpayer elects to include this income and apply the general progressive rate structure. In this case, when dividends are distributed by Portuguese-resident companies or EU/EEA companies (in the latter case, provided that the state of establishment of the distributing company is bound to administrative co-operation for tax purposes equivalent to the rules in force in the EU) and the same requirements established in the Parent-Subsidiary Directive are fulfilled, the taxpayer will be able to include an amount corresponding to 50% of such dividend.

Capital gains realised on the sale of shares by resident individuals are generally taxed at a special 28% rate (Schedule G), unless the taxpayer chooses to include this income and submit it to the progressive rate structure and the solidarity surcharge.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In general, interest, dividends and royalties paid by Portuguese resident companies to non-resident companies are subject to withholding tax at the rate of 25%.

Dividends, interest and royalties, among other forms of capital income, paid or made available to accounts held by one or more holders on behalf of unidentified third parties, or to entities deemed to be tax resident in blacklisted jurisdictions, should be subject to withholding tax at the rate of 35%.

Withholding tax on distributions of dividends may not take place if the Portuguese participation exemption regime is applied.

Dividends distributed by resident entities to non-resident entities should be exempt from CIT provided that:

- the beneficiary of the income is resident in another EU country, an EEA country that submits to administrative co-operation in a similar manner as between EU countries, or a country with which Portugal has executed a double taxation treaty (DTT) that is in force and provides for the possibility of the exchange of information;
- the beneficiary of the income holds, directly and/or indirectly, at least 10% of the share capital or voting rights of the distributing company;
- such participation has been held uninterrupted during the 12 months prior to the distribution of the dividends; and
- the beneficiary of the income is subject to, and not exempt from, any of the income taxes referred to in the EU Parent-Subsidiary Directive, or is subject to, and not exempt from, a tax of a similar nature with a rate that cannot be lower than 60% of the Portuguese CIT rate (ie, currently such tax rate cannot be lower than 12.6%).

In order to benefit from this tax exemption, the beneficiary of the income must fulfil some formal obligations.

This exemption regime also applies to dividends distributed by a resident company to a PE located in other EU or EEA countries of an entity that meets the mentioned requirements.

On the other hand, these tax exemptions are not applicable if there is an arrangement – or several arrangements that are not genuine – whose primary purpose, or one of those, is to obtain a tax advantage that defeats the object and purpose of eliminating the double taxation of dividends. This regime should also not apply if the Portuguese distributing company has not complied with the declarative obligations imposed by the Portuguese legal regime of the beneficial owner central registry.

Regarding interest and royalties income, the withholding tax may be eliminated by the tax framework established by the EU Interest and Royalties Directive (I&RD), provided that the following requirements are met:

- the entity that pays and the entity that benefits from the relevant income should be subject to and not exempt from corporate tax, and incorporated under one of the legal forms listed in the annex of the I&RD;
- both entities should be deemed EU residents for DTT purposes;
- a direct 25% shareholding should be held by one of the companies in the share capital of the other, or a third company should directly hold at least 25% of the capital of both companies, and in any scenario the shareholding must be held for at least a two-year period; and
- the entity that receives the interest payment should be its effective beneficiary.

The payment of interest and royalties to a company or a PE resident in Switzerland may also benefit from this exemption regime, provided that the aforementioned requirements are fulfilled.

The application of this tax exemption regime also depends on the fulfilment of some formal requirements.

The beneficiary may also apply for the later reimbursement of the withheld tax within the next two years following the respective payment.

This tax exemption regime on interest and royalties payments should not be applicable to the part of the income that does not comply with the arm's-length principle.

Interest from debt securities issued by Portuguese companies and made available to non-residents may also be exempt from withholding tax under Decree-Law No 193/2005 of November 7th.

4.2 Primary Tax Treaty Countries

Portugal has so far executed 80 DTTs, 78 of which are in force. The last DTT to enter into force was with Angola. Finland has denounced its DTT with Portugal, so that a DTT has not been available since 1 January 2019.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Over the last few years, the Portuguese tax authorities (PTA) have increased their focus on cross-border tax matters, aiming to tackle treaty shopping practices, following the best international practices on the matter.

The last reports on activities developed for the combating of fraud and tax evasion that were released by the PTA highlighted the efforts to tackle cross-border abusive practices and an increase in the use of the international mechanisms available for the exchange of tax information.

In accordance with such reports, the PTA also intend to increase their control over cross-border transactions made between related parties, as well as over entities developing their business activities by means of new business models based on information technologies. One way to mitigate the risks arising from related-party transactions may be to execute an advance pricing agreement (APA).

4.4 Transfer Pricing Issues

The most common transfer pricing issues that foreign investors usually have to deal with regarding local corporations are related to the terms and conditions established between the related parties regarding interest on financing, as well as on the amount of management fees and royalties.

The Portuguese transfer pricing regime was amended in 2019 in order to expressly establish that the transfer pricing rules are applicable to corporate restructurings whenever they include the transfer of tangible or intangible assets, rights on intangible assets or compensation payments for losses.

4.5 Related-Party Limited Risk Distribution Arrangements

In general, Portugal follows the OECD standards on transfer pricing issues; therefore, the PTA are legally entitled to challenge the agreements established by related parties with reference to limited risk distribution for the sale of goods or the rendering of services. The control of such arrangements is common for international corporate groups. These arrangements may also be covered by an APA.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Considering that Portugal tends to follow the OECD standards on transfer pricing matters, there are no particular differences to emphasise.

4.7 International Transfer Pricing Disputes

From a Portuguese tax standpoint, it is not common to settle transfer pricing disputes through DTTs and mutual agreement procedures (MAPs). Nevertheless, there are some cases duly documented in OECD statistics.

According to such statistics, at the end of 2019, Portugal had approximately 70 ongoing MAPs. Approximately nine of these cases started before 1 January 2016, while the remaining started after such date. Moreover, the number of ongoing MAPs related to transfer pricing cases increased to approximately 39.

The average time needed to close MAPs related to transfer pricing issues and started before 1 January 2016 was approximately 83.5 months. As regards the transfer pricing MAPs started after the previously mentioned date, the "start to end" timeframe was approximately 29.5 months.

On the other hand, the outcome of the MAPs was essentially the following:

- denied MAP access – 8%;
- agreement fully eliminating double taxation – 50%;
- unilateral relief granted – 17%; and
- withdrawn by taxpayer – 25%.

Furthermore, in December 2017, the PTA published Guidelines for the use of the International MAP Procedures in accordance with the Double Tax Treaties entered into by Portugal, and with the Arbitration Convention – Convention 90/436/EEC, of 23 July 1990, on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

As a rule, when the PTA execute a transfer pricing adjustment for one related party in a transaction, a correlative adjustment may be made by the other related party involved in such transaction.

Additionally, several DTTs entered into by Portugal provide a mechanism under which transfer pricing adjustments made by the tax authorities in one state may lead to a correlative adjustment in the other party's state of residence for the avoidance of potential double taxation.

Finally, where a transfer pricing adjustment leads to additional tax liability towards the PTA, the relevant company should be bound to pay compensatory interest to said authorities at a rate of 4% per year. Specific penalties may also apply.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

As a rule, local branches and local subsidiaries of non-local corporations are taxed on the same basis. However, the following aspects in the tax regime applicable to a local branch of a foreign corporation should be considered:

- general administrative and management expenditures made by the head office of the non-local corporation for its local branch may be allocated to the latter;
- income paid by the local branch to its head office should be exempt from withholding tax; and
- some limits on the deductibility of some expenditures charged by the head office to the local branch may apply, namely regarding royalties and interest.

5.3 Capital Gains of Non-residents

As a rule, capital gains made by non-resident entities from the transfer of stock in local corporations are subject to tax at the rate of 25%, but may be exempt from taxation in Portugal provided that the following apply.

- More than 25% of the non-resident company is not held, directly or indirectly, by Portuguese tax residents, unless the following requirements are cumulatively met:
  - (a) the non-resident company is resident in an EU country, in an EEA country that submits to administrative co-operation on tax matters with Portugal in a similar manner as between EU countries, or in a country with which Portugal has executed a DTT that is in force and provides for the exchange of information on tax matters;
  - (b) the beneficial owner is subject to, and not exempt from, a tax identified in Article 2 of Directive 2011/96/UE of 30 November 2011, or subject to, and not exempt from, a tax of a similar nature with a rate not lower than 60% of the Portuguese CIT rate;
  - (c) the beneficial owner uninterruptedly holds, directly or indirectly, at least 10% of the share capital or voting rights of the transferred entity for at least one year; and
  - (d) the beneficial owner is not part of an arrangement or several arrangements with an artificial nature that have been put in place with the main purpose of gaining a tax advantage.
- The non-resident entity is not domiciled in a blacklisted jurisdiction.
- The capital gains obtained by the non-resident are not related to the transfer of shares of a resident company whose assets are composed, directly or indirectly, more than 50% of real estate property located in Portugal.

Some DTTs entered into by Portugal also establish a waiver of taxation regarding capital gains obtained from the sale of a local company, provided that such capital gains are not allocated to a PE located in the Portuguese territory.

Assuming that the beneficiary of the income is not a Portuguese tax resident, no taxation should be triggered in Portugal on capital gains arising from the transfer of non-local holding companies unless the assets of such non-local holding companies are essentially constituted by rights over real estate properties located in Portugal.

5.4 Change of Control Provisions

The most relevant tax issues that may be triggered by a change of control are the following:

- the tax losses registered by the local company may be lost in the event of a change of ownership of 50% of its share capital or the majority of its voting rights;
- if the local company is included in the tax perimeter of a corporate tax group, such group may register changes in its perimeter and, in a worst-case scenario, may cease to exist;
- the possibility of deducting interest that was not deducted in previous financial years as a result of the application of the limits established by the interest barrier rules may also be lost in the event of a change of ownership of 50% of its share capital or the majority of its voting rights; and
- some tax benefits, particularly tax benefits of a contractual nature, may be lost.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The rules that apply to the determination and assessment of the respective taxable income are the same for local-owned and foreign-owned affiliates, including the transfer pricing rules that apply to transactions made between related parties.

5.6 Deductions for Payments by Local Affiliates

As a rule, payments regarding management and administrative expenditures made to non-local affiliates are deductible for tax purposes, assuming that they are deemed necessary for the business of the local affiliate. Formal requirements regarding the documentary support of such expenses should be observed.

Finally, the terms and conditions related to the rendering of said services and the payment of the relevant fees are subject to the Portuguese transfer pricing rules and should be made according to the arm's-length principles. Otherwise, the PTA may deny the tax deductibility of such expenses.

5.7 Constraints on Related-Party Borrowing

As a rule, there are no specific constraints, but such transactions should be made in accordance with the transfer pricing rules and the arm's-length principle, or they risk being challenged by the PTA.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The CIT Code subjects resident companies to tax on all their income, regardless of the country of source. On the other hand, all deductible expenses are also taken into account to determine the taxable income of the local company, independently from the location where such expense is incurred.

Furthermore, the CIT Code expressly provides different methods to eliminate double taxation, namely tax credit and tax exemption methods.

Regarding tax credit methods, a credit deduction for international double taxation is available for situations in which income generated abroad is included in the taxable income.

The tax credit should correspond to the income tax paid in the foreign country, or to the amount of CIT assessed before the deduction, corresponding to the net income that may be taxed in the foreign country, whichever is lower.

Additionally, if a DTT applies, the tax credit should not exceed the tax that should have been borne abroad pursuant to the terms established by the DTT.

For the exemption method, the participation exemption regime should be highlighted, as well as a special regime applicable to foreign PEs that allows the tax exemption of the income generated by them in order to mitigate distinctions between foreign subsidiaries and foreign PEs.

This regime is optional and, if exercised, has to include all the PEs located in the same territory, and should remain in force for a minimum period of three years. Additionally, the following requirements should be met:

- the PE should be subject to, and not exempt from any of, the income taxes identified in the Parent-Subsidiary Directive, or subject to, and not exempt from, a tax of a similar nature with a rate not lower than 60% of the Portuguese CIT;
- the PE should not be considered resident in a blacklisted jurisdiction; and
- the amount of tax effectively paid should not be less than 50% of the amount of tax that would be due under the terms of the CIT Code.

This last requirement may not apply if the following types of income obtained by the relevant entity do not exceed 25% of its global amount of income:

- royalties and other income regarding intellectual property rights, image rights and other similar rights;
- dividends and income arising from the sale of shares;
- income arising from financial leasing;
- income arising from banking business activities, even when not obtained by a credit institution, as well as from insurance activity or any other financial activities entered into with related entities;
- income obtained by invoicing entities whose income arises from transactions made with related entities; and
- interest and other types of capital income.

Moreover, the Portuguese company cannot choose to exclude the profits assessed by the foreign PE from its taxable income, up to the amount of tax losses assessed by such PE as have concurred to determine the Portuguese company's taxable income in the previous five fiscal years, or the previous 12 fiscal years for small and medium companies.

The Portuguese company also cannot choose to include the losses assessed by the foreign PE in its taxable income, up to the amount of profits that such PE has assessed that have not concurred to determine the Portuguese company's taxable income in the previous five fiscal years, or the previous 12 fiscal years for small and medium companies.

6.2 Non-deductible Local Expenses

The optional regime mentioned above with reference to foreign PEs of Portuguese companies should be considered in light of local expenses. Provided that the same regime applies, the expenses made by the foreign PE are not deductible to determine the taxable income of the Portuguese company.

6.3 Taxation on Dividends from Foreign Subsidiaries

As a rule, dividends from foreign subsidiaries are considered taxable income for the resident shareholder and subject to taxation at the rates stated in the Portuguese CIT Code. However, tax relief or even a tax exemption may be obtained in accordance with the applicable DTT.

In order to avoid economic double taxation, the Portuguese CIT Code sets out a participation exemption regime, pursuant to which, inbound dividends may be exempt from CIT, provided that the following requirements are cumulatively met.

- The Portuguese company holds, directly or directly and indirectly, at least 10% of the share capital or voting rights of the distributing company.
- The shares have been held uninterruptedly for a 12-month period prior to the distribution of dividends (or, if held for a minor period, they are kept until the completion of such period).
- The Portuguese company is not subject to tax transparency.
- The distributing company is subject to, and not exempt from, CIT or any of the income taxes identified in the Parent-Subsidiary Directive, or a tax of a similar nature with a rate not lower than 60% of the Portuguese CIT. This requirement may not be applied if the tax effectively paid was not less than 50% of what would have been paid if the distributing company was resident in Portugal.
- The distributing company is not deemed to be a tax resident in a blacklisted jurisdiction.

This tax exemption is subject to a specific anti-abuse clause, pursuant to which, it should not be applicable if there is an arrangement or several arrangements, not deemed as genuine, that have been executed with the main purpose of obtaining a tax advantage defeating the object and purpose of eliminating the double taxation of dividends, taking into consideration all the relevant facts and circumstances.

For this purpose, an arrangement, or a set of arrangements, should be considered as non-genuine when it is not executed for valid economic reasons and does not reflect economic substance.

6.4 Use of Intangibles by Non-local Subsidiaries

Please see **2.2 Special Incentives for Technology Investments** regarding the patent box regime.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

The Portuguese CFC rules contained in the CIT Code closely follow the CFC regimes that have been adopted by several other EU countries.

According to the Portuguese CFC rules, the income generated by a CFC should be subject to taxation regardless of any dividends distribution, provided that some requirements regarding the percentage of shareholding, the location of the foreign entity in a tax haven territory and the evaluation of profit generated by the respective economic activity are met.

As regards the shareholding percentages, the resident shareholders – whether individuals or companies – should hold at least 25% of the shares, voting rights, profit rights or assets of the relevant non-resident entity, either directly, indirectly or by means of a fiduciary or an interposing agent.

With reference to the location criteria, a controlled company is an entity domiciled in a blacklisted jurisdiction, or an entity that is subject to an amount of tax on income that is lower than 50% of the amount of tax that would be due in taxation under the rules set forth by the CIT Code.

Finally, regarding the business activity requirement, CFC rules may not apply if the following types of income obtained by the relevant entity do not exceed 25% of its global amount of income:

- royalties and other income regarding intellectual property rights, image rights and other similar rights;
- dividends and income arising from the sale of shares;
- income arising from financial leasing;
- income arising from banking business activities, even when not obtained by a credit institution, as well as from insurance activity or any other financial activities entered into with related entities;
- income obtained by invoicing entities whose income arises from transactions made with related entities; and
- interest and other types of capital income.

These CFC rules do not apply when the foreign entity is resident in another member state of the EU/EEA (in the latter case, provided that the state of establishment is bound to administrative co-operation for tax purposes equivalent to the rules in force in the EU), and the resident company shows that the setting up and activity of such foreign entity is grounded in valid economic reasons and that the entity develops a business activity that involves employees, assets and business facilities.

6.6 Rules Related to the Substance of Non-local Affiliates

With the exception of the mentioned CFC rules, as well as the substance rules provided by the participation exemption regime and the exemption regime applicable to capital gains made by foreign entities, there are no specific rules regarding the substance of non-local affiliates. Nevertheless, the Portuguese CIT Code sets forth that a company may be considered a tax resident if its effective management takes place in Portugal.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Please see **2.7 Capital Gains Taxation**. The gains should benefit from the participation exemption regime, provided that the following requirements are cumulatively met.

- The local corporation holds, directly and/or indirectly, at least 10% of the share capital or voting rights of the transferred company.
- The local corporation is not subject to tax transparency.
- The transferred shares were held uninterrupted for a 12-month period prior to the transfer.
- The non-local affiliate is subject to and not exempt from CIT, any of the income taxes identified in the Parent-Subsidiary Directive, or a tax of a similar nature with a rate not lower than 60% of the Portuguese CIT. This requirement may not be applied if the income tax effectively paid was not less than 50% of what would have been paid if the distributing company was resident in Portugal.
- The non-local affiliate is not deemed to be a tax resident in a blacklisted jurisdiction.

The requirement of the non-local affiliate being subject to an income tax with a rate not lower than 60% of the Portuguese CIT may not apply if the following types of income obtained by the relevant entity do not exceed 25% of its global amount of income:

- royalties and other income regarding intellectual property rights, image rights and other similar rights;
- dividends and income arising from the sale of shares;
- income arising from financial leasing;
- income arising from banking business activities, even when not obtained by a credit institution, as well as from insurance activity or any other financial activities entered into with related entities;
- income obtained by invoicing entities whose income arises from transactions made with related entities; and
- interest and other types of capital income.

This exemption does not apply if the non-local affiliate has real estate in Portugal valuing more than 50% of its assets, unless such real estate is allocated to an agricultural, industrial or commercial activity (other than a real estate buy and sell activity) or was acquired before 1 January 2014.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There is a general anti-abuse rule (GAAR) under which the PTA can disqualify, for tax purposes, the typical effect of an arrangement or a series of arrangements that, having been put into place for the main purpose of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are executed with an abuse of legal forms or are not genuine, having regard to all relevant facts and circumstances.

Where an arrangement or a series thereof is disqualified for tax purposes, the tax liability shall be calculated in accordance with the tax rules applicable to the arrangements corresponding to the underlying substance or economic reality.

For these purposes, an arrangement or a series of arrangements shall be regarded as non-genuine to the extent that it is not put into place for valid commercial reasons that reflect economic reality.

Whenever the GAAR applies, the compensatory interest rate levied by the tax authorities will be increased to 15%.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

While there is no routine audit cycle that applies to all companies, the PTA prepare a National Tax and Customs Inspections Plan on a yearly basis. This plan establishes the programmes and criteria for tax inspections, directing the audit activities of the tax authorities.

Furthermore, the PTA created a Large Taxpayers Unit, which supports compliance and constantly monitors the tax activity of large taxpayers.

9. BEPS

9.1 Recommended Changes

Portugal has already implemented several BEPS measures, such as the ones that follow:

- non-application of the participation exemption regime if the dividends received correspond to costs that are deductible for tax purposes at the level of the distributing company or if the structure has a lack of economic substance (Action 2);
- neutralising the effects of hybrid mismatch arrangements (Action 2);
- CFC rules (Action 3);
- the introduction of interest barrier rules (Action 4);
- amendment of the patent box regime in order to align it with the “modified nexus approach” (Action 5);
- disclosure of aggressive tax planning practices (Action 13); and

- country-by-country (CbC) reporting (Action 13).

Portugal is also a signatory of the Multilateral Instrument (MLI).

Some of the actions mentioned above are the result of the implementation of EU directives addressing some of the key factors identified by the BEPS Action Plan.

Also, CbC reporting was introduced in 2016, whereby multinational groups should submit country-specific statements disclosing detailed financial and tax information to the PTA, provided certain requirements are met.

9.2 Government Attitudes

As an EU and OECD member, Portugal is committed to the implementation of the BEPS Action Plan. Several BEPS measures have already been implemented, whether by unilateral decision or by implementation of EU directives dealing with the same tax challenges that are identified in several BEPS actions. Thus, for the next few years, the BEPS Action Plan should not give rise to any relevant tax reform in Portugal.

However, there are some specific tax issues that led to slight amendments during 2019. For instance, Law No 32/2019, of May 3rd, was approved, introducing amendments to the CFC rules, interest barrier rules, exit tax and the GAAR in order to conclude the transposition into the Portuguese tax system of the Anti-Tax Avoidance Directive (ATAD). Also, Law No 119/2019, of September 18th, introduced amendments to the transfer pricing rules.

9.3 Profile of International Tax

Portugal enacted major corporate tax reform in 2014 aimed at increasing competitiveness, allowing stability and attracting investment in order to relaunch the Portuguese economy.

Such corporate tax reform, along with other changes in the economic environment, contributed to bringing international investment and, consequently, international taxation to a high level of attention in Portugal.

Moreover, in order to protect the legal framework arising from said tax reform and assure stability for investors, the solutions adopted have already taken into account the international trends in corporate taxation, namely regarding BEPS Action Plan discussion.

Considering the high level of implementation that the BEPS Action Plan already has in the Portuguese corporate tax framework as a result of the solutions established by said tax reform, no relevant developments on these matters are expected in the near future.

9.4 Competitive Tax Policy Objective

Please see the previous sections in relation to this matter.

9.5 Features of the Competitive Tax System

Reference should be made to the relevant preceding sections.

9.6 Proposals for Dealing with Hybrid Instruments

As mentioned above, as an EU country, Portugal is subject to the two EU anti-tax avoidance directives, ATAD and ATAD 2, which establish anti-hybrid rules aimed to cover hybrid mismatches. Anti-hybrid rules established in ATAD 2 were implemented by Law 24/2020, of July 6th.

9.7 Territorial Tax Regime

As a rule, Portuguese tax-resident entities and individuals are subject to income taxation based on their worldwide income. However, new territorial features were introduced by the CIT reform in 2014, including a participation exemption applicable to capital gains and losses, an exemption applicable to gains derived upon the liquidation of non-resident entities, and an elective regime under which profits attributable to foreign PEs may be exempt from CIT in Portugal.

Following the trend established in Germany and Spain, in 2012 Portugal introduced a BEPS-compliant restructuring of its interest deductibility limitations, including a so-called EBITDA rule, which is in line with BEPS Action 4.

9.8 CFC Proposals

Portugal does not have a territorial tax regime. A sweeper CFC rule would likely simplify the CFC rules in general (including the Portuguese), but would likely struggle with both constitutional and EU-level opposition to the extent it could no longer resemble an anti-avoidance mechanism targeted at countering unsubstantiated deferral practices. In addition, such a rule could also disproportionately affect legitimate business decisions, thus creating potential economic distortion/inefficiency.

9.9 Anti-avoidance Rules

Some of the Portuguese DTTs already have limitations of benefits, as well as principal purpose test (PPT)-type provisions. Notwithstanding, the PPT provision should be adopted with the MLI.

Following the examples in other EU countries, the PTA are expected to strengthen their scrutiny of the applicability of double taxation conventions (DTCs). As such, foreign groups with current investments in Portugal should re-evaluate the substance of their investment and financing structures, as well as how they are deploying intangibles in their Portuguese businesses. Portuguese groups using EU holding platforms may also consider restructuring in light of recent developments in Portugal.

9.10 Transfer Pricing Changes
Since 2000, Portugal has had a transfer pricing regime aligned with the OECD guidelines, and for the time being there are no proposed changes. The tax authorities and clients seek direction in the guidelines, and, as such, any further changes to it might have consequences. Generally, the taxation of profits related to intellectual property has not triggered increased controversy in recent years compared to pre-BEPS levels.

9.11 Transparency and Country-by-country Reporting
The transparency and CbC regimes being proposed and implemented, together with the instruments developed in recent years to exchange information automatically or upon request, contribute positively to a fairer international tax environment.

Ultimately, positive spillovers are to be expected as governments and the international organisations with tax policy roles are able to advance the tax system by enforcing taxation where value is created, in a world where digitalised models are also changing the rules of the game.

From a different perspective, the thresholds defined – namely regarding the application of CbC reporting – ensure that these rules will not disturb the functioning of the economy, particularly in companies that do not have a significant multinational footprint.

9.12 Taxation of Digital Economy Businesses
No substantial changes have yet been implemented to address concerns regarding the taxation of digital economy businesses for CIT purposes.

Recently, Law 74/2020, of November 19th, transposing Directive (EU) 2018/1808 of November 14th, introduced the payment of an advertising tax, applicable to audio-visual on-demand services or video-sharing platform services, as well as an annual levy of 1% payable by audio-visual on-demand service operators (the so-called Netflix Tax).

For VAT purposes, relevant changes have already entered into force to tackle the challenges of allocating indirect taxation rights in a fair manner in the digital economy.

9.13 Digital Taxation
Please see **9.12 Taxation of Digital Economy Businesses**.

9.14 Taxation of Offshore IP
The income paid in relation to offshore IP is subject to withholding tax at the aggravated rate of 35%. Moreover, payments made in connection with offshore IP may not be deductible if the local paying company is not able to demonstrate that such payments correspond to existing operations and are not in an exaggerated amount.

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Morais Leitão, Galvão Teles, Soares da Silva & Associados, SP, RL is a leading full-service law firm in Portugal, with a solid background of decades of experience. Broadly recognised, Morais Leitão is a reference in several branches and sectors of the law on a national and international level. The firm's reputation amongst both peers and clients stems from the excellence of the legal services provided. The firm's work is characterised by its unique technical expertise, combined with a distinctive approach and cutting-edge solutions that often challenge some of the most conventional practices. With a team comprising over 250 lawyers at a client's disposal, Morais Leitão is headquartered in Lisbon and has additional offices in Porto and Funchal. Due to its network of associations and alliances with local firms and the creation of the Morais Leitão Legal Circle in 2010, the firm can also offer support through offices in Angola (ALC Advogados) and Mozambique (HRA Advogados).

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Trends and Developments

Contributed by:
Tiago Marreiros Moreira and Francisco Cabral Matos
VdA ***see p.525***

The COVID-19 pandemic made the year of 2020 a turning point for the entire world and so all countries are now placing great expectations on 2021, which obviously impacts the legislative tax options of Portugal.

New Concept of Permanent Establishment

The Portuguese State Budget for 2021 has brought substantial amendments to the concept of permanent establishment, namely, widening the domestic concept in order to bring it closer to recent developments at OECD level. Although, in general, these amendments mostly aim to align the domestic concept of permanent establishment – as foreseen in the Corporate Income Tax Code (the "CIT Code") – with the concept currently embedded in the OECD Model Tax Convention and with Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), interestingly, the Portuguese legislator took the opportunity to go beyond the MLI and include a new form of permanent establishment (a "services permanent establishment") that deviates from the OECD standard and follows the United Nations Model Tax Convention.

It is clear that all amendments serve the purpose of extending Portuguese tax jurisdiction to activities that, up until 2020, were either not covered in the concept of permanent establishment or would fall under the carve-out for "preparatory and auxiliary activities". However, the material impact of such amendments is still to be ascertained, given that the effectiveness of the new provisions depends on their compatibility with the Portuguese double tax treaty network. In this regard, despite that some of these amendments result from the MLI, the fact is that Portugal ratified the MLI on 14 November 2019 (only deposited in February 2020) but made two important reservations regarding Articles 12 and 14 of the MLI.

All in all, the new provisions may be segmented into three categories.

Amendments in accordance with the MLI and not contending with the reservations made by Portugal

This category includes a new concept of a person closely related to an enterprise and the extension of the permanent establishment to activities that were formally deemed merely ancillary (the specific activity exemptions). Both amendments are now in force without the need for further action.

Amendments made in accordance with the MLI, which fall within the reservations made by Portugal

These amendments should not have a direct effect pursuant to the MLI (due to the reservation) and contend with the current wording of several double tax treaties entered into by Portugal. This category includes the new provisions addressing commissionnaire arrangements and similar strategies, and an anti-avoidance rule tackling the splitting up of contracts. This category is unlikely to enter into effect without bilateral renegotiation of the double tax treaties.

Amendments that are not related to the MLI

This is specifically the case for the new services permanent establishment concept. The CIT Code now encompasses within the concept of permanent establishment the provision of services (including consultancy services) by a non-resident company in Portuguese territory. To trigger the existence of a permanent establishment, the provision of services should last for more than 183 days within a 12-months period, irrespective of whether the services are provided by employees of the non-resident entity, or people hired for said purpose.

It is the authors' view that this new type of permanent establishment is inspired by the United Nations Model Tax Convention; however, it brings additional challenges from an interpretative standpoint due to the fact that there is no experience, guidance and virtually no case law on this matter, but also since most of the double tax treaties entered into by Portugal are based on the OECD Model Tax Convention and therefore the new domestic rule is most likely incompatible with most of the tax treaties signed by Portugal.

Additional Challenge of Identifying the Relevant Taxpayer

The concept of a person closely related to an enterprise raises one additional challenge, since the CIT Code does not clarify which should be the relevant taxpayer when several entities are considered closely related. One should bear in mind that neither the CIT Code nor the Portuguese tax authorities have yet implemented a clear methodology for the attribution of profits to permanent establishments. Therefore, provided a permanent establishment is created out of the activities of several "closely related enterprises", it is not clear which entity (if not all) shall be deemed to have a permanent establishment and, ultimately, how the allocation of profits should be made in respect of the activities carried out by each entity.

The coming into force of these amendments represents a significant challenge for taxpayers, as well as for tax authorities and tax courts. In particular, the interplay between domestic provisions and double tax treaties, together with the effects of the MLI, will certainly lead to legal uncertainty and potentially an increase of tax litigation in this regard.

DAC6 Directive

Portugal had a very long transposition process of Council Directive (EU) 2018/822 (DAC6).

Having information transparency and fairness in taxation as a political target, DAC6 sets forth new mandatory disclosure rules regarding cross-border tax mechanisms that meet at least one of the specified hallmarks. The transposition of DAC6 throughout the EU has been affected by several difficulties, not only from a technical standpoint – due to the complexity of the hallmarks and the impacts it has on all taxpayers and (tax) intermediaries in terms of compliance costs – but also due to the fact that the transposition occurred in the context of the COVID-19 pandemic. Following a significant delay in transposing DAC6 into domestic legislation, Portugal has also delayed substantially the approval of the official reporting forms (published in the official gazette on 29 December 2020) and the publishing of the official guidelines issued by Portuguese tax authorities on the matter (released only by the end of January 2021).

In addition, Portugal has decided to extend the territorial reach of this regime to purely domestic transactions, as well as the scope of the reporting obligations to virtually all main taxes, including Value Added Tax.

The fact that, apart from Poland, no other EU member state has followed this approach implies that there is very little guidance for the correct interpretation and application of the new rules, despite that the same are now fully in force, requiring a significant tax compliance effort for both taxpayers and intermediaries, and possibly implying material consequences in the event of incomplete or late filing of the reporting forms, given the tax penalties specifically set forth in this case.

Portugal is also in a peculiar position as regards professional privilege. Whilst DAC6 itself foresees specific rules to safeguard legal professional privilege, Portuguese legislation has taken a deviating path from all other EU member states, setting forth the exact same rules for intermediaries covered by legal or contractual privilege. This implies that intermediaries covered by a confidentiality clause in their service contracts may claim to be on the same footing as lawyers or other professions that are bound to professional privilege by law.

This option may itself prove to be in breach of DAC6, given that under the Directive's rules, intermediaries subject to a contractual privilege would still be primarily liable for any reporting obligations, contrary to the Portuguese rules. Moreover, the Portuguese regime does not dismiss intermediaries from an obligation to report the mechanisms to Portuguese tax authorities; rather, intermediaries subject to professional privilege are secondarily liable for the reporting obligation (if the taxpayer opts not to do so), leading to the disclosure of the identity of taxpayers in the reporting forms, in breach of the legal privilege and professional ethics rules. In light thereof, the Portuguese domestic legislation has been much criticised and it is as yet uncertain how Portuguese courts (ultimately the Constitutional Court) will address this matter.

COVID-19

In spite of the new pandemic wave, 2021 is expected to be a turning point with regard to the COVID-19 situation, where countries all over Europe start recovering from the impact on economic and social structures, and investors regain confidence to do business as usual.

Several tax measures were adopted in the course of 2020, mostly focused on postponing the impact of tax payments (deferring payment deadlines) and allowing an extended period for carrying forward tax losses. This will likely continue in 2021, and new tax measures are expected to foster the economic recovery in a – much expected – post-pandemic period.

VAT

From a VAT standpoint, 2021 was expected to bring two main developments.

On one hand, in August 2020, Portugal transposed Council Directive (EU) 2018/1910 of 4 December 2018, and has established a set of VAT simplifying measures applicable to intra-community transactions of goods – the quick fixes.

In fact, there are four types of in-force quick fixes:

- a harmonisation of the VAT treatment of intra-community chain transactions;
- a simplification of the rules applicable to consignment sales;
- an obligation to validate on the VAT Information Exchange System (VIES) the VAT identification number of the buyer as a conditio sine qua non to be VAT exempt in such transactions; and
- the setting out of a list of necessary documentation for a VAT exemption, which has been in force since January 2020.

The practical effects of these new rules should start to materialise in 2021.

On the other hand, Portugal was expected to add a new requisite for invoicing, so that invoices include a quick response (QR) code. The new rules were already set out in 2019, but their application was postponed initially for 2020 and, due to the COVID-19 pandemic, the measure was again postponed till 2022. That notwithstanding, electronic means of commerce are booming in the pandemic period and although companies benefit from this additional implementation period, it is likely that companies will start a smooth transition in the course of 2021, adapting their invoicing software to the new QR code requirement.

Outlook for 2021

There are no doubts that 2021 will be a challenging year on many levels, especially from a tax standpoint, not only because of the aspects referred to above but also due to the need for constant adaptation to the exceptional measures required by the pandemic. One may not disregard that alongside the legal frameworks in force, the tax function of companies is also affected by the fact that tax authorities are (also) working remotely and facing the struggle of quickly adapting to a new reality. During certain periods of 2020, and once again under the current lockdown in early 2021, judicial proceedings and tax enforcement procedures have been suspended, while tax inspections have been either suspended or primarily made by email or electronic communication. The tax authorities are improving their ability to interact with taxpayers in an efficient manner, but COVID-19 has naturally created additional difficulties regarding tax procedural matters. It is, however, expected that when things go back to a new normality, there will be a huge budgetary pressure to collect more taxes and it is likely that tax litigation may increase.

Together with temporary tax measures, it should be pointed out that starting from 2021, a new financial incentives plan is in force (Portugal 2030), focused on eight pillars:

- innovation and knowledge;
- qualification, training and employment;
- demographic sustainability;
- energy and climate change;
- the economy of the sea;
- competitiveness and territorial cohesion in the coastal areas;
- competitiveness and territorial cohesion in the countryside areas; and
- agriculture and forestry.

The incentive packages will be complemented with the financial package negotiated by member states under the EU's response to COVID-19, and new tax incentives will most likely be designed during the course of 2021 to help the economic recovery and lead stakeholders to focus on the economic sectors and priorities mentioned above.

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VdA VIEIRA DE ALMEIDA

SOUTH KOREA

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Under the Korean Commercial Code (KCC), the following types of legal entities are recognised in Korea:

- Jusik Hoesa – a corporation incorporated by one or more promoters, with each shareholder's liability limited to the amount of contributed capital; this is the type of entity most commonly used in Korea;
- Yuhan Hoesa – a corporation incorporated by one or more members, with each member's liability limited to the amount of contributed capital;
- Yuhan Chegim Hoesa – a corporation incorporated by one or more members, with each member's liability limited to the amount of contributed capital; a Yuhan Chegim Hoesa provides more flexibility and self-control than a Yuhan Hoesa;
- Hapmyong Hoesa – a corporation incorporated jointly by more than two members who are responsible for corporate obligations if the assets of the corporation are not sufficient to fully satisfy such obligations; and
- Hapja Hoesa – a corporation composed of one or more partners with unlimited liability and one or more partners with limited liability.

All five of the above entities are generally taxed as separate legal entities. However, Hapmyong Hoesa and Hapja Hoesa can elect to be treated as transparent for Korean tax purposes, thereby becoming subject to the Korean partnership tax regime.

1.2 Transparent Entities

In Korea, entities that are not a corporation and have an agreed method of distributing profits between members (ie, association, foundation, Johap under the Korean Civil Code, and Hapja Johap or Ikmyong Johap under the KCC) are tax-transparent entities. A Johap is similar to a partnership in concept. Also, trusts formed by a contractual arrangement are generally treated as tax-transparent entities.

In addition, Hapmyong Hoesa and Hapja Hoesa – which are incorporated entities – may choose to be treated as partnerships that are transparent for tax purposes. Under Korean tax law, partnerships are exempt from tax at the partnership level, but each partner is subject to tax on earned income distributed from the partnership.

1.3 Determining Residence of Incorporated Businesses

According to the Korean Corporate Income Tax Law, a corporation that has its head office or principal office in Korea is a resident corporation. Also, a corporation with a place of effective management in Korea is treated as a resident corporation.

The place of effective management refers to the place where the key management and commercial decisions that are necessary for the conduct of the entity's business are made in substance. The determination of the place of effective management is based on all relevant facts and circumstances.

1.4 Tax Rates

The applicable corporate income tax (CIT) rates are as follows:

- taxable income under KRW200 million: CIT rate of 10% (rate including local income tax: 11%);
- taxable income of KRW200 million to KRW20 billion: 20% (22%);
- taxable income of KRW20 billion to KRW300 billion: 22% (24.2%); and
- taxable income over KRW300 billion: 25% (27.5%).

In addition, the income of businesses owned by individuals directly (sole proprietorships) is taxed at the owner's personal income tax (PIT) rates as follows:

- taxable income under KRW12 million: PIT rate of 6% (rate including local income tax: 6.6%);
- taxable income of KRW12 million to KRW46 million: 15% (16.5%);
- taxable income of KRW46 million to KRW88 million: 24% (26.4%);
- taxable income of KRW88 million to KRW150 million: 35% (38.5%);
- taxable income of KRW150 million to KRW300 million: 38% (41.8%);
- taxable income of KRW300 million to KRW500 million: 40% (44%);
- taxable income of KRW500 million to KRW1 billion: 42% (46.2%); and
- taxable income over KRW1 billion: 45% (49.5%).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

In determining taxable income for CIT purposes, expenses (including interest expense, depreciation and general administrative expenses, such as rental expenses) that are reasonably connected with a company's business can be deducted from the company's taxable revenue.

Taxable income is based on the accounting profits, and adjustments are made for tax purposes, as required by the Korean Corporate Income Tax Law.

2.2 Special Incentives for Technology Investments
The Special Tax Treatment Control Law provides various tax incentives to stimulate R&D activities. Tax credits are available for qualifying R&D expenditures used in the development of research and manpower. In addition, until the end of 2021, a 50% CIT credit is provided for income resulting from the transfer of patents and eligible technology by SMEs. A 10% tax credit (up to the value of acquired technology) is also provided to qualifying domestic companies merging or acquiring technology innovative SMEs.

2.3 Other Special Incentives
In accordance with the BEPS initiatives, most of the direct tax incentives and benefits previously available for foreign direct investment were abolished by the Korean government under the 2019 tax reform. However, the existing local tax and indirect tax incentives are maintained for qualifying foreign investors. Foreign investors are entitled to an exemption from acquisition tax and property tax on property acquired and owned for up to 15 years, and to an exemption from customs duties, VAT and individual consumption tax on imported capital goods.

2.4 Basic Rules on Loss Relief
Under Korean tax law, tax losses can be carried forward for 15 years, although annual utilisation is capped at 60% of annual taxable income (with an exception granted for SMEs and distressed companies).

2.5 Imposed Limits on Deduction of Interest
Interest expense deductions are subject to the following limitations:

- the thin capitalisation rule: interest exceeding the 2:1 (debt: equity) threshold will not be deductible and will be treated as a dividend; and
- the 30% interest limitation rule: if the ratio of net interest paid to a foreign related party by a Korean company to adjusted net income (= earnings before interest, taxes, depreciation and amortisation) exceeds 30%, the excess interest will not be deductible.

2.6 Basic Rules on Consolidated Tax Grouping
Consolidation is available for a domestic parent company and its directly or indirectly owned domestic subsidiaries. A taxpayer may elect the consolidated tax filing regime upon approval from the tax authority, but such election cannot be revoked for five years.

2.7 Capital Gains Taxation
Capital gains are generally taxed at the same CIT rate as ordinary taxable income. However, capital gains from the sale of non-business purpose real estate are subject to additional capital gains tax, at the rate of 10%.

2.8 Other Taxes Payable by an Incorporated Business
Value-added tax (VAT) is imposed on the supply of goods and services. The applicable VAT rate is generally 10%, but zero-rated VAT is available for exported goods and services rendered outside Korea and for certain services provided to a non-resident in a foreign currency. If a company carries on a VAT-able business in Korea, it must register its business under the VAT Act, file a quarterly VAT return and pay all VAT collected from its customers during the relevant quarter, minus any VAT credit to which it is entitled (input VAT).

Customs duties are generally imposed on imported goods. Importation means the delivery of goods into Korea to be consumed or used in Korea.

Acquisition tax is imposed on the purchase price of real estate, motor vehicles, construction equipment, golf memberships, etc. The acquisition tax rate varies depending on the type of assets, ranging from 0.96% to 4.6%.

Where an investor acquires shares in a company and becomes a controlling shareholder of such company (ie, the investor and its related parties collectively own, in aggregate, more than 50% of the shares in the company) as a result of the share acquisition, such investor is deemed to have acquired real estate, etc, held by the company and is subject to deemed acquisition tax of 2.2% (including surtax).

Securities transaction tax is imposed on the transfer of shares. The securities transaction tax rate for publicly traded shares is 0.23%, and the tax rate for unlisted shares is 0.43%.

A special excise tax is levied on the production or trading of certain luxury items, alcohol or tobacco. In addition, property tax (a local tax) is charged on the statutory value of land, buildings, houses, vessels and aircraft, while comprehensive real estate holding tax (a national tax) is charged on the aggregate published value of land, buildings and houses exceeding a certain threshold.

2.9 Incorporated Businesses and Notable Taxes
Accumulated earnings tax (AET) is applicable to Korean corporations that have shareholders' equity exceeding KRW50 billion or that are designated as large conglomerates under the Monopoly Regulation and Fair Trade Act. The AET imposes

additional income tax on corporate earnings not utilised for prescribed purposes (eg, designated investments, employee salaries, employee welfare funds).

The AET regime, as revised in 2018, is effective for fiscal years beginning on or after 1 January 2018, with the sunset clause due to expire as of 31 December 2022. Major changes include an increase in the tax rate applied to accumulated earnings from 11% to 22% (inclusive of local income tax), while dividends no longer reduce accumulated earnings.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

The majority of closely held businesses, such as convenience stores and hair salons, operate in non-corporate form, but most businesses operate in corporate form.

3.2 Individual Rates and Corporate Rates

In general, corporate income tax rates are lower than individual income tax rates. However, many individual professionals and businesses choose not to incorporate, so as to avoid subjecting earnings already taxed at the corporate level to double taxation when dividends are paid.

3.3 Accumulating Earnings for Investment Purposes

See **2.9 Incorporate Businesses and Notable Taxes**

3.4 Sales of Shares by Individuals in Closely Held Corporations

Dividends paid to an individual shareholder are subject to a withholding tax of 15.4% (inclusive of local income tax). However, if an individual shareholder's total financial income (interest income + dividends) exceeds KRW20 million per year, the excess is taxed at regular personal income tax rates.

Capital gains arising from the sale of shares in an unlisted SME are subject to 10% capital gains tax (20% for shareholders with a substantial ownership interest). Individual shareholders who realise capital gains from the sale of shares in an unlisted company that is not an SME are subject to 20% capital gains tax (30% for major shareholders).

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends paid from a publicly traded corporation to an individual shareholder are taxed in the same manner as those paid from an unlisted company to an individual shareholder.

Capital gains arising from the sale of listed shares are not subject to tax when sold by a minority shareholder through the securities market. However, when the sale takes place over the counter, the capital gains are subject to a 20% tax (10% in the case of listed shares in an SME). When the total stake of a shareholder in a listed company, together with any related parties (majority shareholder), exceeds 1% of the total shares, or if the total market value of the stock held by the shareholder is KRW1 billion or more (lowered in April 2020 from the previous threshold of KRW1.5 billion), such shareholder will be taxed at 30% on the capital gain regardless of whether the shares were sold through the securities market or over the counter. For this purpose, the threshold amount was supposed to be further lowered to KRW300 million from April 2021, but the Korean government recently announced its plan to maintain the current threshold of KRW1 billion throughout 2021. The presidential decree of the relevant tax law is expected to be amended in early 2021 to reflect the government's recent announcement.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In general, interest, dividends and royalties paid to a non-resident company or individual are subject to 22% withholding tax (inclusive of local tax). The rate may be reduced under applicable tax treaties.

4.2 Primary Tax Treaty Countries

As of January 2021, Korea has concluded double tax agreements with 94 countries. Foreign investors have primarily used the Netherlands, Belgium and Ireland in making investments into Korea through intermediate holding companies.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The Korean tax authority tends to challenge the use of treaty countries by non-treaty country residents by aggressively applying the substance-over-form principle to argue that entities established in favourable treaty countries are not the beneficial owners of the relevant Korean source income. A "beneficial owner" is a person who bears legal or economic risk related to Korean source income and who, in substance, holds ownership rights over such income, including disposition rights.

4.4 Transfer Pricing Issues

The Korean tax authority closely monitors companies whose profitability suddenly drops or whose profits fluctuate over a number of years. The Korean tax authority is likely to scrutinise companies that have had significant business restructuring as well as those paying substantial royalties or management service fees to foreign companies and companies with financial transactions with overseas related parties.

4.5 Related-Party Limited Risk Distribution Arrangements

The Korean tax authority challenges the use of limited risk distribution arrangements from a transfer pricing perspective.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Korea is a member of the OECD and generally follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). However, the OECD Guidelines do not have the force of law, while the Law for the Coordination of International Tax Affairs (which governs transfer pricing) does. Accordingly, the Korean tax authority might not accept a taxpayer's arguments if they are based solely on the OECD Guidelines.

4.7 International Transfer Pricing Disputes

Mutual Agreement Procedures (MAP) can resolve international transfer pricing disputes between Korea and countries that have concluded a tax treaty with Korea. The National Tax Service (NTS), which is in charge of the Korean MAP process, negotiates MAP cases with the other competent authorities. According to MAP Statistics released by the OECD, as of 1 January 2019, there were 72 open MAP cases relating to Korean transfer pricing, and 18 cases that closed during 2019. 36 new MAP cases commenced during 2019, and 90 open MAP cases remained as of 31 December 2019. It typically takes two to three years from the date the initial application is accepted to complete the MAP process.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Taxpayers can resort to a MAP under the relevant tax treaty in order to resolve double taxation arising from a transfer pricing adjustment. A MAP can generally be requested within three years of the date when the taxpayer becomes aware of the adjustment.

A MAP is often initiated in the jurisdiction that is expected to claim a tax refund. Competent authority (CA) negotiations will commence on the date the relevant CA sends a letter to the other CA accepting the request for a MAP. The CAs will then discuss issues through the exchange of position papers and via CA meetings throughout the year.

If the MAP is concluded, the initial transfer pricing adjustment should be reduced or cancelled based on the MAP agreement. Compensating adjustments are allowed.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

In general, Korean branches of foreign corporations are taxed in the same manner as Korean subsidiaries of foreign corporations, with a few notable differences. While dividends paid by a Korean subsidiary to a foreign parent are subject to withholding tax, earnings remitted by a Korean branch to its overseas head office are subject to branch profits tax only when the Korean branch is required to pay branch profits tax under the relevant tax treaty. A Korean branch is allowed to deduct head office expenses allocated to it, whereas a management service agreement would be required to charge similar costs to a subsidiary. In addition, while a Korean subsidiary could qualify for tax benefits under the Foreign Investment Promotion Act and the Special Tax Treatment Control Law, a Korean branch is not eligible.

5.3 Capital Gains of Non-residents

Capital gains derived by non-residents on the sale of shares in Korean corporations are either exempt from Korean tax under an applicable tax treaty or subject to withholding tax at the lesser of 11% (including local income tax) of the sale proceeds or 22% (including local income tax) of the capital gains. The purchaser is obligated to collect and pay the tax.

Capital gains arising from the sale of listed shares are not subject to capital gains tax to the extent the non-resident shareholder did not hold 25% or more of the total outstanding shares at any time during the year when the sale took place or the preceding five years.

5.4 Change of Control Provisions

Since Korea does not have an indirect capital gains tax, gains arising from the sale of shares of a foreign company that directly or indirectly owns shares of a Korean company are not subject to tax (indirect share transfer). However, the Korean tax authority may attempt to impose tax on gains arising from an indirect share transfer by applying the substance-over-form principle.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

No special formulas are used to determine the income of foreign-owned local affiliates selling goods or providing services; the Transfer Pricing Guidelines would apply.

5.6 Deductions for Payments by Local Affiliates

The Korean tax authority often challenges the deductibility of management service fees. In order to deduct the fees, the following conditions must be satisfied (under the Law for the Coordination of International Tax Affairs):

- an agreement should be entered into by the service provider prior to the provision of the service;
- the domestic company should benefit from the service provided by its foreign related party through additional profit or reduced expenses;
- the provision of the service should be verified through supporting documentation; and
- the management service fee should be consistent with the arm's length standard.

5.7 Constraints on Related-Party Borrowing

Where a Korean company borrows from its foreign controlling shareholder and the debt-to-equity ratio exceeds 2:1, interest exceeding such threshold will not be deductible and will be treated as a dividend (thin capitalisation rule).

Also, in line with the OECD's recommendation on the limitation of interest expense deductions, Korea introduced a new rule that treats interest deductions as non-deductible to the extent net interest paid to foreign related parties exceeds 30% of adjusted net income. (For this purpose, adjusted net income equals earnings before interest, taxes, depreciation and amortisation.) Net interest expense refers to the total amount of interest paid on funds borrowed by a Korean company from all foreign related parties minus the total amount of interest income received by the Korean company from foreign related parties. If the resulting value is negative, the net interest expense will be deemed to be zero.

In addition, loans from foreign affiliates should be at arm's length. Currently, the default interest rate (deemed arm's length interest rate) for loans from a foreign affiliate to a Korean company is LIBOR (12 months) plus a 1.5% spread, and the default interest rate for loans from a Korean company to its foreign affiliate is 4.6%. If a separate transfer pricing analysis is conducted, the arm's length rate can be determined based on such analysis.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

As Korean companies are taxed on their worldwide income, their foreign source income is also subject to tax in Korea. However, taxes imposed by foreign governments on foreign income are creditable up to the amount of income tax to be paid in Korea. Any excess foreign tax credit can be carried forward ten years.

6.2 Non-deductible Local Expenses

This question is not applicable in South Korea.

6.3 Taxation on Dividends from Foreign Subsidiaries

Although dividends from foreign subsidiaries are taxed in Korea, a foreign tax credit is available for any direct taxes paid with respect to such dividends.

An indirect foreign tax credit is also available for foreign income taxes paid by the foreign subsidiary in its country of residence. Only first-tier subsidiaries are eligible for the indirect foreign tax credit, and the Korean parent company must hold 25% or more of the shares of the subsidiary for at least six months prior to the distribution of the dividends.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by Korean corporations can be used by or transferred to foreign affiliates. However, arm's length consideration should be received for the transfer, and such consideration would be included in taxable income for corporate income tax purposes.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Korea has CFC rules designed to prevent Korean corporations from avoiding tax on income retained by foreign subsidiaries. The CFC rules apply when a Korean corporation directly or indirectly owns at least 10% of the shares of a company established in a low tax jurisdiction. For this purpose, a country is considered to be a low tax jurisdiction if the foreign subsidiary has an average effective income tax rate of 15% or less for the past three years. When applicable, Korea's CFC regime deems the CFC to have paid a dividend to the Korean parent equal to the earnings of the foreign subsidiary. This dividend is included in the parent corporation's taxable income.

A foreign corporation that is incorporated in a low tax jurisdiction and actively engages in business is not subject to the CFC rules. Furthermore, the CFC rules do not apply to a foreign branch of a Korean corporation.

6.6 Rules Related to the Substance of Non-local Affiliates

Under Korean tax law, the substance-over-form principle applies to both domestic and foreign corporations, and there is no rule relating to substance that applies solely to foreign affiliates. The Korean tax authority tends to use this principle to disregard the immediate foreign recipient of the Korean source income and attribute such income directly to the parent company.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

Capital gains arising from the sale of shares in a foreign affiliate are taxed as ordinary income to the Korean shareholder. Foreign taxes paid by the Korean shareholder on such capital gains are allowed as a credit (up to the amount of Korean income taxes paid).

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

Korean tax law contains substance-over-form rules, which are used by the Korean tax authority to re-characterise transactions and look through entities residing in favourable tax jurisdictions that are not deemed to be the beneficial owner of the Korean source income.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The NTS conducts periodic and non-periodic audits. Periodic audits typically take place every four or five years and are usually completed within two months, unless extended. In the case of periodic audits, advance notice should be provided 15 days prior to the commencement of the audit.

Non-periodic audits do not require prior notice, and can be conducted at any time. According to the NTS, taxpayers are selected for non-periodic audits in the following circumstances:

- when the taxpayer fails to fulfil its tax compliance obligations under the relevant tax law;
- where the taxpayer is suspected of entering into false transactions, such as transactions without valid documentation or disguised/fictitious transactions;
- where detailed information on the taxpayer's tax evasion is reported; or
- where the NTS has evidence of omissions or errors in the tax return.

Upon completion of a tax audit, written notice of the audit results is provided. In the event of any objections, the taxpayer can request a Review of Adequacy of Tax Imposition (RATI) within 30 days of the receipt of such notice (before the final tax assessment is issued).

9. BEPS

9.1 Recommended Changes

Korea has adopted most of the 15 BEPS action plans recommended by the OECD through amending relevant domestic laws and treaties, as follows:

- BEPS Action 1 (digital economy): in 2015, Korea introduced a new provision in the VAT Law that imposes VAT on applications provided in offshore open markets, and expanded the scope of the extraterritorial VAT regime for electronically supplied services in 2019;
- BEPS Action 2 (hybrid mismatch arrangements): the Korean government introduced rules to neutralise the effect of hybrid mismatch arrangements in 2018;
- BEPS Action 3 (CFC rules): Korea expanded the scope of CFCs in 2017;
- BEPS Action 4 (interest deductions): Korea introduced a new interest deduction limitation rule in 2018;
- BEPS Action 5 (harmful tax practices): the Korean government abolished the corporate income tax exemption previously available for foreign-invested companies in 2019;
- BEPS Action 6 (treaty abuse): Korea adopted relevant provisions when entering into or amending tax treaties; Korea also participated in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI);
- BEPS Action 7 (permanent establishment status): Korea broadened its definition of permanent establishments in 2019;
- BEPS Actions 8 to 10 (transfer pricing): in 2019, Korea amended transfer pricing rules relating to the substance-over-form principle and intangibles;
- BEPS Action 11 (BEPS data analysis) and BEPS Action 12 (disclosure of aggressive tax planning): the Korean government is considering legislative changes;
- BEPS Action 13 (transfer pricing documentation): in 2016 and 2017, Korea revised the Korean transfer pricing regulations to require certain multinational companies that engage in cross-border related party transactions to file a Master File, a Local File and a Country-by-Country Report;
- BEPS Action 14 (dispute resolution): in 2017, Korea allowed non-residents and foreign companies that do not have a place of business in Korea to request a MAP in Korea; and
- BEPS Action 15 (MLI): Korea signed the MLI in 2017, which took effect in September 2020.

9.2 Government Attitudes

The Korean government has implemented tax reform to boost economic growth through adopting the OECD BEPS measures. For instance, in alignment with the OECD recommendations, Korea strengthened anti-avoidance measures on BEPS Action 7 to prevent abusive business structures that might erode Korea's tax base.

9.3 Profile of International Tax

Since the launch of the OECD's BEPS Project, the Korean government has increased efforts to comply with the BEPS standards. In addition, many non-governmental organisations have raised concerns over various schemes used by multinational companies to avoid paying taxes in Korea even when substantial revenue is realised in Korea.

9.4 Competitive Tax Policy Objective

Korea previously had tax incentives aimed at attracting foreign direct investment. However, in December 2017, the EU concluded that it was unfair that these tax incentives applied only to foreign investors, and placed Korea on its blacklist of non-co-operative jurisdictions. Korea revised its tax law to eliminate the disputed preferential tax exemptions, reflecting the Korean government's efforts to comply with BEPS standards.

9.5 Features of the Competitive Tax System

Korea is scaling back tax benefits for foreign direct investment and aggressively audits both foreign and domestic companies doing business in Korea, with frequent use of the substance-over-form rules to assess taxes. Korea has relatively high corporate income tax rates compared to other OECD countries, and is one of the few OECD countries that has increased tax rates in recent years. The government has also been consistently eliminating or reducing tax exemptions and deductions, so the tax base is quite broad. The increase in tax rates and the broadening of the tax base may make it more difficult for Korea to remain economically competitive.

9.6 Proposals for Dealing with Hybrid Instruments

Korea introduced a BEPS-driven rule that limits interest deductions for hybrid financial instruments. This rule has been effective since 1 January 2018, and applies to interest on cross-border hybrid financial instruments between Korean corporations (or Korean branches of foreign corporations) and foreign related parties.

9.7 Territorial Tax Regime

Korea has a worldwide tax regime rather than a territorial tax regime.

9.8 CFC Proposals

This question is not applicable in South Korea.

9.9 Anti-avoidance Rules

The Korean tax authority handles treaty abuse by applying domestic anti-avoidance rules, such as the substance-over-form principle. Korea has also adopted the LOB (Limitation of Benefits) and PPT (Principal Purpose Test) provisions, which are aimed at ensuring a minimum level of protection against treaty shopping; therefore, additional scrutiny of cross-border tax planning arrangements is expected.

9.10 Transfer Pricing Changes

The 2019 tax reform introduced a new rule for determining arm's length pricing in cross-border transactions involving intangibles, which also addresses appropriate remuneration for functions performed (ie, the development, enhancement, maintenance, protection and exploitation of intangibles). The comparable uncontrolled price (CUP) method, the profit split method and the valuation method (discounted future cash flows) became effective on 12 February 2019 and take precedence over other transfer pricing methods, and companies performing functions and assuming relevant risks regarding the development, enhancement, maintenance, protection and exploitation of intangibles should receive appropriate remuneration for the contributions they have made.

In light of this tax reform, additional scrutiny is expected on the transfer pricing of intangible assets.

9.11 Transparency and Country-by-country Reporting

According to the OECD, CbC Reporting Compilation of Peer Review Reports (Phase 1), Korea has indicated that measures are in place to ensure the appropriate use of information in all six areas identified in the OECD Guidance on the appropriate use of information contained in CbC reports. In other words, Korea uses CbC reports to assess high-level transfer pricing risks and other BEPS-related risks. As of September 2020, Korea exchanges CbC reports with 77 countries. Korea does not make information received from other jurisdictions available to the public. Since CbC reports provide substantial information to the tax authority that could be used to assess whether companies have BEPS-related issues, these reports may trigger aggressive tax audits and tax assessments.

9.12 Taxation of Digital Economy Businesses

Korea has already amended the VAT Law by introducing an extraterritorial VAT regime for electronically supplied services. Under this regime, a foreign entrepreneur who supplies certain electronic services in Korea bears the obligation to report and pay VAT. For this purpose, "electronic services" includes the supply of electronic goods, such as game/audio/video files or software; advertising posting services; cloud computing services; intermediary services enabling the lease/use/consumption of commodities or facilities in Korea; and the supply of goods or services in Korea.

9.13 Digital Taxation

According to the Ministry of Economy and Finance, the Korean government has proactively adopted OECD BEPS recommendations and will follow the OECD's long-term plan on digital taxation. With respect to whether Korea will adopt an interim unilateral measure like the UK's digital services tax, the Korean government clearly indicated that a prudent approach should be taken by analysing any impact on related industries and tax revenue.

9.14 Taxation of Offshore IP

Korea has not introduced any general provisions dealing with the taxation of offshore intellectual property that is deployed in Korea. However, where a tax treaty which Korea has concluded determines the source of royalties based on the location of use of such royalties, certain intellectual property (eg, patents) that is registered outside Korea but deployed in Korea can be subject to Korean tax.

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Yulchon LLC is a full-service international law firm headquartered in Seoul. It employs nearly 500 professionals, including more than 60 licensed in jurisdictions outside of Korea. Yulchon advises on a wide range of specialised practice areas, including corporate and finance, antitrust, tax, real estate and construction, dispute resolution, intellectual property, and labour and employment. The firm's perspective is international and its reach is global.

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Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Most businesses involving multiple individuals choose to adopt a corporate form. The most frequently used corporate forms are the company limited by shares (*Aktiengesellschaft*/AG or *société anonyme*/SA) and the limited liability company (*Gesellschaft mit beschränkter Haftung*/GmbH or *société à responsabilité limitée*/Sàrl).

The company limited by shares is best suited for major businesses requiring a large amount of capital contribution. Its share capital must amount to at least CHF100,000. Meanwhile, the limited liability company requires a minimum share capital of CHF20,000 and is more suited to small and medium-sized businesses.

Corporations are seen as separate legal entities, and are consequently taxed as such on their profits and their capital.

1.2 Transparent Entities

Transparent entities under Swiss law include the simple partnership (*einfache Gesellschaft*/*société simple*), the general partnership (*Kollektivgesellschaft*/*société en nom collectif*) and the less popular limited partnership (*Kommanditgesellschaft*/*société en commandite*). Such partnerships are created for the sake of simplicity and flexibility.

Specific transparent entities exist under Swiss law for collective investment schemes – namely, the open-ended investment company (*Investmentgesellschaft mit variablem Kapital*/*société d'investissement à capital variable* or SICAV) and the limited partnership for collective investment (*Kommanditgesellschaft für kollektive Kapitalanlagen*/*société en commandite de placements collectifs* or SCPC).

Transparent entities are taxed on their profits and their capital in the hands of the partners.

1.3 Determining Residence of Incorporated Businesses

Corporations are considered to reside in Switzerland if their statutory seat or effective administration is in Switzerland. The statutory seat is determined by the place in which the company is registered, while the effective place of management is determined through the Supreme Court's case law and is considered to be where the company has its effective and economic centre of activity – ie, where its day-to-day management is.

Transparent entities are considered Swiss residents insofar as their partners are themselves residents in Switzerland.

1.4 Tax Rates

The Confederation levies an annual income corporate tax on the corporation's net profits, whereas the canton and the commune in which the corporation has its residence levy corporate income tax as well as capital tax. The effective tax rate on the Confederation level is 7.83%. The effective tax rate of the cantons and communes varies depending on the location.

With the corporate tax reform in 2020, the combined effective tax rates have dropped, and now vary between 12% and 21%, with 15.1% being the average. The capital tax rate depends on the canton and community of domicile but varies between 0.001% and 0.5%.

Profits and capital of partnerships are taxed in the hands of the partners, meaning that the tax rates will depend on the personal tax rate of each partner. Such tax rate varies according to their total income and wealth, as well as their place of residence.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are based on the accounting profits, specifically the balance of the profit and loss account. This tax base is subject to a few adjustments, specifically the following three for tax purposes:

- adjustments to ensure compliance with Swiss mandatory accounting rules;
- adjustments to ensure compliance with the periodicity principle; and
- adjustments aimed at preserving the system when Switzerland loses its taxing rights – for example, in the case of a transfer abroad.

Finally, corporations are taxed on their profits on an accruals basis.

2.2 Special Incentives for Technology Investments

With the introduction of the corporate tax reform in 2020, a mandatory patent regime has been introduced at a cantonal level, as well as optional R&D super deductions. More precisely, in the patent box regime, the net profits from domestic and foreign patents as well as similar rights are taxed separately, with a maximum deduction of 90%. The deduction rate varies depending on the canton. For the optional R&D super deduction, the cantons may choose to introduce and apply a maximum deduction of 50% to personnel expenses for R&D plus a flat rate surcharge of 35% for other costs and 80% of expenses for domestic R&D carried out by third parties or group companies.

2.3 Other Special Incentives
Until recently, other special tax incentives included a privileged regime of taxation of profits for holding companies, domiciliary companies, mixed companies, principal companies and Swiss finance branches. However, the corporate tax reform in 2020 abolished such regimes: all companies are now subject to ordinary corporate income and capital tax. Among the measures taken in order to compensate for the loss of these tax privileges, most cantons have significantly lowered their tax rates.

Moreover, with the entry into force of the corporate tax reform, at the moment of transition from a privileged regime to ordinary taxation or upon migration to Switzerland, hidden reserves (including good will) are confirmed by the tax authorities. In the case of migration and in certain cantons in case of transition, a tax neutral step-up of the hidden reserves will be applied (with later tax effective depreciation), while in other cantons a two-rate system will be applied in the case of transition.

2.4 Basic Rules on Loss Relief
Losses from the seven financial and tax years preceding the current tax period can be deducted to the extent they could not be included in the computation of taxable net profit of those years.

Swiss tax law does not allow losses to be carried back.

2.5 Imposed Limits on Deduction of Interest
Interest payments are considered as a business expense deductible from the corporation's taxable income. Interest payments to related parties (shareholders or affiliates) must respect the fair market rate set out annually by the Federal Tax Administration. In addition, thin capitalisation limitations apply; the relevant debt-to-equity ratio depends on the class of assets (eg, 100% of cash, 85% of receivables, etc). A deviation from these safe harbour rates may be accepted if the company can prove that the rates used are at arm's length.

It should be noted that Switzerland has not taken any measures to implement the recommendations of BEPS Action 4; see **9 BEPS** for full details.

2.6 Basic Rules on Consolidated Tax Grouping
Separate entity taxation applies for tax purposes. There are no tax consolidation rules, and none are expected to be introduced in the near future.

While mergers and other transactions of two or more companies lead to the consolidation of the tax base of the companies involved, such reorganisations are disregarded if the only goal is to combine the tax base of the companies involved and to set off taxable profits with losses of other companies.

2.7 Capital Gains Taxation
Gains on the sale of assets (capital gains) are generally subject to income taxes at the federal, cantonal and communal levels. Two exceptions to the general rule exist:

- participation reduction; and
- the replacement of certain assets.

Moreover, depending on the canton and/or the municipality, gains from the sale of real estate can be exempt from the cantonal and/or communal income taxes, but will be subject to cantonal and/or communal real estate gains taxes.

Participation Reduction
Companies holding at least 10% of the share capital of another company or the rights to at least 10% of the profits and reserves of another company, for at least one year, are entitled to a participation relief on the capital gains realised on the sale of such participation.

The corporate income taxes due are first calculated in the usual way, and are then reduced by the ratio of net earnings on participations (gross earnings minus financial and administrative expenses) to the total net income. For example, if the net capital gains amount to 50% of the company's total net income, corporate income taxes will be reduced by 50%.

Replacement Relief
The replacement relief further allows a company to defer taxation of profits from the sale of fixed assets used in connection with its business, if such profits are reinvested within a reasonable time in the replacement of fixed business assets located in Switzerland. Consequently, the corporate income taxation of unrealised gains can be deferred. This also applies to real estate if the legal requirements above are fulfilled. Thus, if participations are sold by a company and the proceeds of the sale are reinvested in other participations within a reasonable timeframe (ie, within one to three years), no corporate income taxes will be due on the unrealised gains.

Corporate income taxes on capital gains resulting from the sale of shares can be further minimised by using a holding company to acquire the shares. If this acquisition is financed with debt, no push down on the target company is possible, as each entity is considered separately under Swiss law. In addition, a merger between the holding company and the target company would be viewed as abusive. Therefore, the share price is generally kept as low as possible at acquisition (for example, by distributing dividends before the transaction or by reducing the capital of the target company).

2.8 Other Taxes Payable by an Incorporated Business

Stamp duty is generally levied on shareholders' contributions to a company and on the transfer of securities. However, certain transactions are exempt, such as certain restructurings.

The Securities Issuance Stamp Tax is a stamp duty tax that is levied on the issue (primary market) of certain Swiss securities (shares, similar participating rights, etc) and on equity contributions to such corporate entities. The taxable person is the company or the person issuing the securities or benefiting from the equity contribution. The tax rate is 1% of the capital contribution. It should be noted that capital created or increased by a corporation or an LLC is exempt from the issuance stamp tax, up to the amount of CHF1 million.

The Securities Transfer Stamp Tax is levied on the transfer of certain Swiss and non-Swiss securities, if a Swiss stockbroker is involved as a party or an intermediary to the transaction. Stockbrokers are mainly banks, companies holding taxable securities with a book value above CHF10 million, etc. The tax rates applicable on the purchase price are 0.15% in respect of Swiss securities and 0.3% in respect of foreign securities.

Certain transactions require a notarial deed, for which fees are payable (eg, the incorporation of a corporation or limited liability company, or the transfer of real estate). Land register charges are due on selling, acquiring or transferring real estate located in Switzerland.

A withholding tax of 35% is levied on income derived from movable capital assets (eg, interest on bonds and dividend payments). The tax must be deducted by the debtor from the amount due to the recipient. In certain circumstances, a partial or total refund of the tax withheld can be obtained.

2.9 Incorporated Businesses and Notable Taxes

Corporations are subject annually to capital tax, which is levied at a cantonal and communal level, and is based on the corporation net equity – ie, its paid-in capital, opened reserves and retained profits. The amount subject to tax may also be increased by the debt re-characterised as equity in the application of the Swiss thin capitalisation rules. The tax rate depends on the canton and the community of domicile, varying between 0.001% and 0.5%. Since 2020, the cantons have the option to allow capital tax relief for equity relating to patents and similar rights, qualifying participations and intra-group loans. Most cantons allow for significant relief.

Moreover, excise taxes are levied, such as VAT on the supply of goods or services and the import of goods or services. The standard rate is 7.7%, the reduced rate (eg, for medicine, newspapers, books and food) is 2.5% and the lodging services rate is 3.7%.

Other taxes may also be payable, depending on the canton. For example, certain cantons may levy tax on real estate situated in such cantons, or may charge "professional tax", which is calculated as a percentage of the turnover, rent paid and number of employees.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Most closely held local businesses operate in a corporate form. Only very small businesses generally operate in a non-corporate form.

3.2 Individual Rates and Corporate Rates

Individual professionals are generally taxed as self-employed physical persons, on their income and wealth. The taxation of self-employed individuals is the same as that of salaried individuals.

However, they may also operate through an entity subject to corporate taxes, in which case the entity pays a salary and/or dividends to the individual, which are then taxed as income respectively as the wealth of the physical person. In such a case, the sum of the taxes paid by the entity and the taxes paid by the physical person on the dividends received amounts to a total rate similar to that a self-employed individual would pay.

3.3 Accumulating Earnings for Investment Purposes

There are no rules to prevent closely held corporations from accumulating earnings for investment purposes, and particularly no dividend acceleration rules.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Income Tax

Swiss income tax is levied on any distribution of profits qualifying as a dividend and paid to individuals holding shares in closely held corporations. The tax is levied on the gross amount received. Individuals holding at least 10% of the nominal value of the share capital of a company can obtain a reduced tax base.

Individuals holding shares as private or business assets are only taxable, depending on the canton, on 50-70% of the dividend received, or 70% at the federal level if a shareholding threshold of at least 10% is met.

If this threshold is not reached, individuals are taxed on the gross dividend payment.

The tax treatment of gains obtained on the sale of shares depends on whether the shares are held as a private asset or as a business asset. The sale of shares held as a private asset is exempt from taxation, unless they are held as a business asset or the shareholder qualifies as a professional trader.

The definition of a professional trader is not specified under Swiss law. The Swiss tax authorities must examine each case individually to determine whether someone qualifies as a professional trader, generally assessing the following criteria: a shareholding that has lasted less than one year, the frequency of transactions, the necessity to obtain such gains to ensure someone's lifestyle, etc.

Swiss law provides other exceptions to the general principal of gain exemption. In particular, income tax may be levied on the sale of shares by an individual where:

- the shareholder sells at least 20% of its shares to a company and the purchaser uses the assets of the purchased company to finance the sales price;
- the shareholder sells its shares to a company controlled by the same shareholder – such transaction qualifies as a taxable "transposition"; and
- a company purchases its own shares and the maximum percentages of ownership (10% or 20% under certain conditions) provided by Swiss corporate law are not observed, or the purchase is related to a capital reduction.

Withholding Tax (WHT)

Dividend distributions made by Swiss corporations are subject to WHT at a rate of 35%, whether paid to a Swiss-resident or a non-resident recipient. Swiss resident recipients may obtain a full refund of the dividend WHT if they have properly reported the gross amount of dividend received as taxable income and claim the refund within a period of three years. Non-resident recipients may apply for a full or partial refund of the dividend WHT, pursuant to the provisions of an applicable tax treaty. Otherwise, the tax is considered as final.

Capital gains resulting from the sale of private shares by individuals are also exempt from Swiss WHT. If the qualification of an exempt capital gain is challenged by the Swiss tax authorities, a Swiss WHT of 35% may apply. As for dividends, a full or partial refund may be applicable.

Transaction Stamp Duty

A transaction stamp duty may be levied on the transfer of certain Swiss and non-Swiss securities – mainly shares or similar participation rights in corporate entities, if a Swiss security dealer is involved in the transaction. This duty is calculated at 0.15% on Swiss securities and 0.30% on non-Swiss securities sold/purchased during the year.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals that receive dividends from publicly traded corporations are treated identically to those that receive dividends from closely held corporations for Swiss income tax, withholding tax and transaction stamp duty purposes. The reduced tax rate based on a 10% ownership (see **3.4 Sales of Shares by Individuals in Closely Held Corporations**) may be more difficult to reach from an income tax perspective.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Withholding Tax

Swiss WHT may be levied on interest from bonds issued by a Swiss resident issuer, on dividends paid by a Swiss company to a foreign entity or investor, or on interest paid to Swiss or foreign creditors on bonds or similar debt instruments issued by Swiss resident issuers, such as loans. However, Switzerland does not levy any WHT on interest from private and commercial loans (including inter-company loans).

WHT on interest is only levied for companies that qualify as being tax resident for WHT purposes. The application of the WHT only arises if the payment comes from a Swiss tax resident company; the residence of the creditor is irrelevant.

Moreover, profit distributions made by a Swiss corporation are subject to WHT (please see **3.4 Sales of Shares by Individuals in Closely Held Corporations**).

Furthermore, Switzerland does not levy WHT on royalties, whether they are paid to a resident or non-resident person. It should be noted that if the royalties paid do not respect the "arm's-length principle", they can be requalified as hidden dividends if paid to a shareholder or a related party to the shareholder.

The Swiss WHT rate of 35% applies to such interest, dividends and other costs that are economically equivalent, or to hidden dividends. Without the application of an income tax treaty, such tax is considered as final and no reimbursement is allowed by the Swiss tax authorities.

Tax at Source on Mortgage-Secured Loans

A tax at source may be levied on interest paid on a loan that is secured by Swiss real estate. Individuals who are not domiciled or resident in Switzerland for Swiss tax purposes are also subject to a specific WHT levied by the canton where the property is located, which may vary from 13% to 21%.

4.2 Primary Tax Treaty Countries

Foreign investors tend to use double tax treaties concluded with Switzerland where full tax relief can be granted. This includes France, Germany, the UK and the USA for the WHT paid on interest. However, most of the countries provide for a Swiss residual WHT ranging from 5% to 15%.

With regards to dividends, double tax treaties are usually used within the EU, and in particular Luxembourg, where investors can be granted full tax relief based on a 10% ownership.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

In 1962, the Swiss Federal Council introduced a Decree imposing measures against the abusive use of double tax treaties concluded by Switzerland (ACF 1962). Among other aims, this Decree seeks to restrict the right of Swiss resident companies to benefit from double tax treaties. It contains a number of tests that must be fulfilled by every Swiss-resident company in order to be eligible for treaty benefits.

A case of abusive claims is recognised if most of the direct or indirect shareholders of a Swiss company do not benefit from the double tax treaty, provided that the Swiss company does not proceed to appropriate dividend distributions. Another case of abuse is also recognised when an essential part of income benefiting from a double tax treaty is used to directly or indirectly compensate counterparts that do not themselves benefit from the double tax treaty. The compensation can, for example, relate to interest, royalties or any other type of expenses paid to such counterparts.

According to the Swiss tax authorities, a foreign entity claiming a refund of the Swiss WHT must fulfil all the mandatory requirements. In particular, the tax authorities review whether the company requesting a refund is the real beneficiary of the income and is entitled to such refund. The tax administration also has an economic approach to the facts and reviews the structure to determine if it has been arranged with the sole purpose of obtaining a full or partial refund of WHT.

In such cases, a refund of the WHT may be denied by the Swiss tax authorities.

4.4 Transfer Pricing Issues

Swiss domestic law does not provide any specific transfer pricing rules or regulations. As such, Switzerland applies the OECD guidelines to transfer pricing issues, and is participating in the BEPS project.

4.5 Related-Party Limited Risk Distribution Arrangements

There are no specific rules with respect to the use of related-party limited risk distribution arrangements in Swiss tax law. However, the Swiss tax authorities may review the structure with regards to safe harbour rules and the "arm's-length principle" to challenge an abusive use of such related-party limited risk distribution arrangements.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

As mentioned previously, Switzerland applies the OECD standards for transfer pricing issues.

4.7 International Transfer Pricing Disputes

Until recently, few transfer pricing disputes were brought up by the Swiss tax administration. In the last couple of years, however, an increasing number of cases have been taken up by the tax authorities for review of the appropriateness of the transfer pricing. Next to ordinary legal (court) proceedings, mutual agreement procedure (MAP) proceedings have accrued an increasing importance in this context. The traditional easy access to Swiss authorities applies also to MAP proceedings, which makes these proceedings an important add-on to ordinary – in parallel – court proceedings in transfer pricing disputes.

To avoid future transfer pricing disputes, bi- and multilateral advance pricing agreement proceedings confirming in advance a specific transfer pricing by the countries involved are encouraged again by easy access to such proceedings and the competent authorities.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Compensating adjustments are allowed when a transfer pricing claim is successfully settled.

The State Secretariat for International Finance has published a specific form for MAPs in the case of transfer pricing, thereby facilitating MAPs in such cases.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Local branches and local subsidiaries of non-local corporations are taxed similarly in Switzerland for corporate income tax purposes. For WHT purposes, however, subsidiaries are subject to withholding obligations, while branches are not.

5.3 Capital Gains of Non-residents

Capital gains of non-residents on the sale of stock in local corporations are not subject to tax in Switzerland, unless it is a gain derived from the sale of a Swiss real estate company.

If a double taxation treaty corresponding to the OECD Model Tax Convention applies in the case at hand, such real estate gain would typically only be taxable in Switzerland.

5.4 Change of Control Provisions

A change of control in a non-local corporation may trigger taxes/duty charges exclusively for real estate companies. The specifics will depend on the canton's legislation.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

There are no specific formulas recommended by law or in the Administration's published practice. Nevertheless, all transactions with a Swiss related entity must be carried out at arm's length.

5.6 Deductions for Payments by Local Affiliates

Deductions are allowed in Switzerland, including expenses paid to related parties, as long as such expenses are commercially justified.

Management and administrative services provided by a non-local affiliate to a Swiss company are often remunerated based on a cost-plus method in practice. As per this method, the costs incurred by the supplier of services to an affiliate enterprise serve as the basis to determine the income to be allocated to said service provider. An appropriate mark-up – typically oscillating between 5% and 15% – is then added to these costs, resulting in an appropriate profit in light of the functions performed and the market conditions.

5.7 Constraints on Related-Party Borrowing

Borrowings from a non-local affiliate to a Swiss foreign-owned affiliate must be remunerated by interest paid at an "arm's-length rate", published yearly by the Federal Tax Administration. Such interest is typically not subject to Swiss WHT (35%), unless it is characterised as bonds.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Corporations that are resident in Switzerland are subject to Swiss tax on an unlimited basis – ie, on their worldwide profits (including foreign income) and capital, except income that is attributed to a foreign permanent establishment or immovable property.

The implementation of the cantonal tax reform in 2020 abolished cantonal tax privileges for certain businesses predominantly oriented abroad.

6.2 Non-deductible Local Expenses

The expenses proportionally attributable to foreign income that is not subject to Swiss tax are not deductible in Switzerland. However, special rules apply with respect to the debt loss carry over of foreign permanent establishments of local corporations.

6.3 Taxation on Dividends from Foreign Subsidiaries

The participation reduction regime applies at a federal and cantonal/communal level, so that the effective tax rate applicable to the dividends received is proportionately reduced as per the ratio of the net dividend income over the total net taxable income, provided that the Swiss company holds at least 10% of the participation or participation rights with a market value of at least CHF1 million. As a result, such dividend income is usually virtually tax exempt.

The participation exemption applies regardless of whether the dividends are paid by a resident or by a non-resident company.

The corporate tax reform in 2020 abolished the specific cantonal holding tax privilege.

6.4 Use of Intangibles by Non-local Subsidiaries

Switzerland has not yet introduced specific provisions with regard to the taxation of intangibles. The deriving incomes are therefore subject to profit taxes.

With the introduction of the corporate tax reform in 2020, as mentioned above, a patent box with a maximum relief of 90% has been introduced at the cantonal level, with the cantons having the option to apply R&D super deductions of up to 50% and a capital tax relief relating to patents and similar rights. The overall maximum tax relief is 70%.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Switzerland does not have a CFC regime. However, according to the case law of the Federal Supreme Court, the profits of companies formally domiciled abroad with little or no local substance that are effectively managed in Switzerland or have a permanent establishment in Switzerland may be subject to Swiss income tax.

To consider that a company is effectively managed in Switzerland, the local tax authorities (including tax administrations) follow a case-by-case approach, aimed at determining the location of the economic centre of the company's existence. They weigh the different relevant factual elements, but the key element used to determine the location of the effective management is the place where the management is exercised – ie, the day-to-day actions required to realise the statutory purpose. By contrast, the place where the fundamental decisions are taken or the place where the simple administrative work (accounting, correspondence) is done can only be taken into account as secondary elements. Other secondary elements used to determine the location of the effective management are the residency of the managing bodies, the place where the operational contracts are executed or the place of storage of the documents and archives.

Particular attention should be paid to the following elements, which must be avoided so as to limit any requalification of the non-local seat as a pure formal seat (and, as the case may be, recognition of a place of effective management in Switzerland):

- domicile and location;
- infrastructure/employees;
- professional qualifications of employees;
- contracts;
- banking operations;
- book-keeping;
- the board of directors; and
- the annual shareholders' meeting.

Under Swiss tax law, a foreign company is also subject to limited tax liability when it has a permanent establishment in Switzerland. Only the income derived from the permanent establishment is subject to tax in Switzerland. To constitute a permanent establishment, there must be (i) a place of business, (ii) which must be fixed, and (iii) from which business must be carried out. The interpretation of these conditions is wide, and it is considered that such place of business can be located in the premises of another company.

Furthermore, the corporate tax reform of 2020 foresees that the Federal Council is competent to determine under what conditions Swiss permanent establishments of foreign companies should be able to claim withholding taxes on income from third countries with a flat rate tax credit.

6.6 Rules Related to the Substance of Non-local Affiliates

Please see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

If a corporation realises a capital gain on the sale of a qualifying participation, it is entitled to a participation reduction. To qualify for relief on capital gains, a Swiss company must make a profit on the sale of a participation that represents at least 10% of the share capital of another company, which it has held for at least one year. Companies with qualifying capital gains may reduce their corporate income tax by reference to the ratio between net earnings on such participations and total net profit.

Losses incurred as a result of the sale of qualifying participations remain tax-deductible.

A capital gain is defined as the difference between the proceeds from the sale of a qualifying participation and the acquisition cost of the investment. Hence, any amount of previously tax-deductible depreciation or provision on the participation is not taken into consideration to calculate the amount of gain that can benefit from the relief. In addition, revaluation gains from participations do not qualify.

Favourable tax treatment is also available for qualifying participations transferred to group companies abroad; the group holding or sub holding company must be incorporated in Switzerland.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

In Switzerland, general anti-avoidance rules (GAARs) are not contained in a specific act. Through the years, the Federal Supreme Court has developed a general principle of abuse of law or tax avoidance, which applies to all Swiss taxes. In accordance with this principle, which is applied by all Swiss courts and tax authorities, tax authorities have the right to tax the taxpayer's legal structure based on its economic substance, in certain situations.

In addition, Swiss tax authorities generally apply the arm's-length principle and follow the OECD transfer pricing guidelines. Swiss regulation also contains specific anti-avoidance provisions.

Regarding the specific issue of treaty shopping, on 7 June 2017 Switzerland signed the OECD's Multilateral Instrument, which introduced a "principle purpose test" (PPT), according to which a benefit under a tax treaty shall not be granted if obtaining that benefit was one of the principal purposes of an arrangement or transaction. Several recently bilaterally amended Swiss double taxation treaties now include the PPT (for more details see **9.1 Recommended Changes**).

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Swiss law does not outline the specifics of the tax audit process. After the filing of the tax return by the taxpayer, the tax authorities may request further information/documentation prior to issuing the tax assessment. The tax authorities are obligated and entitled to gather all necessary information to assess a taxpayer on a true and complete basis.

With regard to the resolution of tax disputes, Switzerland has a well-established and efficient practice. When confronted with an unlawful tax assessment, the taxpayer is generally not obliged to immediately challenge said assessment in court. Rather, the taxpayer may turn to the tax authority that issued the tax assessment decision being challenged, to force it to make a new decision. For the purposes of this chapter, this procedure will be called a formal complaint. A formal complaint is a quick and efficient procedure that allows numerous questions to be resolved with little cost, the majority of these being technical questions. This formal complaint procedure thus eliminates the need for court proceedings and generally takes a few months. However, for complicated issues, this way of appeal offers limited solutions. In such cases, tax authorities usually prefer to wait for a binding judgment made by a higher independent body (ie, a tribunal). It is very common for taxpayers to exercise their right to challenge the tax assessment decision of a tax authority. Tax authorities then issue a decision on the formal complaint.

9. BEPS

9.1 Recommended Changes

Switzerland is actively participating in the BEPS project and, as such, has already implemented some of the project's outcomes or is in the process of doing so. Switzerland intends to implement the minimum standard of the BEPS project. Few changes are needed in order to meet these minimum standards.

Multilateral Convention to Implement Tax Treaty Measures to Prevent BEPS (MLI)

On 7 June 2017, Switzerland signed the MLI, which will serve to efficiently amend double taxation agreements in line with minimum standards agreed upon in the BEPS project. Switzerland will implement these minimum standards either within the framework of the multilateral convention or by means of the bilateral negotiation of double taxation agreements. These include the modification of the preamble of Double Tax Agreements (DTA) and the prevention of treaty abuse via the PPT. Switzerland has reserved the right not to apply the standards for transparent and dual-resident entities (Articles 3 and 4), the anti-abuse rules for permanent establishments situated in third jurisdictions (Article 10) and the artificial avoidance of permanent establishment status through commissionaire agreements (Article 12).

Switzerland has already renegotiated a significant number of tax treaties to include the MLI measures. The MLI has been approved by the Swiss parliament and entered into effect in accordance with Article 35 of the MLI.

BEPS Action 5 (Counter Harmful Tax Practices and Patent Boxes)

The implementation of the corporate tax reform in 2020 abolished the privileged tax regimes for holding companies, domiciliary companies and mixed companies, and the existing allocation rules on principal companies, which are no longer acceptable as per international standards. Furthermore, a patent box regime has been introduced in accordance with the OECD standards and is mandatory for all cantons. The net profits from domestic and foreign patterns, as well as similar rights, are to be taxed separately, with a maximum deduction of 90%.

In order to counter further harmful tax practices and to promote transparency, Switzerland introduced the spontaneous exchange of information in tax matters through the adoption of the OECD Convention on Mutual Administrative Assistance in Tax Matters and the revision of the Swiss Federal Act and Ordinance on Tax Administrative Assistance Act. All the above entered into force on 1 January 2017. The first exchange of information took place on 1 January 2018 and included an exchange of information on tax rulings.

Finally, as of 2009, Switzerland no longer makes a reservation on Article 26 of the OECD Model Convention on Income and Capital in its double tax treaties on income and capital, and has therefore fully adopted the OECD standards in exchange of information in tax matters.

BEPS Action 6 (Prevention of Treaty Abuse)

With the entry into force of the MLI, Switzerland is expected to adapt the title and preamble of the Swiss tax treaties to the minimum standard. Furthermore, it has opted for the PPT rule alone, which provides that a benefit under a tax treaty shall not be granted if obtaining that benefit was one of the principal purposes of an arrangement or transaction.

BEPS Action 13 (Country-by-Country Reporting)

The Swiss Federal Act on the International Exchange of Country-by Country Reports (CBCR) came into force on 1 December 2017.

BEPS Action 14 (Dispute Resolution Mechanism)

Switzerland chose mandatory MAPs within the framework of the MLI, with corresponding adjustment as well as mandatory arbitration. It should be added that Switzerland has more than 30 provisions that deal with arbitration in its treaty network, in the form of either arbitration clauses or most-favoured nations.

9.2 Government Attitudes

Switzerland has embraced the BEPS project from the beginning and is actively contributing to its development. The country is supporting the primary aim of the BEPS project, which is, in essence, the taxation of profits in the jurisdiction where the economic activity that gave rise to the profits took place. Switzerland's goal remains to be compliant with the OECD recommendations and that is why it intends to implement the minimum standard of the BEPS project.

Switzerland has focused mainly on the following standards:

- patent/IP boxes;
- the spontaneous exchange of information on tax advance rulings;
- preferential regimes;
- dispute resolution mechanisms;
- the prevention of treaty abuse; and
- country-by-country reports.

9.3 Profile of International Tax

As has been the case in other Western countries, over the last few years international tax policy has become more and more of a public debate in Switzerland.

In 2020 Switzerland introduced a major corporate tax reform, mostly due to international developments such as the abolition of holding, mixed and domiciliary company taxation along with the disclosure of hidden reserves and the introduction of higher taxation of dividends for qualifying shareholders. Moreover, various measures have been included to maintain the attractiveness of the Swiss tax system, such as the introduction of a mandatory patent box regime, and the voluntary introduction of R&D super deduction at the cantonal level along with significant general reductions of corporate tax rates.

9.4 Competitive Tax Policy Objective

As mentioned in **9.3 Profile of International Tax**, the corporate tax reform in 2020 introduced various measures in order for Switzerland to maintain its attractive tax system.

9.5 Features of the Competitive Tax System

The competitive tax system in Switzerland includes features such as relatively low ordinary corporate income tax rates (in most cantons in the range of 12% to 14% overall effective tax rate), patent box regimes and R&D super deduction regimes, tax neutral step-up of hidden reserves upon entering into Switzerland or transfer of functions to Switzerland and the possibility to easily obtain advanced tax rulings. All of these rules are in line with OECD/BEPS recommendations.

With the implementation of the corporate tax reform in 2020 and the BEPS recommendations as analysed in **9.1 Recommended Changes**, Switzerland should not have any "vulnerable" areas in its tax regime.

9.6 Proposals for Dealing with Hybrid Instruments

As far as hybrid mismatch arrangements are concerned, the current Swiss tax law is sufficient to prevent any hybrid structures. Switzerland has adopted the common approach. The country's international tax policy has always supported the elimination of double non-taxation, resulting in an unintended lack of tax co-ordination. It should be noted that the recommendations of the BEPS project are much wider, so any implementation by Switzerland would require a number of changes in Swiss tax domestic law.

Finally, Switzerland will apply the switch-over clause of Article 5 of the MLI to its residents.

9.7 Territorial Tax Regime

Switzerland applies a worldwide basis jurisdiction to tax, which is limited by the principle of territoriality in certain cases, such as foreign subsidiaries. For the time being, no interest deduction rules in line with Action 4 have been implemented or are expected to be implemented.

Switzerland has thin capitalisation rules that apply only to related parties. In the future, Switzerland may need to change its capitalisation rules in order to expand to the overall level of interest deductions in an entity, but no such motion has yet been put in place.

9.8 CFC Proposals

Switzerland does not have CFC legislation, as Swiss residents are not taxed on profits derived by foreign legal entities, such as foreign subsidiaries, up until they are distributed to the shareholder. Moreover, Switzerland provides for unconditional unilateral tax exemption that is not conditional on the payment of taxes abroad. The above is also reflected in its double tax treaties, as Switzerland favours the application of the exemption method. However, recent jurisprudence has allowed the taxation of passive income with insufficient nexus with a foreign country. As such, the corporate veil of a foreign legal entity may be pierced, and a broader interpretation of effective management may be admitted. Therefore, although the courts tend to adopt a position similar to the BEPS project principles, Switzerland for the time being does not intend to introduce any CFC legislation in its tax system.

9.9 Anti-avoidance Rules

Switzerland has accepted limitation of benefit articles in its DTAs only at the request of some of its treaty partners, namely the USA and Japan. Otherwise, Swiss treaty practice has never favoured such articles.

With the entry into force of the MLI, a GAAR in the form of the PPT applies in accordingly revised tax treaties. However, this GAAR is not new to Swiss law and policy – case law of the Swiss Federal Supreme Court (2005) recognises an unwritten GAAR that is conceptually similar to the PPT and is consequently implicitly included in every Swiss DTA. It should be pointed out that controversial issues might arise, as the scope of the PPT is much broader. The current unwritten GAAR is limited to dividends, interest or royalties, whereas the PPT will be applied to all provisions of a DTA.

9.10 Transfer Pricing Changes

Switzerland does not have any specific transfer pricing rules in its domestic law. The authorities usually follow OECD guidelines. Furthermore, Switzerland does not plan to make transfer pricing documentation compulsory.

9.11 Transparency and Country-by-country Reporting

Parent entities of multinational enterprises residing in Switzerland with more than CHF900 million consolidation revenue in the financial year preceding the reporting year, or surrogate parent entities, must comply with the country-by-country reporting obligations and provide the Federal Tax Administration with the report.

The first financial year in which country-by-country reporting became mandatory was on or after 1 January 2018, and the reports have been exchanged with partner countries since the beginning of 2020. The submission of reports for the 2016 and 2017 tax years is still optional.

As far as transparency is concerned, Switzerland issues tax rulings including advanced tax rulings that clarify the tax consequences of a certain given transaction planned by the taxpayer. Tax rulings are a very important tool that facilitates the co-operation of the taxpayer with the authorities, rendering the Swiss tax system even more attractive. In order to be in line with BEPS Action 5, tax rulings have been subject to the spontaneous exchange of information since 2018.

9.12 Taxation of Digital Economy Businesses

Switzerland has not taken any unilateral action with regards to the taxation of the digital economy. The State Secretary for International Finance has been working intensively on the taxation of the digital economy, and has performed an analysis on the subject. Switzerland is of the view that it is necessary to favour multinational approaches, where tax profits are taxed in the jurisdiction where added value is generated and that does not cause double or over-taxation, and also that measures outside the scope of double taxation agreements are to be avoided.

9.13 Digital Taxation

As mentioned previously, Switzerland favours multinational approaches and, as such, has not taken any specific unilateral measure towards digital taxation. In light of the OECD's "programme of work", on 31 May 2019 the State Secretary for International Finance updated his position regarding digital taxation, as follows: Switzerland wishes to ensure that further developments will not hamper innovation or competition, and has pronounced itself against the introduction of minimum tax rate. Switzerland favours taxation where value is created and supports a comprehensive review of whether the rules for a nexus and the allocation of profit should be adapted to digitalisation. Finally, Switzerland is not convinced by the digital tax proposed in the EU, given that measures based solely on turnover in market areas can lead to double taxation and over-taxation and make it more difficult to achieve a global consensus for a definitive solution.

9.14 Taxation of Offshore IP

Switzerland has not introduced any specific provision regarding the taxation of offshore intellectual property deployed from inland. Moreover, Switzerland does not levy WHT on royalties, whether paid to a resident or a non-resident person. However, profits of companies formally domiciled abroad with little or no local substance that are effectively managed in Switzerland or that have a permanent establishment in Switzerland may be subject to Swiss income tax (see **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules** for full details).

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Trends and Developments

Contributed by:
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Three trends and developments in Swiss corporate tax law are worth highlighting in 2021:

- the practical implementation of the Tax Reform and AHV Financing (adopted in 2019 and put into force in 2020) is still an ongoing topic;
- a new reform of the law on companies limited by shares will enter into force in 2022 and will have an impact on corporate tax law; and
- contrary to what was expected, tax measures related to the COVID-19 pandemic have been few in number.

Tax Reform and AHV Financing

On 19 May 2019, the Tax Reform and AHV Financing (TRAF) was accepted by the people and the Cantons in a referendum and consequently entered into force on 1 January 2020.

TRAF was initiated by an important disagreement between Switzerland and the European Commission regarding special corporate tax statutes, considered by the European Commission as a violation of the free trade agreement existing between Switzerland and the European Union's ancestor. These special corporate tax statutes have been abolished by TRAF.

Certain special corporate tax statutes allowed full or partial cantonal tax exemption for holding companies ("holding company status") and companies with predominantly foreign-oriented business activities ("administrative or mixed company status").

Other special corporate tax statutes allowed partial federal and cantonal tax exemption for companies centralising different functions of a company group with a tax treatment partially allocating income abroad, hence reducing their own tax base ("principal company") and for Swiss permanent establishments acting as the central treasury department for a company group, allowing them to deduct notional interest expenses ("Swiss finance branch").

As indicated, the European Union disputed these corporate tax statutes for several years, under the opinion that they constituted a violation of the free trade agreement between Switzerland and the European Community of 1972, placing Switzerland under threat of potential blacklisting and termination of tax treaties with EU Member States.

It can be argued that the third major reform of the Swiss corporate tax system is the farthest reaching in its implications, given its impact on a foundation of the Swiss tax system as well as the significant reduction in cantonal tax rates.

The following are the main features of TRAF:

- the abolition of cantonal tax regimes;
- lower corporate tax rates at the cantonal level;
- the disclosure of hidden reserves (step up);
- increased dividend taxation;
- patent box at the cantonal level;
- deductions for self-financing;
- relief restrictions;
- capital tax adjustment;
- capital contribution principle restrictions; and
- fiscal equalisation and social security financing.

Reform of Corporate Law

On 19 June 2020, Parliament adopted a reform on the law of companies limited by shares (*société anonyme* – SA/*Aktiengesellschaft* – AG), which will enter into force on 1 January 2022. This reform will have an impact on direct tax, both federal and cantonal, withholding tax and stamp duties.

The object of revising Switzerland's legislation on companies limited by shares is to adopt into federal law the Ordinance against Excessive Remuneration in Listed Companies Limited by Shares, which came into force on 1 January 2014, and to improve corporate governance at listed and non-listed companies alike. The rules on company foundation and capital are to become more flexible, and legislation on companies limited by shares is to be brought into line with the new accounting legislation. In addition, the preliminary draft contains a proposal for transparency rules for economically significant companies in the extractive industries.

Tax Measures Related to the COVID-19 Pandemic

As a general comment, not many tax measures have been adopted with regard to the COVID-19 pandemic. The main measure worth mentioning is the suspension of default interest for payments of VAT and direct taxes between 1 March 2020 and 31 December 2020. Also, businesses that were forced to interrupt their activities due to the pandemic will be able to book tax-deductible provisions in their accounts. Finally, most cantons have prolonged their deadlines for submitting tax returns.

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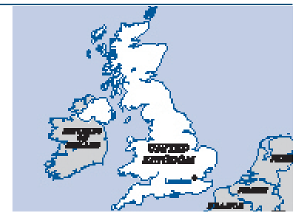

Contents

1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

The UK has one of the longest tax codes in the world. This is merely an overview of what is a very complex system. It is not possible to give the full details of any of the rules referred to below. Tax reliefs, for example, are always subject to detailed conditions, and various provisions designed to prevent avoidance. Therefore, no transaction should be entered into without taking specific advice (and, indeed, various anti-avoidance penalties apply where independent, individual advice has not been taken).

In the UK, there are three basic types of business entity:

- a company;
- a partnership; and
- sole trader status.

A company can have a single owner or a number of owners; a partnership must have a number of partners; and a sole trader is simply that, an individual in business on his or her own account.

There are a number of different types of company: the most common is a company limited by shares, although non-profit-making companies are often limited by guarantee (so that shareholders only have to pay the amount of their liability if and when the company is wound up; liability can be limited to a nominal amount).

There are three types of partnership: a "standard" partnership, where all partners have unlimited liability; a limited liability partnership, where all partners have limited liability; and a limited partnership, where there has to be at least one partner with unlimited liability who manages the business, but all other partners, provided they do not participate in managing the business, have limited liability.

For tax purposes, a company is taxed separately on its profits; its shareholders are taxed (generally) only on dividends received (although anti-avoidance provisions can charge UK shareholders to tax also on, for example, capital gains made by non-UK-resident companies, or loans made by companies, in both cases only where the company is controlled by five or fewer people). Partnerships are tax transparent, at least where they genuinely carry on business (including non-profit-making activities). Sole traders are taxed as individuals: there is nothing to look through. Apart from tax issues, shareholders in companies, members of limited liability partnerships and limited partners in limited partnerships benefit from limited liability. Finance providers tend to prefer to deal with companies or limited liability partnerships.

1.2 Transparent Entities

The main type of transparent entity is a partnership (of which there are three types, mentioned above). The most frequently used are limited partnerships and limited liability partnerships.

In a limited partnership, the manager alone has unlimited liability, but the importance of this is diminished by having a company be the general partner. In addition, there are limited registration and publicity requirements. For example, a limited partnership need not publish the identity of its ultimate beneficial owners, and it need not publish accounts.

In a limited liability partnership, all partners have limited liability. All of them may participate in managing the partnership's business, but accounts have to be published. These must show (broadly) the same sort of detail as accounts of companies.

1.3 Determining Residence of Incorporated Businesses

There are very different approaches for determining the residence of incorporated businesses and transparent entities.

For incorporated businesses, they are resident (i) where they are incorporated and also (ii) where their central management and control is exercised. This may give them two tax jurisdictions of residence. Central management and control depends on where the board actually meets and makes high-level management decisions (it does not depend, for example, on where shareholders' meetings are held, or on the residence or domicile status of shareholders or directors). Where board meetings are conducted by phone, or some of the directors participate by phone, it is therefore important that at least one director is physically present in the jurisdiction in which it is intended that the company should be resident, and to record the location in that jurisdiction where that individual is present and the meeting is administered from. That person should also be the "host" of any conference call.

Partnerships do not have any residence of their own. Because they are tax transparent, it is considered unnecessary for them to have a residence. The taxation of each partner depends on that partner's own residence (and, indeed, the basis of taxation depends on whether that partner is an individual, and therefore liable to income tax, or a company, and therefore liable to corporation tax). The residence of each partner is determined according to the usual rules applicable to that type of person (in other words, if a partner is an individual, his or her residence is determined according to the usual rules that apply to determine individual residence; where that partner is a company, it is the rules applicable to determine a company's residence that apply: see above).

Of course, any individual case may also be governed by a double taxation treaty, so that any tie-breaker provisions have to be taken into account.

1.4 Tax Rates

Currently, the corporation tax rate applicable to companies in the UK is 19%. Any changes take effect normally on April 1st in any year. From 1 April 2023, this will increase to 25% for companies with profits above £250,000; and will increase in a graduated way from 19% to 25% for companies with profits between £50,000 and £250,000. Where a company's accounting period over which it measures its profits for corporation tax purposes has a different year end, the profits are apportioned between the period before and the period after April 1st, and the applicable rates applied accordingly.

There are different rates for profits of oil extraction activities. These depend on the amount of profits and are from 19% (for profits up to £300,000 per annum) to 30% (for profits of £1.5 million per annum or more), with a gradual increase in between. Unit trusts and open-ended investment companies, when subject to tax, are charged at 20% (the same as the basic rate of income tax).

Tax-transparent entities do not pay any corporation or income tax. Any tax is charged directly on the partners in those entities. Corporate partners are charged at the rates above. Individual partners have a personal allowance for the first £12,570 (this is reduced by £0.50 for every pound of income over £100,000, and so an individual with income over £125,140 has no allowance); thereafter, the rates are 20% for income up to £50,270; 40% for income up to £150,000; and 45% for any income above that.

There are different income tax rates for individuals resident in Scotland, ranging from 19% for income up to £14,550 to 46% for income above £150,000 (the same personal allowance applies). Individuals must also pay National Insurance contributions (NICs) on trading income (but not investment income; there are different rules for employment income). Current rates are a further flat rate of £156 per annum, plus 9% of profits between £8,632 and £50,270, and 2% of profits over £50,270.

Sole traders are charged at the same income tax rates as individuals who are partners in a partnership.

Capital profits made by individuals on any assets other than non-business residential property, whether on their own account as sole traders or as partners in a partnership, are charged normally at 20% (where the person pays income tax at the rate of at least 40%). Individuals who have owned a business (whether shares in a private company, as partners in a partnership, or as a sole trader) for at least two years and (in the case of a company) have been a director for at least that time can pay a reduced rate of tax of 10% on the first £1 million of gains (aggregated over the individual's lifetime).

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The taxation of profits for business entities depends on the form of the entity.

For a company, broadly, revenue profits are calculated for its trading activities, any property-based activities and investment activities. Any capital profits (for example, on the sale of capital assets) are also calculated. Revenue and capital profits are then combined and charged at the tax rates set out above. Revenue profits are based on accounting profits. Essentially, receipts are calculated on an earnings basis (for trade and property businesses).

Expenses incurred wholly and exclusively for the purpose of the business are deducted, again on an earnings basis, from trading and rental receipts. Certain types of expense, such as capital expenditure, are excluded (but can be deducted elsewhere: for example, capital expenditure can be deducted when disposing of the asset acquired). Loan relationships and similar transactions, as well as intangibles, are the subject of specific regimes that are basically aligned with their accounting treatment, with profits and losses taxed as revenue items. There are a variety of reliefs for certain elements of receipts. For example, where a company has a substantial shareholding in another trading company or trading group (generally 10% or more of shares in topco), any gain on a sale of shares is exempt from tax.

A limited liability partnership is a body corporate for the purposes of general law. However, as above, it is tax transparent. Accordingly, its members are taxed by reference to their own status and circumstances. Corporate members are taxed as above. Individual members are taxed as if they were sole traders. Thus, they likewise calculate their profits on an earnings basis, deducting revenue expenses incurred wholly and exclusively for the purpose of the trade.

Capital expenses are excluded from deduction, as are various other specific types of expense, such as entertainment; any bad debt provision (actual bad debts are deductible); and certain salaries paid to employees, unless and until the employees actually receive them. However, rules such as those applicable to loan relationships and intangible assets of companies do not apply to individuals. They are treated broadly as capital assets, and therefore subject to capital gains tax at the rates applicable to individuals (although, for example, debt is generally not an asset for capital gains tax purposes). In addition, certain types of capital expenditure give rise to deductions against trading profits by way of capital allowances. The most important types of expenditure are on plant and machinery, and research and development.

2.2 Special Incentives for Technology Investments

There are a number of special rules for technology investments.

First, research and development expenditure incurred for the purposes of a trade (including a trade that the taxpayer intends to commence, even if, ultimately, it does not) is subject to enhanced deductions from profits. Thus, small and medium-sized enterprises can claim a deduction of 230% of the amount actually incurred on research and development. Alternatively, they can claim a credit against other taxes paid equal to 12% of the amount spent on research and development. The latter is claimable also by large companies. For SMEs, there will be introduced, from 1 April 2021, a cap of £200,000, plus three times the company's total PAYE and NICs liability, on the amount that may be reclaimed by credit in any one year.

In addition, capital expenditure on research and development for the purposes of a trade (again, including an intended trade) gives rise to writing down allowances of 100% in the accounting period in which the expenditure is incurred. These allowances may be deducted against trading profits (so that relief is obtained as revenue profits are earned, rather than waiting for the sale of the asset). On the sale of any asset that has been created by the expenditure, the disposal proceeds must be brought into account. This has the effect that only net expenditure receives relief, and any profit is taxed.

Other capital expenditure relating to the creation of intangible assets is relieved according to the provisions applying to intangible assets. Tax on this expenditure follows the accounting treatment.

There is currently a patent box system in the UK. Any corporate profits that derive from patents registered in the European Economic Area (whether nationally or with the European Patent Office) are subject to corporation tax at the lower rate of 10%. To qualify, the taxpaying company must either own the patent or have an exclusive licence to exploit it. The income to which the reduced rate applies is income from marketing patented goods or marketing the actual patent. It applies also to profits from using a patented manufacturing process, or providing services using a patented tool.

2.3 Other Special Incentives

A variety of special incentives apply to a range of industries, transactions or businesses.

For example, the investment industry receives a variety of beneficial tax regimes. Investment trusts and real estate investment trusts are free of UK corporation tax on profits.

There are special capital allowances for expenditure on renovating business premises; that is, premises that have fallen out of use and are being renovated so as to be used once again for the purposes of a trade or profession.

Commercial woodlands are outside the scope of tax on revenue profits altogether.

On the other hand, for a number of years there has been a focus on disincentives to certain industries and activities. For example, airplane passenger duty is intended to deter people from flying, landfill tax is intended to deter disposal of waste to landfill (and encourage re-use and recycling of material) and soft drinks levy is intended to make drinks that are relatively high in sugar more expensive. A new plastic packaging tax is to be introduced from April 2022: this will apply to packaging that contains less than 30% recycled plastic.

2.4 Basic Rules on Loss Relief

General Rules

The ability to obtain corporation tax relief for (income) losses is dependent on both the type of loss (ie, its source) and (in relation to carry-forward relief) when it originally arose. The main loss relief categories are trading losses and non-trading deficits (non-trading deficits are basically losses from a company's debt and derivative financial instruments, excluding those held on trading account). Relief can also be available for other types of losses (including losses arising in a property business and, for companies that carry on an investment business, management expenses).

Corporate Income Loss Restriction

Major reforms of the UK's corporation tax rules relating to carry-forward relief took effect in 2017. Under those reforms, carry-forward relief for income losses is subject to a cap under the UK's corporate loss restriction (CILR). In broad terms, CILR limits loss carry-forward relief to no more than 50% of future profits (subject to a (group) annual allowance of £5 million a year, which is only available if certain administrative requirements are met). From 1 April 2020, the (group) annual allowance – the deductions allowance – applies to both CILR and the corporate capital loss restriction (CCLR), which imposes a similar restriction on the use of carry-forward capital losses (see **2.7 Capital Gains Taxation**).

Trading Losses

A company can obtain relief for its trading losses in one of three ways: carry back, same year or carry forward.

Carry-back relief generally allows a company to offset trading losses arising in a particular accounting period against any profits of the preceding 12 months (subject to special rules on cessation of a trade that can extend that period to three years). However, as part of its response to COVID-19, the UK government announced in March 2021 that for losses arising in an accounting period ending between 1 April 2020 and 31 March 2022, a temporary three-year carry-back will apply (subject to a £2 million cap). Same-year relief allows a trading loss to be offset against any other profits of the same period. Both carry-back and same-year relief must be claimed.

The nature of carry-forward relief depends on when the trading loss arose. Trading losses that arose up to 31 March 2017 carry forward automatically to offset against profits of the same trade (subject to the company claiming not to use them). However, for trading losses that arise on or after 1 April 2017, carry-forward relief is available against any type of profit (subject to a claim being made). In both cases, carry-forward relief is subject to the cap under CILR.

Non-trading Deficits

The rules for non-trading deficits are similar: here, although same-year relief allows offset against any profits, carry-back relief is more limited (to offset against profits under the UK's loan relationship rules only).

In relation to carry-forward relief, non-trading deficits that arose up to 31 March 2017 carry forward to offset any non-trading profits of the same company (basically, any profits other than trading profits) whereas for non-trading deficits that arise on or after 1 April 2017, carry-forward relief allows offset against any profits (subject to a claim being made). Again, in both cases, the cap under CILR applies to limit carry-forward relief.

Group Relief

In addition, the UK has rules that allow losses to be surrendered between companies that are members of a group. Originally, group relief only allowed a company to surrender current-year losses to another group company (in the same accounting period). But, for losses that arise on or after 1 April 2017, group relief is now available on a carried-forward basis, although again subject to the cap under CILR. See **2.6 Basic Rules on Consolidated Tax Grouping** for further information on the UK grouping rules.

Non-resident Companies and Property Losses

From 6 April 2020, a non-UK-resident company that carries on a UK property business becomes subject to corporation tax (having previously been subject to income tax on rental income). If that non-resident has any carry-forward (income tax) property losses at that time, transitional rules allow those income tax losses to be offset against future (corporation tax) profits of the property business.

2.5 Imposed Limits on Deduction of Interest

Relief for interest and equivalent financing costs is generally provided for under the UK's loan relationship regime, with interest generally being a deductible expense (and relief given broadly in accordance with accounting treatment). For trading companies, relief for interest costs on trade debts will generally be given as a trading expense; in other cases, relief will be given in the form of a non-trading deficit (for further information, see **2.4 Basic Rules on Loss Relief**).

UK tax legislation contains a number of rules that restrict or deny relief for interest expense. These include provisions that can deny deductibility where the relevant debt is quasi-equity in nature as well as transfer pricing rules that limit interest deductions to the arm's-length amount, and various targeted anti-avoidance rules.

Corporate Interest Restriction

In response to the OECD BEPS Action 4 recommendation, the UK introduced a corporate interest restriction (CIR) in April 2017. The rules are complex, and, in addition to reducing the amount of tax relief given for interest, impose significant compliance obligations on groups.

Under CIR, relief for (net) interest and equivalent financing costs is limited to a percentage of a group's taxable earnings before interest, taxes, depreciation and amortisation (EBITDA). That percentage will generally be 30% under the fixed ratio but groups can elect for the "group ratio" instead. The group ratio (in broad terms) is calculated using accounts numbers and is basically the ratio that the group's third-party (net) interest expense bears to its EBITDA. Whichever ratio applies, the CIR rules also apply a debt cap, which can further limit interest relief by reference to the group's overall external (ie, third-party) interest costs. As a result, groups with a high level of related-party debt are likely to find their ability to get tax relief for interest costs restricted under CIR.

The UK CIR rules include an annual de minimis of £2 million (so groups with no more than £2 million net interest expense should not, in practice, find their interest costs restricted). Plus, there is a (limited) exemption available for certain infrastructure and UK property businesses that meet a "public benefit" test: to benefit from this exemption, a company must meet certain detailed conditions as to its activities and elect in.

From 6 April 2020, non-UK-resident companies that own UK land and carry on a property business will become subject to corporation tax and, as a result, CIR.

2.6 Basic Rules on Consolidated Tax Grouping

The UK does not offer a fiscal consolidation regime. Instead, individual companies file and pay corporation tax on a standalone basis.

However, under CIR, CILR and CCLR, a company may have to have regard to the tax profile of other companies within its group when working out its own taxable profits. This is because, under CIR, the interest restriction is worked out at group level ("group" for these purposes means an International Accounting Standards consolidated group); for CILR and CCLR this is because the £5 million annual allowance is a group allowance and so shared between group companies.

In addition, the UK has a number of distinct "grouping" provisions for different taxes that go some way to alleviating some of the tax/economic mismatches that could otherwise arise for groups under a pure "solus" tax system.

As each type of "group" has its own rules, care is needed as it is possible for two companies to be grouped for one particular purpose, but not for others.

Group Relief Group

One of the most important UK tax "groups" is the group relief group.

Companies that are members of a group relief group can surrender (income) losses between each other, both on a same-year and (for losses arising on or after 1 April 2017) carry-forward basis (see **2.4 Basic Rules on Loss Relief**). For group relief purposes, companies are members of the same group if one is a 75% subsidiary of the other or both are 75% subsidiaries of a third company. In determining whether a company is a 75% subsidiary of another company, account is taken of both ownership of ordinary share capital and effective economic ownership (which takes account of rights a person has as a creditor under loans that have equity-like features). The group relief rules also include specific anti-avoidance provisions; for example, group relief is not available if there are arrangements for one of the companies concerned to leave the group.

Capital Gains Group

Another important UK tax grouping is the capital gains group.

If a company that is a member of a capital gains group transfers an asset to another group member, that transfer should normally be capital gains tax-free (it is treated as taking place on a no gain/no loss basis). However, if the transferee subsequently leaves that group within six years, there could be a degrouping charge. Members of a capital gains group can effectively offset capital losses of one against gains of another – this is done by the relevant group companies jointly electing that the gain (or loss) is transferred by one to the other. Where, as a result of an election, a group company is looking to offset carry-forward capital losses against gains, CCLR applies (see **2.7 Capital Gains Taxation**).

The capital gains group definition, like group relief, requires ownership of 75% of ordinary share capital, but in testing effective economic ownership, a lower threshold of 51% applies.

Stamp Duty Group

Specific grouping rules apply for the purposes of certain UK transfer taxes, including stamp duty (in relation to shares and securities) and stamp duty land tax (SDLT) (in relation to land in England and Wales). Under these grouping rules, assets can be transferred between group companies without stamp duty/SDLT being chargeable (as applicable). The group definition here is very similar to that which applies for group relief (namely, the 75% subsidiary test), but is subject both to specific anti-avoidance provisions (and, in relation to SDLT, degrouping provisions).

2.7 Capital Gains Taxation

The UK distinguishes between income and capital gains for tax purposes. For companies, capital gains and losses arising on sales or other disposals of assets are calculated separately, with net chargeable gains included in the company's total profits and taxed at normal corporation tax rates.

CCLR

Capital losses can only be offset against capital gains, and then only against capital gains that arise in the same or a future accounting period. The CCLR applies to carry-forward capital losses from 1 April 2020. Under CCLR, carry-forward capital losses can only be used to offset no more than 50% of future capital gains (subject to the £5 million (group) annual allowance that, as mentioned in **2.4 Basic Rules on Loss Relief**, now applies to both income and capital losses).

Reliefs

The UK capital gains rules include a number of capital gains exemptions and reliefs, many of which are relevant for trading businesses only. For example, the substantial shareholding exemption (SSE) provides an exemption from capital gains tax for gains arising on the sale of a "substantial shareholding" in a trading company (in broad terms, a holding of at least 10% held for a continuous period of at least 12 months can qualify as a substantial holding).

In addition, where a trader sells an asset used in its business, it may be able to "roll over" (and so defer) any gain on that sale if it reinvests in a replacement business asset within a specified period (basically, one year before the disposal to three years after). This only applies to certain specified categories of asset (including land used for business purposes), and any "rolled-over" gain is realised when the replacement asset is sold.

There are also specific deferral reliefs that apply to certain types of share reorganisation and/or corporate reconstruction provided the relevant transaction is carried out for bona fide commercial purposes (and not tax avoidance).

Until December 2017, companies could benefit from indexation allowance when computing their capital gains to allow for the effects of inflation. Indexation allowance ceased to be available from 1 January 2018, as a result of which, for assets owned prior to that date, indexation is now calculated up to December 2017.

2.8 Other Taxes Payable by an Incorporated Business

Other taxes that an incorporated business may have to pay include value added tax (paid as part of the price of goods or services purchased but sometimes capable of being recovered from HMRC through a VAT return); income tax (which may have to be withheld from interest payments, or payments of patent royalties, and paid over to HMRC); and other indirect taxes, payable as part of the price to a supplier, can also be charged, such as landfill tax, airplane passenger duty and insurance premium tax. The import of goods attracts customs duty, and the manufacture of certain goods (mainly alcohol, tobacco and petroleum-based products) attracts excise duty.

2.9 Incorporated Businesses and Notable Taxes

The main other taxes to which incorporated businesses may be liable are local taxes on property. Thus, occupation of commercial property attracts non-domestic rates. These are a form of levy that is charged by local government. It is charged by reference to the value of the property in question. The rate is fixed annually by the relevant local authority, at a percentage of the value of the property.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

In the UK, most closely held local businesses operate in non-corporate form. Thus, the majority of small businesses are sole traders. According to the Federation of Small Businesses (a UK trade organisation representing small businesses), there were approximately 5.8 million small businesses in the UK at the start of 2019, out of a total number of private sector businesses of about 5.9 million. Of the 5.8 million small businesses, approximately 3.5 million were sole traders, 2 million were companies, and 400,000 were partnerships.

3.2 Individual Rates and Corporate Rates

In general, if corporate rates are lower than individual rates, there are no tax rules to prevent "genuine" professionals taking advantage of the lower corporate rates. Certain professions (for example, the Bar) have a code of conduct that prevents members from operating through the medium of a company. However, as a generality, professionals are free to carry on business in any form they choose, including corporate form.

However, there is a wide range of anti-avoidance rules aimed at preventing individuals who would otherwise count as employees from incorporating and seeking to provide their services through companies in order to reduce their tax rates. In particular, individuals who provide services personally to a client via a company, and over whom the client is entitled to exercise the control normally associated with an employer, are taxed in effect as if they were employees (although any expenses that would be deductible by an employee can be deducted from profits). Where the client of such an individual is either a public body or a medium-sized or large enterprise, the client must operate a payroll deduction system in the same way as for direct employees.

3.3 Accumulating Earnings for Investment Purposes

There are no specific rules preventing closely held corporations from accumulating earnings for investment purposes.

However, beneficial treatment is often given to holders of shares in trading companies that is not available to holders of shares in investment companies. For example, business asset disposal relief on the disposal of shares in a company is limited to shares in companies whose sole or main purpose is trading. Rollover relief from capital gains tax is available where shares in a private trading company are sold and the proceeds used to invest in shares of another private trading company. Inheritance tax relief is available on the value of shares held by a deceased in a company whose sole or main purpose was not making or holding investments.

3.4 Sales of Shares by Individuals in Closely Held Corporations

Individuals are taxed on dividends from closely held companies in the same way as from any other company. Thus, the first £2,000 of dividend income attracts no income tax. Thereafter, the rate is 7.5%, 32.5% or 38.1%, depending on the amount of the individual's total income.

The sale of shares is taxed as a chargeable gain, at the rate of 20% on the profit on sale (deducting, for example, the costs of acquisition; the costs of establishing and defending title to the shares; the costs of marketing the shares; and the costs of sale, including, for example, professional fees such as lawyers, accountants and so on). Where an individual owns at least 5% of the ordinary share capital in a trading company that is not publicly traded, and has done so, and has also been a director, for at least two years, business assets disposal relief (previously entrepreneurs' relief) may be available. This relief reduces the tax rate to 10% of the gain on disposal. Any individual may claim entrepreneurs' relief on up to £1million of gain in the course of his or her lifetime.

Anti-avoidance provisions apply. These are the so-called transactions in securities provisions. Thus, where shares are disposed of in circumstances where the sale has a sole or main purpose of avoiding income tax, an individual may be obliged to pay the difference between the capital gains tax actually due and the income tax that would have been due on a dividend up to the amount of the company's distributable profits at the time of the sale. The purpose of these provisions is to prevent the building up of a cash reserve that is sold rather than distributed, and to prevent the sale of shares to be paid from future revenue profits.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals are taxed on dividends from publicly traded companies in the same way as from any other company. Thus, the first £2,000 of dividend income attracts no income tax. Thereafter, the rate is 7.5%, 32.5% or 38.1%, depending on the amount of the individual's total income. Relief is available for dividends paid by certain collective investment vehicles, such as venture capital trusts. Dividends from those types of company are free of income tax.

The sale of shares is taxed as a chargeable gain, at the rate of 20% on the profit on sale (deducting, for example, the costs of acquisition; the costs of establishing and defending title to the shares; the costs of marketing the shares; and the costs of sale, including, for example, professional fees such as lawyers, accountants and so on).

Anti-avoidance provisions apply. These are the so-called transactions in securities provisions. Thus, where shares are disposed of in circumstances where the sale has a sole or main purpose of avoiding income tax, an individual may be obliged to pay the difference between the capital gains tax actually due and the income tax that would have been due on a dividend up to the amount of the company's distributable profits at the time of the sale. The purpose of these provisions is to prevent the building up of a cash reserve that is sold rather than distributed, and to prevent the sale of shares to be paid from future revenue profits. However, it is only in exceptional circumstances that these provisions could apply where the shares are in a company listed on any stock exchange.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

UK withholding tax generally applies to payments of interest to non-UK residents, subject to the availability of an exception. The rate of withholding tax on interest is currently 20% (the basic rate of income tax).

There are a number of possible exceptions, including where the non-resident is eligible for relief from UK tax under the terms of an applicable double tax treaty. Where a non-resident wishes to rely on the terms of an applicable double tax treaty to receive interest gross, it must submit a claim to HMRC. If HMRC accepts that relief is available, it will authorise the payer to pay that interest gross, but until that authorisation is received, UK withholding will apply.

Other exemptions under domestic UK law include the quoted Eurobond exemption (which applies to listed debt securities and is intended to facilitate capital raising through the capital markets) and an exemption for (third-party) private placements that meet various conditions. In addition, the UK has a treaty "passport" scheme that allows (registered) treaty-eligible non-residents to fast-track treaty clearance – this is commonly used by participants in the syndicated loan market.

UK withholding tax does not apply to payments of dividends by UK companies (save where the dividend is a "property income dividend" paid by a UK REIT).

UK withholding tax can apply to patent, copyright and design royalties, again subject to relief under an applicable double tax treaty. Following the UK's departure from the EU, the

UK government has announced that, from June 2021, UK companies will no longer be able to benefit from a specific withholding exemption that applied to payment of interest or royalties to an EU company, with relief only then being available under an applicable double tax treaty.

UK withholding tax can also apply to rent from UK land payable to a non-resident, although if the non-resident undertakes to HMRC that it will meet all its UK tax obligations, it should be able to receive gross payment of rents under the UK's Non-Resident Landlord Scheme.

4.2 Primary Tax Treaty Countries

The UK has an extensive network of double tax treaties: details of the UK's treaties are published by HMRC (see www.gov.uk/government/collections/tax-treaties, accessed 1 March 2021).

Figures from the UK's Office for National Statistics indicate that, in 2018, the four jurisdictions with the highest levels of foreign direct investment into the UK were the USA, the Netherlands, Jersey and Luxembourg (with the same report noting that, looking at indirect (or ultimate) investment, the highest levels came from the USA, Japan and Germany).

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

The UK is a signatory to the Multilateral Instrument (MLI) that implements a number of the OECD's BEPS recommendations, including the adoption of a principal purpose test in affected treaties that is intended to give countries the ability to deny treaty benefits in cases of treaty shopping.

The MLI came into force in the UK on 1 October 2018, and already applies to a number of the UK's double tax treaties (and will apply to others as and when the MLI is ratified by other countries). Given the complexities involved in determining both how and when the MLI takes effect in relation to a particular treaty, HMRC is publishing synthesised texts of individual "updated" treaties online as and when MLI-related changes are to take effect.

In addition, if HMRC considers that a non-resident is treaty shopping, it may use the Indofood principle and apply an "international fiscal meaning" of beneficial ownership to deny treaty relief.

The UK has recently introduced measures that extend the territorial scope of UK tax, particularly in relation to non-residents that own UK land. These measures generally include a specific treaty-related anti-forestalling rule, intended to discourage non-residents from treaty shopping in advance of these new measures coming into force.

4.4 Transfer Pricing Issues

The biggest transfer pricing issue for inbound investors is not so much the amount of tax that may be required to be paid, but the energy that may have to be devoted to a lengthy enquiry from HMRC (which may not result in any significant amount of tax being payable).

4.5 Related-Party Limited Risk Distribution Arrangements

The authors are not aware of any systematic challenge by HMRC of limited risk distribution agreements (in other words, there is always a risk of challenge by HMRC to a corporation's tax return and assessment, but no specific risk arises in relation to related-party limited risk distribution agreements).

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

UK transfer pricing rules apply not only in an international context but also in a domestic context; that is, the rules apply also to transactions between UK-resident companies in the same group. Where the potentially advantaged corporation is a small or medium-sized entity, transfer pricing provisions do not apply, except on an opt-in basis. Advance pricing agreements can be a useful way of minimising risk and uncertainty.

4.7 International Transfer Pricing Disputes

The authors are not aware of any data as regards the frequency with which international transfer pricing disputes are resolved through double tax treaties and mutual agreement procedures. In general, HMRC tends to look favourably upon the resolution of disputes by means other than litigation. The authors expect that this attitude prevails in relation to mutual agreement procedures covering transfer pricing disputes.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When transfer pricing claims are settled, compensating adjustments are allowed to the other party.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Broadly, the basis of taxation of local permanent establishments of non-resident companies is limited to taxation of profits of any trade carried on through the permanent establishment, and UK-sited capital assets used for the purposes of the establishment's trade. By contrast, local subsidiaries of non-resident companies are subject to worldwide taxation.

5.3 Capital Gains of Non-residents

Prior to 6 April 2019, the general rule was that a non-resident company was outside the scope of UK capital gains tax (other than in relation to certain disposals of residential property).

Since 6 April 2019, gains and losses realised by a non-resident that makes a direct or an indirect disposal of UK land is within the scope of capital gains tax (for individuals) or corporation tax (for companies). In working out any gain, the base cost is generally taken as the market value of the relevant asset as at 6 April 2019 market value, subject to the company being able to elect to use actual base cost instead (for certain residential property, the default is April 2015 market value).

A non-resident makes a direct disposal where it sells UK land directly.

A non-resident makes an indirect disposal of UK land where it makes a disposal of (all or part) of its holding in a company that is "UK property-rich" where, at the date of the disposal, the non-resident holds (or has in the previous two years held) a minimum 25% interest in that company. In determining if this minimum ownership test is met, account can be taken of interests held by connected persons in that two-year period.

A company will be "UK property-rich" if 75% or more of the gross value of its assets derives from UK land, taking account of both directly and indirectly held assets.

Normal capital gains rules apply in working out any gain on a direct or indirect disposal, including reliefs (like SSE; see **2.7 Capital Gains Taxation**). Indirect disposals also benefit from a specific exemption where the company being sold is a trading company and the vast majority of the land it owns is used for the purposes of its trade.

A limited number of the UK's double tax treaties restrict the UK's taxing rights in relation to capital gains for eligible non-residents. Given these treaties, the indirect disposal provisions include a treaty override to counter treaty shopping.

There are special rules that apply where the company being sold is, or is part of, a collective investment vehicle.

5.4 Change of Control Provisions

Changes in ownership amounting to a change in control can lead to a company's ability to access loss relief (both on a carry-forward and carry-back basis) being restricted where the profits against which the loss is to be offset arise under different corporate ownership.

There are also restrictions on the use of capital losses where a company with capital losses joins a new group.

Change of control rules also apply under CIR, where they can limit carry forward of interest allowance under the CIR regime (interest allowance being the amount of interest a group is entitled to get relief for in a particular period).

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

The authors are not aware of formulas being used to determine the income of foreign-owned local affiliates selling goods or providing services.

5.6 Deductions for Payments by Local Affiliates

The standard applied is that of an arm's-length transaction; that is, a deduction will be allowed if the amount would reasonably have been incurred between parties at arm's length.

5.7 Constraints on Related-Party Borrowing

As mentioned in **2.5 Imposed Limits on Deduction of Interest**, UK tax legislation contains a number of rules that restrict or deny relief for interest expense. These rules generally apply whether or not a borrowing is a related-party borrowing: however, for related-party borrowings, particular issues may arise under the transfer pricing rules and/or as a result of the exclusion of related-party debt if using the group ratio under CIR.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

Foreign income of UK-resident companies is liable to tax on the same basis as profits from UK activities. Relief may be available pursuant to double tax treaties, and a credit may be available for foreign taxation.

6.2 Non-deductible Local Expenses

UK-incurred expenses are deductible in general only in so far as they are incurred "wholly and exclusively" for the purposes of earning taxable income. Accordingly, on general principle, expenses that are incurred for the purpose of earning exempt income of any sort, including exempt income that arises abroad, are not deductible against other income.

6.3 Taxation on Dividends from Foreign Subsidiaries

The general rule is that dividends received from foreign companies, including subsidiaries, are taxable. This is subject to a number of exceptions.

Where the receiving company is a small company, the distribution is exempt if all of four conditions are satisfied:

- if paid by a company in a qualifying territory (in short, a territory with a sufficiently high corporation tax rate);
- it is not on a non-commercial security;
- there is no deduction allowed for the dividend by any person outside the UK; and
- the distribution is not part of a scheme to avoid tax.

Otherwise, to be exempt, a distribution must also meet one of five criteria:

- the payer is controlled by the recipient, or the recipient plus one other entity;
- the distribution is on non-redeemable ordinary shares;
- the distribution is of a portfolio holding (broadly, the recipient has a less than 10% interest in the payer);
- the dividends are paid otherwise than from profits arising from transactions whose sole or main purpose is tax avoidance; and
- the dividends are paid on shares that would be accounted for as a liability if they were held for the purposes of tax avoidance.

Thus, in short, dividends from controlled subsidiaries are exempt provided the subsidiary is in a jurisdiction with an acceptable corporation tax rate, the security is not a non-commercial security, and there is no deduction for any person outside the UK for the dividend from taxable profits of some form.

6.4 Use of Intangibles by Non-local Subsidiaries
Assuming intangibles developed by a UK-resident company remain owned by it, the use of the intangible by a non-UK resident subsidiary will be subject to transfer pricing rules.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules
UK-resident companies are taxed on the income of foreign companies they control where such foreign companies are located in territories listed in secondary legislation. Relevant foreign territories are, broadly, those with an insufficiently high rate of corporation tax. There are a variety of exemptions; for example, where the foreign entity's profits are less than £50,000, or its profit margin is less than 10% by reference to operating expenditure. Profits of non-UK branches of UK-resident companies are fully included in the UK corporation tax calculation, subject to credit for foreign tax actually paid.

6.6 Rules Related to the Substance of Non-local Affiliates
No information has been provided in this jurisdiction.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates
UK-resident companies pay corporation tax at the normal rate on gains from the sale of shares in non-UK subsidiaries or associated companies. However, the substantial shareholdings exemption applies on the same conditions as it applies to UK-resident subsidiaries or associated companies. Key points are whether the shares held in the foreign subsidiary count as ordinary share capital on the UK definition of that term, and whether the foreign entity is classified as a company for UK tax purposes.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions
There is a general anti-abuse rule in place in the UK. This allows HMRC to adjust a company's tax return where the company has entered into arrangements designed, in short, to take advantage of any shortcomings or loopholes in the UK tax system. The legislation gives, by way of example of the criteria to be considered:

- whether the substantive results of the arrangements are consistent with the principles on which the relevant legislation is based;
- whether the arrangements involve any contrived or abnormal steps; and
- whether the arrangements are intended to exploit any shortcomings in the legislation.

There are significant procedural steps to be completed before any adjustments can be made, including reference to an independent panel. Significant penalties apply if a taxpayer enters transactions within these provisions.

8. Audit Cycles

8.1 Regular Routine Audit Cycle
The frequency of tax investigations depends on a variety of factors, including size of the taxpayer. Large corporates can expect to have ongoing dialogue with specific individuals in HMRC who are responsible for considering their tax affairs.

9. BEPS

9.1 Recommended Changes

The UK is an active supporter of the OECD BEPS project and has implemented many of its recommendations. The UK has enacted legislation to implement BEPS Action 2 (hybrid instruments) and BEPS Action 4 (interest restriction), and has also modified its patent box rules (BEPS Action 5).

The UK government has also introduced country-by-country reporting (BEPS Action 13) using the OECD template; this came into effect in January 2016.

The UK is a signatory to, and has ratified, the MLI (BEPS Action 6 and BEPS Action 15), and has adopted some (but not all) of the recommended changes to "permanent establishment" (BEPS Action 7).

There have been no changes to the UK's CFC rules as the UK considers them to be compliant with BEPS Action 3. Similarly, the UK has not introduced specific measures in relation to BEPS Actions 8–10 and 13 (transfer pricing) as its rules already follow OECD guidelines. On BEPS Action 14 (dispute resolution), the UK is committed to mandatory binding arbitration.

In relation to BEPS Action 12 (disclosure), in January 2020 the UK enacted the EU's DAC 6 Directive (Mandatory Disclosure) into domestic law, under which details of certain cross-border arrangements need to be reported to HMRC (supplementing the UK's existing disclosure of tax avoidance schemes regime). However, following the end of the EU transitional period on 31 December 2020, the UK announced that it would no longer be implementing DAC 6 but would instead be adopting disclosure rules based on the OECD's model Mandatory Disclosure Rules (MDR).

On the digital economy (BEPS Action 1), see **9.12 Taxation of Digital Economy Businesses**.

9.2 Government Attitudes

As above, the UK has been actively involved at the OECD in relation to the BEPS project. It is also keen to see reform to the taxation of digital companies – and has recently introduced unilateral measures in advance of an OECD solution (see **9.13 Digital Taxation**).

9.3 Profile of International Tax

International tax has a high profile in the UK, particularly following the Paradise Papers investigation of 2017 and the recent introduction of a digital services tax (DST).

9.4 Competitive Tax Policy Objective

The UK participated heavily in the BEPS project, and either was already compliant with or has so far implemented a significant number of BEPS measures. It is likely that, politically, tax competition will be restricted in the future, not only because of BEPS but also other, more general political pressures.

9.5 Features of the Competitive Tax System

No response has been provided in this jurisdiction.

9.6 Proposals for Dealing with Hybrid Instruments

The UK was one of the first countries to implement anti-hybrid measures compliant with BEPS Action 2, replacing more limited rules that had been originally introduced in 2010. The rules are very detailed and complex and are very wide in scope. As well as double-deduction mismatches and deduction/non-inclusion mismatches, the rules cover "imported mismatches" (meaning that they can apply where the UK borrower is party to a "vanilla" loan if somewhere else in the funding chain there is a mismatch).

The rules have been subject to various technical amendments since 2017. In 2020, the UK government announced a number of detailed changes to the hybrids rules, with legislation to implement them expected in 2021.

Extensive guidance and commentary has been published by HMRC to assist taxpayers and their advisers with making sense of the rules. Even with the help of the guidance, the rules are challenging to apply in practice, and concerns have been expressed that the rules can apply in unexpected circumstances.

9.7 Territorial Tax Regime

The UK has a mixed system, in that companies resident in the UK, whether because that is the place of their incorporation or because central management and control is exercised there, are taxed on worldwide profits; whereas permanent establishments of non-UK resident companies are taxed on the profits of their UK activities. It is difficult to foresee how interest deductibility changes will affect people investing in and from the UK.

9.8 CFC Proposals

The UK does not have a territorial tax regime for UK-resident companies.

9.9 Anti-avoidance Rules

Certainly, the UK is now seeking to have limitation of benefit and/or anti-avoidance rules in double taxation conventions (DTCs) it negotiates. However, the effect is difficult to foresee, other than a reduction in the abuse of UK DTCs.

9.10 Transfer Pricing Changes

The transfer pricing changes are unlikely to give rise to any radical changes in the UK transfer pricing rules. Taxation of profits is a source of controversy because certain well-known companies are notorious for locating their intellectual property in related companies in low-tax jurisdictions in order remove profits from the UK tax net, while, on the other hand, the UK has adopted a patent box regime that is regarded by a number of other countries, including member states of the EU, as overly competitive.

9.11 Transparency and Country-by-country Reporting

The UK has already implemented the proposals for transparency and country-by-country reporting. It is not easy to identify any disadvantages resulting from them.

9.12 Taxation of Digital Economy Businesses

The UK introduced the diverted profits tax (DPT) in 2015, which was (in part) directed at digital businesses that structured their activities to avoid a permanent establishment. The tax, currently charged at 25%, is charged by reference to the “diverted” profits, with companies under an obligation to notify HMRC if they are potentially within its scope. The rate was deliberately set higher than the rate of corporation tax to encourage companies to restructure their operations (to fall within corporation tax instead). With corporation tax rates set to increase in April 2023, the UK government has announced that DPT will also then increase – to 31%.

In 2019, HMRC launched a Profit Diversion Compliance Facility to encourage businesses effectively to self-report non-compliance with DPT and agree arrangements for paying any additional tax (and applicable interest/penalties).

9.13 Digital Taxation

The UK introduced a digital services tax in 2020 that is intended to tax the value attributable to UK-based users of the relevant digital services, rather than by reference to whether the business has a presence in the UK. The DST is a 2% tax on revenues from UK-based users of digital services businesses that provide an online marketplace, a social media platform and/or an internet search engine. DST is worked out at group level and is chargeable whether or not the group has a physical presence in the UK. However, it only applies to groups receiving worldwide revenues of at least £500 million from relevant activities, of which £25 million or more derives from UK users – and where DST applies, only UK user revenues in excess of the £25 million threshold are subject to the tax. It applies from 1 April 2020. The DST also contains standalone compliance and reporting rules.

The UK has committed to review the DST before the end of 2025: this reflects the UK’s stated commitment to support the ongoing work at the OECD to agree a multi-country approach to taxing such businesses.

9.14 Taxation of Offshore IP

The UK introduced income tax on offshore receipts in respect of intangible property in April 2019. The tax, in broad terms, applies to certain non-residents who receive amounts in respect of IP that is referable to UK sales of goods and services. Where it applies, tax is charged at a rate of 20% on the gross receipts from the IP (whether income or capital in nature).

A non-resident is in the scope of the tax if it is based in a low-tax jurisdiction (being a jurisdiction that does not have a “full” tax treaty with the UK). There are also a number of exemptions to the tax, including a £10 million de minimis UK sales threshold.

Old Square Tax Chambers is a specialist tax chambers in Lincoln's Inn, London. It comprises 13 barristers, including three Queen's Counsel, all focusing on UK tax matters. All UK taxes are covered, but a significant amount of chambers' work involves offshore matters and clients based outside the UK but with UK interests. Chambers' clients include a mix of HNWIs (most frequently in relation to capital gains tax, income tax and inheritance tax, including UK and offshore trusts) and corporate clients (generally on corporation tax and VAT matters). Property taxes, including stamp duty land tax, are a significant part of chambers' work. Chambers covers both tax advisory work and tax litigation. Advisory work involves one-off transactions (for example, M&A and corporate structuring) and more general tax structuring. Members have appeared in litigation at all levels of the UK court system, including the Supreme Court, and before the European Court of Justice. Recent cases have involved VAT, income tax, national insurance contributions, and HMRC enquiry and investigation powers.

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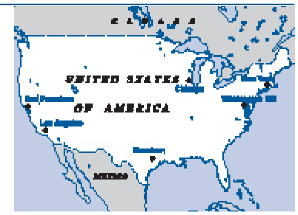

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

In the USA, the four most common forms of business organisations are sole proprietorships, partnerships, limited liability companies (LLCs) and corporations. While the corporation remains the entity of choice for most large businesses, primarily due to liability protection, LLCs have become increasingly popular over the last several decades, and also offer increased liability protection. Each form has distinct tax and non-tax advantages and disadvantages, some of which are discussed below.

An entity's treatment for tax purposes does not need to align with its treatment for non-tax purposes. For example, certain entities can make a "check-the-box" election, which can change the way in which the Internal Revenue Service (IRS) will treat the business for tax purposes. Thus, if an individual sets up their business as an LLC (which is generally taxed as a "pass-through" entity), they can nevertheless choose to have the business taxed as a corporation.

Sole Proprietorships

A sole proprietorship can be used where a single individual owns and operates a business. In such a case, the income and other tax attributes (such as deductions and credits) generated by the business are attributed to the sole proprietor and taxed at the tax rates applicable to individuals. In addition, the sole proprietor is personally liable for all of the obligations of the business (both tax and non-tax). For this reason, new business owners tend to gravitate towards one of the other entity forms that limit the business owner's exposure to the liabilities of the business (eg, an LLC).

General Partnerships

Where two or more individuals own a business together, the arrangement is – by default – treated as a general partnership. In a general partnership, each partner is liable for all of the partnership's obligations, which means that each partner in a general partnership is at risk of losing more than the capital that they contribute to the partnership. In contrast, a limited partnership is an arrangement whereby the business owners enter into a "limited partnership agreement", pursuant to which a single general partner is responsible for the management of the business, and one or more limited partners act as investors, with very limited or no managerial power.

Similar to a general partnership, the general partner in a limited partnership is liable for all obligations of the business. The limited partners, however, are only at risk for their own capital contribution. If a limited partner begins to exercise a level of managerial control indicative of a general partner, however, it could lose its limited liability protection and become exposed to all of the limited partnership's obligations.

Limited Liability Companies

Like a limited partnership, an LLC is an arrangement whereby the business owners ("members") enter into a contract that sets out the rights of each party. Each LLC member's exposure to the LLC's obligations is limited to the amount of that member's individual capital contributions. Unlike a limited partnership, an LLC need not necessarily have a general partner with managerial responsibility and unlimited liability. Instead, the management of the LLC and allocation of liabilities is determined contractually and can involve any number of the LLC's members.

For tax purposes, both partnerships (general and limited) and LLCs are referred to as "pass-through" entities, meaning that the entity's income and other tax attributes (such as depreciation, basis and losses) are attributed to the individual partners or members based on their ownership interest in the entity rather than to the entity itself. Accordingly, the entity itself is not generally subject to taxation. As noted above, however, the members of an LLC may choose to "check the box" and have the LLC treated as a corporation for tax purposes.

Stakeholders generally have the flexibility to allocate the income, losses and tax attributes generated by the entity amongst each other in any way they see fit (subject to certain anti-abuse rules). In light of the flexibility offered by limited partnerships and LLCs, and the fact that they are not automatically subject to tax at the entity level, such entities are often used to form investment funds. In addition, LLCs and partnerships are especially beneficial in business ventures where it is desired that deductions and losses flow through to investors so as to reduce taxable income from other sources.

Corporations

Unlike the pass-through entities described above, corporations themselves are subject to tax. Accordingly, profits earned by a corporation are taxed once at the corporate level and again after they are distributed to the corporation's shareholders as dividends. This "double taxation" is the primary drawback of organising a business in the corporate form.

Despite double taxation, the corporate form remains popular for various reasons, three of which are described below.

- The corporate form is favoured by companies that want to raise capital by issuing widely held, publicly traded securities. This is primarily because corporations are easier to administer than other entity forms, making it simpler to deal with a large number of shareholders.

- Corporations can be used as "blocker entities" to protect foreign or not-for-profit investors from being subject to tax on the business's income, and from being required to file tax returns and deal with the IRS.
- Although people are becoming more familiar with the use of LLCs and partnerships, many people are simply more comfortable using a traditional corporation.

1.2 Transparent Entities

See **1.1 Corporate Structures and Tax Treatment** regarding partnerships and LLCs. A US partnership or LLC generally is treated as a transparent entity for US federal tax purposes unless a "check-the-box" election is made to treat such entity as a corporation. Subchapter S corporations (closely held corporations that elect to be treated as a pass through) and certain trusts also may be fiscally transparent.

1.3 Determining Residence of Incorporated Businesses

The USA taxes residents on worldwide income; for example, all of the profits of a corporation organised in the USA are taxed in the USA, regardless of the country in which such profits are generated. The following summarises how tax residence is determined based on the type of entity.

Corporations

A corporation formed under US federal or state laws is a domestic corporation. Other corporations are foreign corporations. See **5.2 Taxing Differences between Local Branches and Local Subsidiaries of Non-local Corporations** for discussion of the different tax treatment of domestic and foreign corporations, including treaty considerations.

Pass-through entities

As discussed above, partnerships and LLCs are not themselves subject to income tax. Instead, partners and members are taxed based on the underlying investments and activities of the business. Accordingly, the tax residence of partnerships and LLCs (whether or not they are formed in the USA) is less important than where the assets of the business are located and where the business is conducted. For example, a non-US member of an LLC formed outside the USA will still be subject to US tax on its share of income effectively connected to a US trade or business of the LLC. Also, the USA generally imposes tax on any US person who earns income from a flow-through entity regardless of where the business operates. Again, the existence of a tax treaty may affect the analysis.

1.4 Tax Rates

The tax rate on the earnings of a corporation is a flat 21%. Dividends paid to a US person are generally subject to a 20% tax, plus an additional 3.8% "net investment income tax". Dividends paid by a US corporation to a non-US person generally are subject to a 30% withholding tax (subject to reduction by applicable income tax treaties). Accordingly, earnings of a US corporation are subject to two layers of tax that may exceed 40% once the earnings are distributed to its shareholders.

Income generated by pass-through entities is "passed through" to the owners and is therefore subject to taxation at the individual or corporate tax rates, as the case may be. The highest graduated individual tax rate on ordinary income is 37%. The highest graduated rate on net capital gains and qualified dividends is 20%. Individuals are also subject to an additional 3.8% "net investment income tax", which generally applies to passive income (such as dividends, interest and capital gains). Some individuals may be eligible for a 20% pass-through deduction on some or all of their pass-through income.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

A corporation's taxable income is its gross income for the year minus allowable deductions. Gross income is similar but not identical to financial profits and can include receipts from sales, dividends received, interest collected, income from rents and royalty payments, and capital gains. Deductions include all "ordinary and necessary" expenses of the business, which typically include compensation (ie, payroll) and benefits expenses, repairs and maintenance expenses, taxes, licences, interest payments, depreciation and depletion, and advertising and marketing. Corporations generally must calculate gross income on an accrual basis, but certain smaller businesses can account for gross income using a cash or modified cash accounting method.

Corporations are generally taxed equally on all types of income, so there is no reduced rate applicable to corporations for capital gains. Capital losses of a corporation can generally only be used to offset the capital gains, not ordinary income, of the corporation. Generally there are no special exemptions for distributions from the "capital" of a corporation. A distribution is a taxable dividend to the extent the corporation has any current or accumulated earnings and profits (thus payments are deemed to be made out of earnings before they are treated as a return of capital), although a corporation that receives a dividend from another corporation is generally entitled to a "dividends received" deduction ranging from 50% to 100%.

2.2 Special Incentives for Technology Investments

The USA provides special incentives for certain industries and activities, the most important of which are aimed at encouraging corporations to develop new, and refine existing, technology. Corporations may claim a deduction or credit for certain research and experimental expenditures in the experimental or laboratory sense. In addition, a special research credit may be claimed by corporations in connection with incremental research expenses.

2.3 Other Special Incentives

The USA also provides special incentives for a handful of other industries and businesses, including clean energy (eg, advanced energy credit, credit for electricity produced from renewable sources), railroads (eg, railroad track maintenance credit) and pharmaceuticals (eg, orphan drug credit). Businesses should generally consult with their tax counsel or tax preparer to determine their eligibility for special tax credits.

A 100% first-year deduction generally is allowed for certain qualified new and used property acquired and placed in service between 27 September 2017 and 2023.

2.4 Basic Rules on Loss Relief

Rules on Carry-Backs and Carry-Forwards for Corporations

When a corporation operates at a net loss for a given taxable year, it incurs a net operating loss (NOL), which can be used to offset taxable income in other tax years. In general, a corporation cannot use an NOL from a given tax year to offset taxable income from prior years (no "NOL carry-back") but can use the NOL to offset income from future years with no expiry (an indefinite "NOL carry-forward"). The use of an NOL deduction is limited to 80% of income in the year the NOL carry-forward is used. These general rules were modified in March 2020 to permit a corporation to carry back NOLs generated in tax years beginning after 31 December 2017 and before 1 January 2021 for up to five years and to provide that use of NOLs generated in tax years prior to 1 January 2021 is not subject to the 80% income limitation.

Treatment of Capital Gains and Losses for Individuals

In contrast to corporate NOLs, the US tax rules limit an individual's use of certain losses in situations where the individual does not have significant capital "at risk", and where the individual does not materially participate in the business generating the loss. These limitations generally apply to individuals who incur these losses directly or through the ownership of pass-through entities or "closely held" corporations.

For individuals, capital gains and losses are first characterised as long term (underlying asset held for more than one year) or short term (underlying asset held for one year or less). For individuals, short-term capital losses are first applied to offset short-term capital gains. Long-term capital losses are then applied to offset long-term capital gains. If there is a net short-term capital loss, it would then be applied to offset the net long-term capital gain.

If a net capital gain results at the end of this netting process, tax rates lower than the normal tax rates applicable to ordinary income will apply (with some exceptions). If the end result is a net short-term capital gain, instead of a net capital gain computed as described above, that gain would be subject to the same graduated tax rates as ordinary income. If an individual ultimately realises a net capital loss instead, the net capital loss may be used to reduce a limited amount of other income and may be carried over to subsequent years.

Treatment of Capital Gains for Corporations

Corporations do not enjoy preferential tax treatment on their long-term capital gains and there is no deduction against income for capital losses that exceed capital gains. A corporation nets capital losses against capital gains. If the corporation has excess capital losses, the losses are carried back three years or forward five years and applied against capital gains. The losses must be used in the earliest year in which there are net capital gains. Capital losses cannot produce or increase NOLs in the year in which the capital loss is carried back.

2.5 Imposed Limits on Deduction of Interest

Net business interest deductions are generally limited to 30% of the "adjusted taxable income" of the company (with some exceptions). Excess interest deductions may be carried forward to later years. Under the "AHYDO" rules, certain interest on high-yield obligations is deferred or disallowed. Also, US tax rules can treat instruments as equity (resulting in non-deductible dividends or other payments instead of interest), notwithstanding that the instruments are labelled as, or otherwise in the form of, debt instruments. In particular, Treasury regulations can apply to treat certain related-party debt instruments as equity. Other US tax rules can limit deductions connected to acquisitions whose principal purpose is to secure the benefit of a deduction.

Subject to certain income thresholds and elections, there is a limit on a corporation's or pass-through's ability to deduct "net business interest" (ie, business interest expenses minus business interest income). Any business interest deduction disallowed under this limitation generally can be carried forward to future taxable years.

2.6 Basic Rules on Consolidated Tax Grouping

In general, an "affiliated group" of corporations (a chain of corporations owned by a common parent in which 80% of the vote and value of each corporation is generally directly or indirectly owned by the parent corporation) may file a consolidated income tax return covering all group members. Foreign corporations generally may not file a consolidated return.

While there are administrative burdens, one of the most important advantages is the general ability to use losses generated by one corporation in the group to offset the taxable income of another corporation in the group (generally not possible for related corporations that do not file a consolidated return). Inter-corporate dividends for corporations filing a consolidated return are generally not taxed. Inter-corporate profits arising as a result of sales or services exchanged within the group also may be deferred.

2.7 Capital Gains Taxation

Unlike individuals, corporations do not enjoy preferential tax treatment on their long-term capital gains. All capital gains, whether long term or short term, are subject to the corporate tax rate. See discussion in **2.4 Basic Rules on Loss Relief** regarding carry-overs of capital losses.

2.8 Other Taxes Payable by an Incorporated Business

In addition to the US federal income taxes imposed on incorporated businesses, such businesses may also be subject to numerous other taxes, including state, local and municipal income taxes, a range of withholding taxes, sales and other transfer taxes, employment and payroll taxes, and, for non-US businesses, taxes imposed under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

2.9 Incorporated Businesses and Notable Taxes

To prevent companies from stripping earnings out of the USA through deductible payments made to related foreign parties, the USA applies a base erosion minimum tax (BEAT). BEAT applies to corporations with average annual gross receipts of USD500 million or more that made deductible payments to foreign affiliates of at least 3% (2% for banks and securities dealers) of the corporation's total deductions for the year. The tax is structured similar to an "alternative minimum tax".

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses in the USA typically operate in non-corporate form, usually as sole proprietorships, partnerships or LLCs. See **1.1 Corporate Structures and Tax Treatment** for discussion of these pass-through entities.

While partnerships and LLCs are generally the preferred form of entity to operate a closely held business, a Subchapter S corporation is sometimes used (albeit less frequently now that people have become more comfortable using LLCs). A Subchapter S Corporation is a hybrid between a partnership and a corporation where (i) tax is generally not imposed on the entity but instead the income and losses generally pass through to its owners (similar to a partnership for tax purposes) and (ii) it follows certain corporate rules for distributions, redemptions and reorganisations for corporations. Nonetheless, for non-tax purposes, an S corporation must still observe all corporate formalities applicable under state law, and does have the liability protections normally afforded corporations.

In order for a corporation to qualify as a Subchapter S corporation, it must meet numerous requirements, including:

- having 100 or fewer shareholders;
- having no non-US resident shareholders;
- having only one class of stock;
- having only shareholders that are individuals, estates, certain trusts and certain tax-exempt organisations; and
- conducting a business that is not a financial institution, an insurance company or certain other types of businesses.

A Subchapter S Corporation is often the preferred form of entity for a pre-existing corporation seeking to achieve pass-through taxation because the conversion itself does not generally result in tax, whereas a conversion from a corporation to a partnership or LLC would result in a taxable liquidation.

Some closely held US businesses choose to operate as corporations for a variety of reasons, including facilitating an initial public offering and to rely on the robust and settled case law governing corporations in certain states. Additionally, non-US persons generally favour conducting business in the USA through corporations rather than pass-through entities in order to avoid incurring a requirement to file a US tax return, thereby becoming subject to the investigatory authority of the IRS, and due to certain US tax laws that specifically eliminate some of the benefits of pass-through taxation for certain non-US persons.

3.2 Individual Rates and Corporate Rates
While entity-level corporate tax rates may be lower than individual tax rates, various factors and rules exist that discourage individual professionals (eg, architects, engineers, consultants, accountants) from forming corporations taxed as corporations to earn income for their services. As discussed above, corporations and their shareholders are subject to two levels of taxation that, when combined, are greater than the generally applicable individual income rates. Nonetheless, if earnings are not distributed to shareholders, then the corporate form may offer tax savings.

Accordingly, there are rules governing personal service corporations that prevent individual service providers from utilising corporate entities to reduce their tax burden. A personal service corporation performs personal services as its principal business, and such services are substantially performed by the corporation's employee-owners. If a corporation is a personal service corporation, the IRS may allocate the income, deductions, credits, exclusions and other allowances of the corporation between the corporation and its employee-owners in certain circumstances.

3.3 Accumulating Earnings for Investment Purposes
Passive activity loss rules limit the deductions and credits that closely held corporations and personal service corporations can claim with respect to passive activities. Under these rules, losses and credits derived from passive activities cannot be used to offset income from other non-passive activities. A passive activity is a trade or business activity in which the taxpayer does not materially participate; this generally means a regular, continuous and substantial involvement in the operations of the activity (sometimes interpreted as over 500 hours of participation). In addition, in certain circumstances, an "accumulated earnings tax" of up to 20% can apply to earnings of a corporation that are not distributed, to the extent that such accumulated earnings are beyond the reasonable needs of the business.

3.4 Sales of Shares by Individuals in Closely Held Corporations
Individuals are generally taxed at the preferential long-term capital gains rate on the sale of shares in a closely held corporation that have been held for a period of more than one year. Short-term capital gains on the sale of shares held for one year or less are taxed at the same rate as ordinary income. "Qualified" dividends (dividends paid by US and certain non-US corporations with respect to stock held by the owner for a certain minimum holding period) are also taxed at the preferential capital gains rate. Capital gains from the sale of shares in a corporation may also be subject to an additional "net investment income tax".

3.5 Sales of Shares by Individuals in Publicly Traded Corporations
The taxation of dividends and gains applicable to individuals holding shares in a publicly traded corporation are the same as those applicable to those who hold shares in a closely held corporation. See discussion in **3.4 Sales of Shares by Individuals in Closely Held Corporations**.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes
Non-US persons may be subject to either of two different US federal income tax regimes, or both. The first regime applies to items of income from US sources that are not "effectively connected" with the conduct of a US trade or business ("FDAP" income). The second regime applies to net income that is "effectively connected with the conduct of a US trade or business".

Payments of US-source FDAP income made to non-US persons are generally subject to US withholding tax at a rate of 30%, subject to certain exemptions and reductions (described further below). FDAP income subject to this type of withholding generally includes all US-source income except gains from sales of real or personal property. Common types of FDAP income include interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations and emoluments. US tax rules provide specific sourcing rules to determine whether a particular type of income is "US source". For example, dividend income is generally US-sourced if it is paid by a US corporation.

The 30% withholding tax may be reduced or eliminated pursuant to a provision of US tax law (such as the "portfolio interest" exemption), or a tax treaty between the USA and the country in which the recipient of the income is resident (and who qualifies for the treaty benefit).

An additional withholding may be imposed under the Foreign Account Tax Compliance Act (FATCA), enacted in 2010 in order to prevent US persons from evading US tax by holding income-producing assets through accounts at foreign financial institutions (FFIs) or through other non-US entities (non-financial foreign entities, or NFFEs). FATCA generally requires FFIs to identify US account holders and report them to the IRS (either directly or by reporting to the FFI's home country, which will then share such information with the IRS pursuant to an applicable intergovernmental agreement). In addition, NFFEs are generally required to provide information regarding their ownership to withholding agents, including identifying any substantial US owners. FFIs and NFFEs that do not comply with the requirements of FATCA incur a 30% withholding tax on payments to them of certain categories of US-source passive investment income.

4.2 Primary Tax Treaty Countries

The primary tax treaty countries that foreign investors use to make investments in US corporate stock or debt are the Netherlands, Ireland and Luxembourg.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

If an entity is a resident of a contracting state within the meaning of an income tax treaty (ie, the USA or the treaty partner), that entity is generally entitled to the benefits of that treaty. However, there are certain circumstances in which the US tax authorities will challenge the use of treaty country entities by non-treaty country residents.

Certain treaties contain limitations of benefit (LOB) clauses intended to prevent "treaty shopping", premised on the idea that an entity that is a resident of a contracting state must have a sufficient nexus to that country to be eligible for the tax treaty benefits. While the LOB provisions differ in treaties, they commonly enumerate objective tests used to establish entitlement to treaty benefits. An entity that fails these tests may nonetheless apply to the competent authority for a (discretionary) determination that it did not engage in treaty shopping and is still entitled to treaty benefits.

In addition to applying LOB provisions, the USA may challenge the use of treaty country entities through various economic substance and substance over form doctrines. These doctrines are discussed in further detail in **7.1 Overarching Anti-avoidance Provisions**.

4.4 Transfer Pricing Issues

The USA has one of the oldest and most mature transfer pricing regimes. In 2010, the IRS reorganised its international division to focus its resources on enforcement of transfer pricing rules and regulations and resolve transfer pricing disputes, among other things; the IRS's focus on transfer pricing has not abated. The increasing complexity of transfer pricing disputes has led the IRS to require substantial evidentiary support from the taxpayer. At the outset, an inbound investor will have to be prepared to substantiate the transfer pricing methodology chosen, among other things. Treasury regulations provide penalty protection if a taxpayer prepares and maintains contemporaneous transfer pricing substantiation documents at the time they file the relevant tax return.

For inbound investors, knowledge of the adversarial nature of the complex US transfer pricing regime is important. IRS audits can be time consuming and costly.

4.5 Related-Party Limited Risk Distribution Arrangements

Where a limited risk distributor purchases products for resale from a related party, the price at which the products are purchased (ie, the transfer price) must be arm's length. This, in turn, is dependent upon the functions performed and risks assumed by the distributor. Thus, with respect to a limited risk distributor, the transfer price should be respected if the profits earned by the limited risk distributor are comparable to the profits earned by an unrelated distributor performing similar functions and, likewise, assuming limited risks.

Limited risk distributor arrangements are also subject to potential challenge under agency principles. If the distributor bears insufficient risks, it may be treated as the agent of the parent. This could subject the parent to taxation as it is treated as being engaged in a US trade or business through the agent distributor.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

The USA has a comprehensive transfer pricing regime, which it currently believes sufficiently addresses the issues raised by BEPS Actions 8 through 10. The US transfer pricing regulations are generally viewed as being consistent with the OECD standards. A question remains, however, regarding how the OECD guidelines will be interpreted by other countries and, thus, there remains a possibility that the guidelines will be interpreted by other countries in a way that results in differences.

4.7 International Transfer Pricing Disputes

The IRS has long had an Advance Pricing and Mutual Agreement (APMA) Program. The APMA Program assists taxpayers both in resolving transfer pricing disputes through mutual agreement procedures (MAPs) and avoiding disputes through advance pricing agreements. The IRS's requirements and procedures are set forth in Revenue Procedures 2015-40 and 2015-41.

A key challenge of the MAP process is that treaties ordinarily provide only that the tax authorities endeavour to avoid taxation in contravention of the treaty. Accordingly, relief is not guaranteed. While many current treaties do not contain an arbitration provision, a trend in more recent treaties is the inclusion of an arbitration option in an effort to provide relief even where the initial negotiations were unsuccessful. Nevertheless, MAP is largely successful. The APMA Program closes approximately 300 MAP cases per year. Approximately 85% of cases result in either unilateral relief being granted or an agreement fully eliminating double taxation or taxation otherwise not in accordance with the relevant treaty.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

When the IRS and a taxpayer resolve a transfer pricing dispute, it is common for the IRS to impose a transfer pricing adjustment as well as collateral adjustments. A common collateral adjustment is one that conforms a taxpayer's accounts to reflect the initial transfer pricing adjustment. For example, if a corporation paid above-arm's length consideration to its parent company, the excess amount may be recharacterised as a dividend. There are also procedures that may apply to allow a taxpayer to make payments to conform its accounts and avoid conforming adjustments.

Where the related party is also a US taxpayer, the IRS will ordinarily make a correlative adjustment to the related party to avoid double taxation. If the related party is not a US taxpayer but is a resident of a country with which the USA has a tax treaty (and the parties are eligible for the benefits of the tax treaty), the IRS may work with the foreign government to achieve a result that avoids double taxation. See discussion in **4.7 International Transfer Pricing Disputes** regarding the APMA Program.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations

Non-US entities operate in the USA either through a subsidiary structure or through a branch. In a subsidiary structure, the foreign parent incorporates a wholly owned corporate subsidiary in the USA. The US subsidiary is liable for US tax on all profits earned by the US subsidiary. Further, the repatriation of profits (a dividend distribution) by the US subsidiary to the foreign parent is generally subject to a withholding tax of 30%, subject to treaty relief.

Conversely, a non-US entity may operate in the USA through a branch (whether a pass-through entity or an office that is not a legal entity). The income from the US branch passes through to the non-US entity. The non-US entity would then be subject to US tax on the income that is "effectively connected" to the US business at normal US corporate tax rates. The non-US entity with effectively connected income operating through a branch may also be subject to a branch-level tax of 30% (which may be reduced pursuant to a tax treaty) imposed on the repatriation of earnings as well as on certain excess interest paid or accrued on liabilities booked in the USA. The intent behind the branch profit tax is to put the earnings and profits of a branch on equal footing with the earnings and profits of a US subsidiary.

5.3 Capital Gains of Non-residents

In general, capital gain derived by non-US persons (including non-US corporations) from the disposition of stock issued by a US entity is not subject to US tax. If a non-US person sells the stock of a US entity that holds substantial US real property, however, such gain might be subject to US tax under FIRPTA.

5.4 Change of Control Provisions

Generally, there are no change of control provisions that could apply to trigger tax or duty charges upon the disposal of an indirect holding higher up in the overseas group. Judicially developed doctrines such as the sham transaction and economic substance doctrines may operate to pierce arrangements structured for tax avoidance purposes.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

Mandatory formulas are not used to determine the income of foreign-owned local affiliates selling goods or providing services in the USA. Rather, pursuant to the US transfer pricing rules and regulations, a taxpayer must select an appropriate pricing method to test the arm's-length nature of its transfer prices. While formulas are used in transfer pricing, the values in the formulas are derived from uncontrolled transactions and should not be seen as "mandatory formulas".

For services, a transfer pricing method referred to as the services cost method (SCM) provides for reimbursement at cost-plus 0%. The SCM applies to "specified covered services". While this may be viewed as a formulaic approach, the SCM is an elective method.

5.6 Deductions for Payments by Local Affiliates

Where a non-US affiliate charges a related US entity for management and administrative expenses incurred by it, the costs charged will be determined against the "arm's-length" standard. In certain cases, the SCM may apply (see **5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates**).

5.7 Constraints on Related-Party Borrowing

Related-party debt is subject to special scrutiny, including under (i) related-party debt rules for certain large group entities and (ii) general substance over form principles of the US tax rules. Related-party interest deductions are also subject to the limitation of 30% of adjusted taxable income that applies to all corporations.

Treasury regulations regarding debt between related entities set forth certain documentation requirements that must be complied with in order for a purported debt instrument issued and held by certain members of an "expanded group" to be treated as debt. These regulations only apply to a purported debt instrument issued by a US corporation and held by a member of such US corporation's expanded group (which generally is a corporation directly or indirectly connected by at least 80% common ownership).

In addition, these regulations treat certain purported debt instruments as equity in certain other circumstances, notwithstanding that the documentation requirements are met. In order for an instrument to be treated as debt, the instrument must satisfy certain criteria that establish that the instrument, in substance, is a debt instrument.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

US taxation of foreign income differs depending on whether the income is earned directly by a US corporation or indirectly through a foreign subsidiary of that US corporation.

US corporations are subject to tax on their worldwide direct income; the USA does not have a territorial system for direct income. Accordingly, the same tax rules generally apply to income earned by a US corporation inside and outside the USA. This worldwide taxability often results in income earned outside the US being taxed twice, by both the USA and the foreign jurisdiction. In order to address double taxation, the USA generally permits a US corporation to credit certain foreign taxes against its US taxes, subject to limitations.

US corporations with foreign subsidiaries are generally exempt from federal income tax through a participation exemption. See **6.3 Taxation on Dividends from Foreign Subsidiaries**. Further, the USA has base erosion and minimum tax provisions that are imposed on multinational groups.

6.2 Non-deductible Local Expenses

Deductions and limitations on deductions are governed by statute.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends received by US corporations from their foreign subsidiaries are generally exempt from US taxation via a 100% dividends received deduction. In order to qualify for this exemption, the US corporation must own at least 10% of the vote or value of the foreign subsidiary. There are also holding period and foreign tax benefit restrictions.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by US corporations may be used by non-US subsidiaries, subject to transfer pricing rules. Royalties earned by the US entity from the licensing arrangement are subject to US tax.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

Pursuant to the US "controlled foreign corporation" (CFC) rules and the "GILTI" rules, a US corporation can be taxed on the income of its foreign subsidiaries before the foreign subsidiary distributes such amounts. A CFC is a foreign corporation where more than 50% of the stock by vote or value is owned by "US shareholders". For this purpose, a US shareholder is a US person who owns 10% or more of the total combined voting power or value of all classes of stock in the foreign corporation.

Once a foreign corporation is classified as a CFC, its US shareholders must currently report and pay tax on a portion of certain types of income of the CFC (including certain related-party sales, services income and passive income), through what is effectively an annual deemed dividend. Further, gain on the sale of a CFC's shares is generally treated as a dividend rather than capital gain to the extent the earnings and profits of the CFC were not previously subject to US taxation. US corporations with CFCs are also subject to a minimum tax provision that effectively works as a deemed dividend. This minimum tax, imposed on earnings above a set return, is at a reduced rate.

In addition to the tax imposed by the CFC rules, another tax is imposed on the US shareholders of a CFC based on "global intangible low-taxed income" (GILTI). In general, GILTI equals the CFC's aggregate net income, reduced by 10% of adjusted tax basis in depreciable tangible personal property. The GILTI tax rate is generally 10.5%; foreign tax credits may apply.

6.6 Rules Related to the Substance of Non-local Affiliates

In order for transactions involving non-local affiliates to be respected, the non-local affiliate must have substance. See **7.1 Overarching Anti-avoidance Provisions**.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

When US corporations sell shares of their foreign subsidiaries, any resulting capital gains are generally taxed at the ordinary corporate income tax rate of 21%, potentially reduced by credit for foreign taxes. See **6.5 Taxation of Income of Non-local**

Subsidiaries Under CFC-Type Rules for special rules if the foreign subsidiary is a CFC.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are four primary judicial doctrines commonly invoked by the IRS to invalidate tax structures or transactions:

- the economic substance doctrine;
- the business purpose doctrine;
- the step transaction doctrine; and
- the sham transaction doctrine.

All four are utilised by the IRS to determine the substance of the transaction over its form (substance over form is also sometimes used as a separate doctrine). These doctrines sometimes overlap in their application.

Traditionally, courts have used either a one or two-pronged test to determine whether a transaction has economic substance. Under the one-pronged test, a transaction has economic substance if, viewed objectively, a non-tax business purpose exists for the transaction. Under the two-pronged test, the first prong is objective – does the transaction, viewed objectively, have economic substance? The second prong is subjective – does the taxpayer have a subjective business purpose for the transaction? Some courts that apply a two-pronged test apply the two prongs conjunctively (both elements must be satisfied) and some apply the test disjunctively (satisfying either prong will satisfy the test). The economic substance doctrine was codified in 2010, with limited substantive impact on when the doctrine is applied, but with additional penalty provisions.

The business purpose doctrine sets forth the requirement that a transaction be driven by some business consideration other than the reduction of tax. To determine the intent of the taxpayer, many factors have been considered by the courts.

The step transaction doctrine applies to multi-step transactions. Under this doctrine, certain formal steps of an integrated transaction can be ignored for US tax purposes in certain circumstances. Courts apply one (or more) of three tests to ascertain whether transactions are integrated for tax purposes:

- the binding commitment test;
- the mutual independence test; or
- the end result test.

The sham transaction doctrine also looks at the substance of a transaction. A sham transaction can either be a sham in fact or a sham in substance. A sham in fact is a transaction where the economic activity that generates the tax benefit at issue did not, in fact, occur. A sham in substance is a transaction that actually occurred, but the only economic effect is the creation of a tax benefit.

In the partnership context, certain "anti-abuse" Treasury regulations have been issued with the purpose of ensuring that the income tax treatment of each partnership transaction is consistent with the intent of the US partnership tax rules. In addition, a host of specific statutory and administrative provisions may invalidate specific transactions or subject them to adverse treatment, including with respect to disguised sales, related-party losses, mixing bowl transactions and issuances of profits interests.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

Taxpayers are generally obliged to file tax returns with the IRS on an annual basis, but there is not a regular, routine audit cycle. In general, the IRS may audit a tax return for three years after the due date of the tax return or the date it was filed, whichever is later. If there has been a substantial omission of gross income on the return, the statute of limitations is extended to six years.

The taxpayer and IRS can agree to extend the statute of limitations. This often happens when a statute of limitations for a year under audit is due to expire and the IRS has not yet completed its audit. There is no statute of limitations where a required return has not been filed or where the IRS alleges that there has been fraud. This can be a trap for the unwary where, for example, a non-US person has a US income tax filing obligation but fails to file the required return.

Selection of Returns for Auditing Purposes

Whether, or to what extent, a taxpayer may be subject to audit depends, in part, on the nature of the taxpayer; ie, individual or smaller entity versus large entity.

Individuals and organisations that do not meet the requirements of the IRS's Large Business & International (LB&I) Examination Process may be subject to an audit for any year. For such taxpayers, the IRS uses several methods for selecting a tax return for audit, including random selection and computer screening, related examinations and information matching.

Some returns will be selected for audit simply based on a statistical formula where the IRS compares returns against "norms" for similar returns. The "norms" are developed from audits conducted by the IRS as part of its National Research

Program. A return may also be selected for an audit because it involves an issue or transaction with other taxpayers whose returns have been selected for audit. In addition, since 1984, certain investment transactions are required to be registered with the IRS by the investment organiser as a tax shelter, increasing the likelihood of audit for any person claiming a tax benefit from the tax shelter. Information matching may result in an audit where, for example, a bank issues an interest statement but the income reported on a return does not match. Other methods for audit selection may occur; for example, where there is a local compliance initiative.

Audit Procedure
If a return is selected for audit, the IRS will notify the taxpayer by mail. There have been a number of phone and email "scams" in recent years as a result of various data breaches and many people have, unfortunately, responded to these fake requests and either lost a considerable amount of money or released Trojan horse programs into their computer systems. The IRS has warned about these scams and reiterated that it will not initiate an audit by telephone or email. The IRS encourages people who receive such scam calls or emails to report them to the IRS.

Assuming an audit is undertaken, it will be managed either by mail or through an in-person interview to review relevant records. The interview may be held at an IRS office or at the taxpayer's home or office. The IRS will request various documents that the examining agent wishes to see. Additional requests may follow. The length of the audit is dependent on the facts and circumstances.

The LB&I Division of the IRS serves entities (including pass-through entities such as partnerships) with assets greater than USD10 million. Some LB&I taxpayers are audited every year. The examination process has three phases: planning, execution and resolution.

In the planning phase, the scope of the audit is set, the issues that will be audited are determined, and an examination plan is created. In the execution phase, the facts will be developed and the auditor's position developed. In the resolution phase, the goal is to try to reach agreement, if possible, on the issues examined during the audit.

Dispute Resolution
If no agreement is reached, the taxpayer may opt to attempt resolution of an issue through various alternative dispute resolution options. Alternatively, the taxpayer could "protest" the proposed changes and attempt to resolve the unagreed issues with the IRS Office of Appeals. To the extent resolution of an issue would result in double taxation and an income tax treaty exists between the countries at issue, the taxpayer could attempt to seek relief through the competent authority process.

Tools exist to resolve disputes before they occur, including pre-filing agreements, advance pricing agreements for transfer pricing issues and private letter rulings. In addition, where an issue affects a particular industry, it is possible that the issue could be resolved on an industry-wide basis.

To the extent an audit is not fully resolved, the taxpayer may pursue litigation. Litigation may be pursued in the United States Tax Court after the IRS issues a notice of deficiency. The taxpayer need not pay the deficiency in order to litigate its dispute in the Tax Court. Alternatively, the taxpayer could choose to pay the asserted deficiency, file a claim for refund, and later file a lawsuit in either the United States Court of Federal Claims or the relevant United States District Court. The decision as to choice of forum will generally depend, in large part, on an analysis of the relevant law in that court and the court to which a decision would be appealed.

9. BEPS

9.1 Recommended Changes
The USA has a comprehensive tax regime, which it believes satisfactorily addresses the issues raised by the BEPS Action Plan. Although the USA has only adopted one of the BEPS Actions, it does not oppose many of the concepts. Indeed, many of the underlying policies of the BEPS Action Plan are already reflected in US law or in bilateral treaties signed by the USA.

Country-by-Country Reporting
Country-by-country reporting, as recommended by BEPS Action 13, is the only proposal that the USA has adopted thus far. Action 13 proposed that countries require their multinational enterprises to report the following information annually and for each tax jurisdiction in which they do business:

- information pertaining to global business operations and transfer pricing policies ("master file" documentation);
- detailed transactional transfer pricing documentation that identifies material, related-party transactions, amounts involved and the company's analysis of the transfer pricing determinations made with respect to those transactions ("local file" documentation); and
- a country-by-country report (a "CbC report").

The CbC report is required to identify the amount of revenue, profit before income tax, and income tax paid and accrued. It also requires multinational enterprises to report the number of personnel employed, stated capital, retained earnings and tangible assets in each tax jurisdiction. Finally, the CbC report should identify each entity within the corporate group doing business in a particular tax jurisdiction, and provide a description of the business activities each entity is engaged in. Action 13 envisions that the CbC reports will be exchanged automatically pursuant to double tax conventions and under tax information exchange agreements.

In June 2016, the Treasury Department released final regulations that require annual CbC reporting by US entities that are the ultimate parent entity of a multinational enterprise with annual revenue of USD850 million or more. The IRS has issued Form 8975 (Country-by-Country Report) and the accompanying Schedule A (Tax Jurisdictions and Constituent Entity Information), along with accompanying instructions for both forms. Revenue Procedure 2017-23 describes the process for filing Form 8975 and Schedule A for reporting periods on or after 1 January 2016 but prior to the required reporting period as prescribed in Treasury Regulations §1.6038-4 (TD 9773). On 30 March 2018, the IRS released Notice 2018–31, modifying the CbC reporting requirements for certain MNEs qualifying as specified national security contractors. The IRS intends to amend Regulations Section 1.6038–4 to reflect this guidance.

Bilateral Agreements

Citing confidentiality concerns and adequate data security protocols, the USA has opted to enter into specific bilateral agreements on the basis of double tax conventions or tax information exchange agreements, rather than sign the multilateral competent authority agreement for the automatic exchange of CbC reports. The USA has signed bilateral competent authority arrangements with approximately 50 treaty partners for the exchange of CbC reports, with more competent authority arrangements still being negotiated.

9.2 Government Attitudes

The USA believes that its existing tax statutes, rules and regulations sufficiently address the issues raised by the BEPS recommendations, and is generally supportive of the OECD's BEPS initiative. Representatives of the US Treasury Department have actively participated in various OECD working committees, and have negotiated to ensure that US interests are properly represented and protected. There is some concern amongst US lawmakers, however, that BEPS proposals may allow foreign jurisdictions to unfairly target US-developed intellectual property, even in the absence of critical factors such as local IP development, assumption of entrepreneurial risk and presence of significant assets.

9.3 Profile of International Tax

International tax has a high public profile in the USA. However, as discussed above, the USA believes that its current regime already addresses the key BEPS proposals.

9.4 Competitive Tax Policy Objective

BEPS reforms have had a modest impact on US tax laws and their interpretation, administration and enforcement. Currently, implementation of tax reform is a significant issue for the USA.

9.5 Features of the Competitive Tax System

No information has been provided in this jurisdiction.

9.6 Proposals for Dealing with Hybrid Instruments

BEPS Action 2 is intended to help neutralise the effect of cross-border hybrid mismatch arrangements that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction. The USA has certain rules intended to address certain of the arrangements covered in BEPS that pre-date BEPS. Additionally, the USA has adopted a new Section 267A, which is in line with Action 2. Section 267A denies deductions for interest or royalties paid to a related foreign person in accordance with a hybrid transaction or hybrid entity if such amounts are excludable from income or entitled to a deduction under the local tax laws of the related person's country.

9.7 Territorial Tax Regime

As discussed in further detail in **6.1 Foreign Income of Local Corporations**, the USA taxes the worldwide income of local corporations but has some aspects of a territorial tax regime with respect to foreign subsidiaries. The USA already has certain restrictions on the deductibility of interest under Section 163(j).

9.8 CFC Proposals

As discussed above, the USA has some aspects of a territorial tax regime. The USA has recently significantly expanded the definition of CFCs. First, Section 958(b)(4), which generally prevented foreign-owned stock from being attributed downward to a domestic subsidiary, was repealed. Now, a US person can be attributed ownership of a foreign corporation when determining CFC status. Second, the definition of "US Shareholder" was altered. Previously, a US Shareholder was defined as a US person who owned, directly or indirectly, at least 10% of the voting power of the stock of a CFC. Now, the 10% includes both vote and value of the stock of a CFC. That is, non-voting stock is no longer excluded from the 10% calculation for purposes of determining whether a taxpayer is a US Shareholder. Together, these changes have turned many foreign corporations that were not previously CFCs into CFCs.

9.9 Anti-avoidance Rules
The US tax system currently has judicially created anti-avoidance doctrines (economic substance, business purpose, substance over form, step transaction, sham transaction) in addition to rules and regulations that address anti-avoidance. Furthermore, certain US tax treaties have LOB provisions consistent with the LOB provision in the 2016 US Model Treaty.

9.10 Transfer Pricing Changes
The general view is that the US transfer pricing rules are consistent with the BEPS Actions. Thus, the general view is that there will not be radical changes.

The application of transfer pricing rules to intangibles has been a source of controversy in the USA. Since the early 2000s, and as recently as 2016, the IRS has voiced the view that transfer pricing disputes involving intangibles is a significant focus for the USA.

There are two new regimes affecting the taxation of intellectual property. The first, Section 951A, addresses GILTI, and aims to reduce the incentive to relocate intangibles to low-tax jurisdictions. See **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**. The second, Section 250(a)(1)(A), addresses foreign-derived intangible income (FDII), and aims to incentivise development of intangibles in the USA. FDII allows taxpayers to deduct a portion of income earned from exporting products derived from certain (generally intangible) assets held in the USA.

9.11 Transparency and Country-by-country Reporting
The USA has mandated the submission of country-by-country reports by US multinational enterprises with annual revenue of USD850 million or more. However, the USA has raised concerns regarding the misuse of taxpayer information and confidentiality, and the administrative and enforcement burdens associated with adhering to the proposals for greater transparency and country-by-country reporting. In addition, there is concern that US taxpayers will be forced to simultaneously comply with multiple conflicting tax rules, which carries with it increased tax burdens and compliance costs, and defending disputes in multiple jurisdictions. Moreover, leakage of confidential or proprietary, competitive information remains a significant concern.

9.12 Taxation of Digital Economy Businesses
The USA has implemented base erosion and minimum tax provisions that, while not specific to digital economy businesses, would apply to such businesses.

9.13 Digital Taxation
The USA generally opposes any approach that would isolate digital economy businesses rather than apply generally and also opposes individual country approaches to taxation of the digital economy. The Office of the United States Trade Representative has determined that digital service taxes adopted by various countries – including France, India, Italy, Spain, Austria, Turkey and the United Kingdom – are "unreasonable or discriminatory", or otherwise actionable under Section 301 of the Trade Act of 1974.

The USA prefers arriving at a mutually agreed-upon approach through the OECD's Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy, supporting the Modified Residual Profit Split method and voluntary application of the Pillar One allocation method. This approach would allow multinational enterprises to choose between the new formulary apportionment of taxing rights between jurisdictions or the traditional principles of international taxation.

The USA generally supports the base erosion principles of Pillar Two, pending agreement on the mechanics of co-existence with similar rules under domestic law, particularly the GILTI rules discussed under **6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules**.

9.14 Taxation of Offshore IP
Offshore intellectual property deployed within the USA may result in taxation under generally applicable US principles. In particular, royalties paid to foreign recipients are among the categories of income subject to withholding tax. The 30% withholding rate may be reduced by treaty.

White & Case LLP has more than 90 tax professionals in multiple jurisdictions across the Americas, Europe, the Middle East, Africa and Asia-Pacific. The firm provides local tax law advice in the USA, the UK, France, Germany, Russia, Mexico, Australia, Poland, Slovakia, the Czech Republic, Turkey and Spain to public and private corporations, pass-through entities, joint ventures, funds, governmental entities, sovereigns and individuals. It has a significant non-transactional tax practice, including tax controversies at the administrative level, as well as civil and criminal litigation, transfer pricing, internal investigations, treaty requests and competent authority. Key practice areas are M&A, private equity, capital markets, project development and finance, and real estate. The firm won two deal awards at the 2020 International Tax Review Awards for seminal transactions and was shortlisted for many more.

The firm would like to thank Christina Culver, an associate in White & Case's tax controversy practice, for her contribution to the chapter.

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ZAMBIA

Law and Practice

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Contents

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

Businesses in Zambia generally adopt a corporate form. The two main alternative forms of corporate structures are public companies and private companies, which could be structured into any of the following categories:

- a private company limited by shares;
- a private company limited by guarantee;
- an unlimited private company;
- a public liability company;
- a partnership; or
- a sole proprietorship.

Except for partnerships, these are all taxed as separate legal entities.

The key differences are as follows:

- a public company is one that does not impose any restrictions on the right to transfer any of its shares through its Articles of Association, other than restrictions on the right to transfer a share that has not been fully paid for, and a provision for the compulsory acquisition – or right of first refusal – of shares being transferred to other members of the company in the event of shares not being fully paid for;
- a private company limited by shares is a company whose Articles limit the number of members to no more than 50;
- an unlimited private company is a private company whose Articles allow for more than 50 members;
- a company limited by guarantee is a company whose subscribers at incorporation make a declaration of guarantee specifying the amount they undertake to contribute to the assets of the company in the event of the company being wound up; and
- an additional category of business entity is the entity that is referred to as a business name, which can be either a partnership or a sole proprietorship for one or two individuals.

Regardless of the category, all companies are taxed similarly. However, business names (partnerships and sole proprietorships) are taxed differently from companies.

1.2 Transparent Entities

A private company limited by shares is commonly used. Investment entities, including private equity and hedge funds, prefer the route of a private company limited by shares, for the following reasons:

- for the concept of separate legal personality between the members of the company and the corporate entity itself;
- because members are not personally liable for the debt of the company and, in the event of winding up, the liability of members is limited to the extent of their respective unpaid obligation towards the capital of the company;
- because there is less stringent regulatory scrutiny than applies to a public company; and
- because a private company is taxed on the basis of profits only, after deducting the allowable expenses of the company.

1.3 Determining Residence of Incorporated Businesses

The test used for determining the residence of incorporated businesses and transparent entities is whether they are incorporated or formed under the laws of Zambia, or whether the place of effective management and control of the entity's business or affairs is within Zambia for the charge year.

1.4 Tax Rates

Incorporated businesses are subject to corporation tax, which is currently 35%.

Income earned by hotels and lodges on accommodation and food services will be taxed at a reduced rate of 15% for the charge year 2021. This reduction was introduced in order to provide tax relief to hotels and lodges as a result of decreased income due to the COVID-19 pandemic.

The tax rate for partnerships/business names or sole proprietorships is the rate of tax applied to individuals. The current top tax rate is 37.5% for any annual income in excess of ZMW82,800 (approximately USD3,887).

The presumptive tax on a person carrying on the business of betting and gaming is as follows:

- casino live games: 20% of gross takings;
- casino machine games: 35% of gross takings;
- lottery winnings: 35% of net proceeds;
- betting: 25% of gross takings;
- gaming:
  - (a) slot machines (bonanza): ZMW250 per machine; and
  - (b) gaming machines: ZMW500 per machine (limited pay out).

For the purposes of betting and gaming, "net proceeds" means the gross proceeds minus sums paid out for the prizes; "gross takings" means the total amount staked by players minus winnings payable.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

Taxable profits are calculated after deducting any losses and expenditure incurred in a charge year wholly and exclusively for the business, other than those of a capital nature, and/or any expense that may be allowable in terms of the Income Tax Act Chapter 323 of the Laws of Zambia (the Income Tax Act).

Taxable profits are based on the accounting profits realised after taking revenue expenses wholly and exclusively incurred in earning revenue into account.

Capital allowances are deductions that businesses can claim for wear and tear of qualifying fixed assets bought and used in a trade or business. Qualifying fixed assets include:

- buildings;
- implements;
- plant and machinery;
- fixtures and fittings; and
- motor vehicles and several other capital assets used in the production of income.

2.2 Special Incentives for Technology Investments

The Income Tax Act permits a "deduction for research" as an incentive. This applies to expenditure, not of a capital nature, that is incurred by a business in a charge year on experiments or research relating to the business.

2.3 Other Special Incentives

There are no other special incentives that apply to particular industries, transactions or businesses.

2.4 Basic Rules on Loss Relief

Losses that are not of a capital nature are deductible from a business's gains or profits.

For mining operations or businesses involved in the generation of electricity, losses may be carried forward from year to year, for a maximum of ten years.

For all other businesses, such losses can only be carried forward for a maximum period of five years.

2.5 Imposed Limits on Deduction of Interest

Deductibility of gross interest expense is limited to 30% of a company's tax earnings before interest, tax, depreciation and amortisation (EBITDA) and cannot be carried forward for more than five years. This limit excludes businesses on the turnover tax system and taxpayers engaged under the Banking and Financial Services Act.

2.6 Basic Rules on Consolidated Tax Grouping

Consolidated tax grouping is not permitted under the Income Tax Act. Groups of companies cannot utilise separate company losses.

2.7 Capital Gains Taxation

There is no taxation on capital gains in Zambia. However, if a company sells shares that it owns in another company, the vendor will be liable for the payment of property transfer tax in accordance with the Property Transfer Tax Act Chapter 340 of the Laws of Zambia, at a rate of 5% of the realised value of the shares.

The realised value is the price at which the share could have been reasonably sold on the open market at the time of the transfer as determined by the Commissioner General of the Zambia Revenue Authority or its nominal value, whichever is greater.

2.8 Other Taxes Payable by an Incorporated Business

Pursuant to the Property Transfer Tax Act, the sale of land results in the vendor paying property transfer tax on the land. The rate of tax in this instance is 5% of the realised value of the land or the price at which the land could have been sold on the open market at the time of the transfer as determined by the Commissioner General of the Zambia Revenue Authority, whichever is greater.

2.9 Incorporated Businesses and Notable Taxes

Mining companies are required to pay the following taxes:

- withholding tax on management and consultancy fees at a rate of 15% for residents and 20% for non-residents;
- withholding tax on interest payments at a rate of 15% for residents and 20% for non-residents;
- withholding tax on dividends payments at a rate of 15% for residents and 20% for non-residents;
- withholding tax on rental payments at a rate of 10%; and
- mineral royalty tax, which varies depending on the type of mineral, as follows:
  - (a) 5% of the norm value for base metals (other than copper, cobalt and vanadium); 5% of the gross value for energy and industrial minerals; 6% of the gross value for gemstones; 6% of the norm value for precious metals; and 8% of the norm value for cobalt and vanadium; and
  - (b) the mineral royalty rates for copper increase by 1.5% at all levels of the previous price ranges. The first level of the scale at 5.5% is applicable when the copper price

per tonne is below USD4,500; the second level of the scale at 6.5% is applicable when the copper price per tonne is between USD4,500 and USD6,000; the third level of the scale at 7.5% is applicable when the copper price per tonne is between USD6,000 and USD7,500; the fourth level of the scale at 8.5% is applicable when the copper price per tonne is between USD7,500 and USD9,000; and a fifth level of the scale at 10% should apply when copper prices rise to USD9,000 and above.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

Closely held businesses mostly operate in corporate form.

3.2 Individual Rates and Corporate Rates

The legislation and rules that govern professionals in Zambia do not permit them to practise as corporate entities to the extent that they are separate and distinct entities from their practice.

3.3 Accumulating Earnings for Investment Purposes

There are no rules that prevent closely held corporations from accumulating earnings for investment purposes.

3.4 Sales of Shares by Individuals in Closely Held Corporations

A company that declares and pays dividends will have to deduct withholding tax at a rate of 20% and obtain a withholding tax certificate from the Zambia Revenue Authority. The withholding tax will be treated as an advance payment by the individual shareholder to the extent that, when the aggregate income of the shareholder is calculated in the charge year after the submission of the annual tax return, the withholding tax will be treated as a credit towards the final tax liability.

If an individual shareholder sells their shares in a corporation, property transfer tax will apply at a rate of 5% of the realised value.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Dividends on shares in publicly traded companies are subject to withholding tax at a rate of 20%.

The sale of shares in publicly traded companies is not subject to any tax under the Property Transfer Tax Act.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of income tax treaties, Zambian law provides for withholding tax on interest, dividends and royalties on all income earned or deemed to be from a source within Zambia. The withholding tax on interest, dividends and royalties is charged at a rate of 15% for Zambian residents and 20% for non-residents.

In the absence of income tax treaties, there are no reliefs available.

4.2 Primary Tax Treaty Countries

The primary tax treaty countries used by foreign investors to make investments in Zambian corporate stock or debt are as follows:

- the Netherlands;
- the United Kingdom;
- Ireland;
- the Seychelles; and
- South Africa.

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Local tax authorities do not challenge the use of treaty country entities by non-treaty country residents.

4.4 Transfer Pricing Issues

The primary transfer pricing issue for inbound investors who operate through local corporations or subsidiaries is whether the loans granted by the investors to their associated local corporations – or the goods and/or services rendered by the investors to the local subsidiaries – are done so on an “arm’s-length basis”.

4.5 Related-Party Limited Risk Distribution Arrangements

Local tax authorities challenge the use of related party limited risk distribution arrangements for the sale of goods and the provision of services locally.

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Zambia’s local transfer pricing rules and/or enforcement do not vary from the OECD standards in the sense that Zambia recently promulgated the 2018 Transfer Pricing (Amendment) Regulations, Statutory Instrument No. 24 of 2018 (the Regulations), which are construed in a manner that is consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as supplemented and updated from time to time.

4.7 International Transfer Pricing Disputes
Where there is a double taxation treaty in force between the jurisdictions of the parties to a controlled transaction, the provisions of that treaty will prevail over the provisions of the Income Tax Act in the resolution of any dispute concerning international transfer pricing. The use of the mutual agreement procedure (MAP) is only permissible where it is contained in a double taxation agreement. Given the lack of case law pertaining to transfer pricing disputes and the fact that the Zambia Revenue Authority does not release information on such disputes, it is difficult to state with certainty how often international transfer pricing disputes are resolved through double taxation treaties and MAPs.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled
Compensating adjustments are allowed/made when a transfer pricing claim is settled. There are no difficulties in operating a MAP where a transfer pricing claim applies, as long as the MAP is available in a double taxation agreement.

5.2 Taxation Differences between Local Branches and Local Subsidiaries of Non-local Corporations
There is no difference in the way local branches of non-local corporations and local subsidiaries of non-local corporations are taxed.

5.3 Capital Gains of Non-residents
There is no capital gains tax in Zambia. However, if a non-resident sells shares in a company in Zambia, property transfer tax on the value of the sale will apply, at a rate of 5% of the realised value of the shares.

Property transfer tax at the rate of 5% of the realised value is also payable on the transfer of any shares in a non-resident holding company that holds at least 10% of the issued shares in a company incorporated in Zambia. The realised value for the transfer of shares in a non-resident company is limited to the value of the effective shareholding in the Zambian entity. Effective shareholding is defined as the extent of control or ownership in the company incorporated in the Republic by the company incorporated outside the Republic, expressed as a percentage.

There is an exemption from the payment of property transfer tax for indirect transfers arising out of a group reorganisation that does not result in any change in the effective shareholding of the Zambian entity. However, the exemption is only available to companies that have been part of the group of companies for at least three years preceding the group restructuring.

If the shares are in a publicly listed and traded company, there will be no property transfer tax.

5.4 Change of Control Provisions
There are no change of control provisions that could trigger tax or duty charges.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates
No formulas are used because local affiliates of foreign-owned companies are treated as independent entities that are selling goods and services in Zambia.

5.6 Deductions for Payments by Local Affiliates
If a local affiliate makes a payment for management and administrative expenses incurred by a non-local affiliate, the local affiliate should be able to demonstrate that the transaction is on an "arm's-length" basis in order for the expense to be allowed as a deduction, in accordance with the Transfer Pricing Regulations.

5.7 Constraints on Related-Party Borrowing
The only restriction is that the interest rates charged by non-local affiliates to local affiliates should be charged on an "arm's-length" basis in accordance with the Transfer Pricing Regulations.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations
Zambian income taxation is based on the principles of "residence" and "source". Corporate tax will not be imposed on a local corporation's income that is not derived from a source within Zambia or not deemed to be derived within Zambia. However, interest and dividends received by local corporations from a source outside Zambia will be subject to Zambian corporate tax.

6.2 Non-deductible Local Expenses
The following are non-deductible expenses as prescribed under the Income Tax Act:

- capital expenditure or loss of capital, other than loss of stock in trade, unless specifically permitted under the Act;

- any loss or expense that is recoverable under any insurance contract or indemnity; and
- any tax or penalty chargeable under the Act.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends from foreign subsidiaries of local corporations are taxed at the standard corporate tax rate of 35% on the basis that they constitute income accruing to the local corporation.

6.4 Use of Intangibles by Non-local Subsidiaries

Intangibles developed by local corporations can be used by non-local subsidiaries in their business without incurring local corporate tax, as there are no regulations covering this.

6.5 Taxation of Income of Non-local Subsidiaries Under CFC-Type Rules

There is no tax on local corporations in respect of the income of their non-local subsidiaries; this also applies to non-local branches of local corporations.

6.6 Rules Related to the Substance of Non-local Affiliates

No rules related to the substance of non-local affiliates apply.

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

If a local corporation receives income on the sale of shares in a non-local affiliate, it will be considered as income and will be subject to local corporate tax.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are overarching anti-avoidance provisions whereby if the Commissioner-General of the Zambia Revenue Authority has reasonable grounds to believe that the main purpose or one of the main purposes of any transaction was the avoidance of – or reduction of liability for – tax for any charge year, or that the main benefit that might have been expected to accrue from the transaction within the three years immediately following the completion thereof was the avoidance or reduction of liability for tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as regards liability for tax as he considers appropriate to counteract the avoidance or reduction of liability for tax that would otherwise be effected by the transaction.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The routine audit cycles by the Zambia Revenue Authority are as follows:

- investigations; and
- routine audits, usually covering a period of up to five years.

9. BEPS

9.1 Recommended Changes

The recommended BEPS changes that have already been implemented are as follows:

- capacity enhancement through the creation of a transfer pricing unit, and capacity building of staff in international taxation;
- setting out the following five transfer pricing methods through regulations – a taxpayer is required to choose only one of the methods to determine the "arm's-length" basis for a given transaction:
  - (a) a comparable uncontrolled price method;
  - (b) a resale price method;
  - (c) a cost plus method;
  - (d) a transactional net margin method; or
  - (e) a transactional profit split method;
- strengthening domestic anti-abuse legislation; and
- rationalising tax treaty incentives and scaling down on tax holidays.

9.2 Government Attitudes

In 2017, the Zambian government joined the Inclusive Framework on Base Erosion and Profit Shifting and agreed to adopt the BEPS project agreement, the country-by-country reporting measures to prevent tax treaty shopping and also the minimum standards that were set out by the OECD and G20 nations in 2015.

By so doing, the Zambian government aims to increase the government's tax revenue payments and reduce the tax burden on easy-to-pay taxes by creating an atmosphere of fairness among the companies that are liable for tax, which, it is hoped, will lead to voluntary compliance.

9.3 Profile of International Tax

International tax is an issue that preoccupies the tax authorities and multinationals operating in Zambia. However, there is not much intense public scrutiny or interest that could have an influence on BEPS recommendations.

9.4 Competitive Tax Policy Objective
The Zambian government is under intense pressure to raise revenue to plug the fiscal deficit experienced in the recent past. On account of this, there will always be a challenge to keep marginal tax rates low, which is not consistent with a competitive tax code. Furthermore, because of the fiscal pressure, there is a constant review of legislation that may not create predictability and certainty, which is an incentive for tax avoidance.

9.5 Features of the Competitive Tax System
There are no key features of the Zambian competitive tax system that might be more vulnerable than other areas of the tax regime.

9.6 Proposals for Dealing with Hybrid Instruments
The current provisions of the Zambian Income Tax Act have dealt with hybrid instruments and the BEPS process that has been implemented through the Transfer Pricing Regulations of 2018. In this regard, the recommended changes will not have any significant impact on how the authority deals with hybrid instruments.

9.7 Territorial Tax Regime
Zambia has a territorial tax regime, and interest deductibility restrictions are tailored to this regime.

9.8 CFC Proposals
The CFC proposals would be defective in Zambia to the extent that Zambian legislation is intended to cover Zambian income or income deemed to be Zambian income because it is earned by entities resident in Zambia.

Under current Zambian legislation, a proposal that the profits of subsidiaries that are taxed at low rates should be subject to CFC apportionment would not be workable.

9.9 Anti-avoidance Rules
The proposed double taxation convention limitation of benefit and anti-avoidance rules are not likely to have any impact in Zambia.

9.10 Transfer Pricing Changes
Transfer pricing changes have not made a radical change to the Zambian tax regime. The taxation of profits from intellectual property is not a particular source of controversy in Zambia.

9.11 Transparency and Country-by-country Reporting
Zambia is in favour of the proposals for transparency and country-by-country reporting, as they will help Zambian tax authorities deal with profit shifting and avoidance by local corporates affiliated to multinational enterprises.

9.12 Taxation of Digital Economy Businesses
There are currently no changes being made or discussed in relation to the taxation of transactions effected or profits generated by digital economy businesses operating largely from outside Zambia.

9.13 Digital Taxation
The country has not yet taken a position in relation to the BEPS proposals for digital taxation, and there is no legislation in place at the moment.

9.14 Taxation of Offshore IP
Payments in respect of royalties for the use of intellectual property from a source within Zambia or deemed to be within Zambia to a non-resident are subject to withholding tax at the rate of 20%.

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Trends and Developments

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On 25 September 2020, the Minister of Finance Dr. Bwalya Ngandu delivered a ZMW119.6 billion (approximately USD5.5 billion) budget with the theme "*Stimulate Economic Recovery and Build Resilience to Safeguard Livelihoods and Protect the Vulnerable*." This was the first national budget following the outbreak of the COVID-19 pandemic and, according to the Minister, the focus in the medium-term will be on containing the spread of the virus, mitigating the effects of the pandemic and restoring macroeconomic stability as well as growth.

As is customary following the delivery of the national budget, various amendments to the fiscal statutes came into force on 1 January 2021. This article covers the measures that have been introduced to take effect from 1 January 2021, as well as both direct and indirect taxes applicable to corporate entities in Zambia.

Direct Taxes

Corporate Income Tax

Corporate Income Tax in Zambia is anchored on the principles of source and residence. Income deemed to be from a Zambian source is subject to Zambian income tax. In addition, the residence of an entity in Zambia will widen the scope of taxation to include interest and dividend income from abroad. A person falling within the definition of residence in Zambia for tax purposes is subject to income tax on interest and dividends from a source outside Zambia. A non-Zambian resident enterprise that has a permanent establishment in Zambia will be subject to corporate income tax on its income derived in Zambia. If the non-resident enterprise does not have a permanent establishment in Zambia, the income of the non-Zambian resident earned in Zambia may still be subject to Withholding Tax (WHT), which is deducted at source.

The Income Tax Amendment Act No 20 of 2020 sets out the amendments to the Income Tax Act, which took effect on 1 January 2021 and are summarised below.

Adjustment to Corporate Income Tax rates

The rate of Corporate Income Tax on income earned by hotels and lodges on accommodation and food services has been reduced to 15% from the standard rate of 35%. According to the Minister of Finance in his budget address, this move was aimed at resuscitating the tourism sector and promoting local tourism given the impact that COVID-19 has had on the Zambian tourism industry.

The rate of presumptive tax on an entity carrying on the business of gaming and betting has been increased from 10% to 25%.

Transfer pricing

The Zambian Transfer Pricing Regulations have been amended to revise the threshold for the preparation of transfer pricing documentation in Zambia and to introduce the submission of a Country-by-Country (CbC) Report.

The threshold for the preparation of transfer pricing documentation for local companies has been increased. The previous threshold covered entities with an annual turnover of ZMW20 million, but the adjusted threshold is now ZMW50 million (approximately USD2.3 million).

With respect to the new requirement to file a CbC report, an ultimate parent entity that is tax resident in Zambia and has consolidated group revenue of EUR750 million or ZMW19.63 billion in the previous accounting year is required to file a CbC report with the Commissioner General, 12 months after the last day of the reporting year of the multinational enterprise with respect to that reporting accounting year.

Specific terminology and definitions have been provided for relating to CbC reporting, a specific template has been provided for the CbC report and specific regulations have been issued for guidance.

The regulations take effect from the charge year ending on 31 December 2021, and each subsequent charge year.

Thin capitalisation

The Income Tax Act was amended to clarify the rule limiting interest expense deductibility for income tax purposes. Prior to the amendment, interest expense was limited to 30% of earnings before interest, taxes, depreciation and amortisation (EBITDA). The amendment to the rule clarifies that the limitation applies to gross interest on loans.

Disclosure obligations

A further amendment was introduced to extend the obligation to furnish information to the Zambia Revenue Authority (the ZRA). The amendment provides that the obligation to furnish information extends to information that might be held outside Zambia or by a person that is not a Zambian resident. The Income Tax Amendment Act further provides that a person who fails to furnish a record that has been requested shall be barred from using that record to challenge an assessment before a court or tribunal. This change appears to be intended to enhance full disclosure by taxpayers when submitting their tax returns.

Adjustment of development allowance period

The Income Tax Act provides for an allowance of 10% annually for expenditure incurred for the growing of rose flowers, tea, coffee and citrus fruit trees, among others. For persons growing these plants for the first time, the expenditure incurred is not deductible and may be carried forward to the following charge year, up to the first year of production. The allowance was previously claimable for three consecutive years. The period of claim has now been extended from three to five years.

Introduction of local content allowance on agricultural produce

A provision has been added to the Income Tax Act to allow for the deduction of a local content allowance of 2% of expenditure incurred, other than that of a capital nature, for the growing or purchase of agricultural products by companies carrying on agro-processing or manufacturing in a particular charge year. The local content allowance may be claimed for a period not exceeding three years. This appears to be aimed at encouraging local agricultural production.

Taxation of mining entities

The Mines and Minerals Development Act has been amended to introduce a provision stating that the Mineral Royalty Tax (MRT) may be paid in advance as prescribed. Previously the MRT was payable 14 days after the month in which the sale of the mineral occurred. The regulations governing the prepayment of MRT are yet to be promulgated.

In order to encourage local processing, import duty on copper ores and concentrates has been removed.

Changes to Indirect Taxes

Value-added tax

Value-added tax (VAT) is charged on any transaction relating to the sale of goods and services conducted in Zambia. It is important to note that services procured outside of Zambia but used in the country are subject to a reverse charge VAT if the provider of a service does not appoint a tax agent in Zambia. The current rate for VAT in Zambia is 16%.

The Value Added Tax Amendment Act No 23 of 2020 sets out the new amendments to the VAT Act, effective from 1 January 2021.

There has been an increase in the fines payable for evasion of VAT, and for late payment. There has been an amendment to provide for an escalatory fine for filing false returns and statements. In addition, the penalty for tax evasion in respect of the supply and importation of goods and services has been increased from 30,000 penalty units to 300,000 penalty units (ZMW9,000 to ZMW90,000 – USD400 to USD4,000).

Under the VAT Act, the Minister of Finance has issued amendments to the VAT (Zero) Rating Order to introduce new items to be zero rated. These items fall under Group 12 (Petroleum products) of the VAT (Zero) Rating Order and specifically include petrol and diesel. The VAT (Zero rating) Order specifies certain goods and services that are to be taxed at 0%. The zero rating of petroleum products is aimed at cushioning the impact of the depreciation of the local currency on the consumer price of petroleum products.

Customs and excise

The Customs and Excise Act governs customs and excise duty. Excise duty is a tax on particular goods or products, whether imported or produced domestically, imposed at any stage of production or distribution, by reference to the weight, strength or quantity of the goods or products, or by reference to their value. Customs duty is charged on the importation of goods. The Customs and Excise (Amendment) Act No 21 of 2021 sets out the tax changes, which are effective from 1 January 2021.

Duty on importation of electric motor vehicles

Customs duty on the importation of electric motor vehicles has been reduced from 30% to 15%, in an effort to encourage the use of electric motor vehicles and reduce the use of fossil fuel.

Increase in duty on certain agricultural products

Customs duty has been increased from 25% to 40% on the following agricultural products:

- beef and beef processed products;
- pork and pork processed products;
- chicken and chicken processed products; and
- fish.

The stated aim of this measure is to support local agricultural production.

Suspension of customs duty on tourism vehicles

In a move aimed at spurring the local tourism industry, the previously applicable 15% customs duty on tourist buses and coaches and safari game viewing vehicles has been suspended for a specified period of one year, effective from 1 January 2021.

Additional measures

Excise duty at the rate of ZMW1.50 per litre has been introduced on reconstituted milk, and the customs duty rate for powdered milk has been harmonised at 15%. The amendment is intended to stimulate the local dairy sector.

There has also been a removal of the 10% export duty on crocodile skins.

Property transfer tax

The Property Transfer Tax Act (PTT Act) prescribes a tax of 5% of the realised value on the transfer of land, mining rights and shares.

With respect to shares, property transfer tax is also payable on indirect transfers – ie, transfers of shares in a holding company incorporated outside Zambia that holds at least 10% of the issued shares in a company incorporated in Zambia.

The Property Transfer Tax Amendment Act No 22 of 2021 has introduced amendments to the Act, which are effective from 1 January 2021.

The PTT Act has been amended to redefine the method for determining the realised value on the indirect transfer of shares. This is in order to capture only the Zambia proportion of the value of the consideration or the nominal value.

A further amendment has been made to prescribe the exchange rate applicable to foreign currency-denominated transactions, which will be the appropriate Bank of Zambia mid-rate as at the end of the day immediately preceding the day on which the provisional return is submitted.

Other Key Developments

Double taxation agreements

In June 2020, the government of the republic of Zambia resolved to terminate the double taxation agreement (DTA) with Mauritius. The termination took effect in Zambia on 31 December 2020. The DTA covered income from a number of specific sources and provided for reduced rates of withholding tax, as follows:

- 5% on dividends (where the beneficial owner holds at least 25% of the capital of the payor);
- 10% on the gross amount of interest; and
- 5% on the gross amount of royalties.

No new DTA has been entered into between Zambia and Mauritius.

A new DTA between Zambia and Switzerland came into force on 26 October 2020, replacing the previous one that had been in force since 1959. The previous DTA provided for 0% deduction of withholding tax on dividends, interest, management fees and technical fees earned in a contracting state. Under the new DTA, the rates of withholding tax on income earned in a contracting state are limited as follows:

- 5% on dividends (where the beneficial owner holds at least 10% of the capital of the payor);
- 10% on the gross amount of interest; and
- 5% on the gross amount of royalties.

Mulenga Mundashi Legal Practitioners is a full-service law firm with strong capabilities and a proven track record in tax advisory and tax litigation. It has its office in Lusaka and a team of five partners, five associates, two legal assistants and eight trainee advocates.

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Michael M Mundashi is the managing partner at MMLP, and specialises in commercial dispute resolution and tax advisory services. He has a wealth of experience in Income Tax, VAT and Customs and Excise Tax. Between 1998 and 2003, Michael served as the first Chairman of the Zambia Revenue Appeals Tribunal, a quasi-judicial tribunal handling tax appeals from taxpayers challenging tax assessments of the Zambia Revenue Authority. Michael has more than 30 years of experience as a lawyer and enjoys the dignity and rank of State Counsel in recognition of his contribution to the legal profession in Zambia.

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