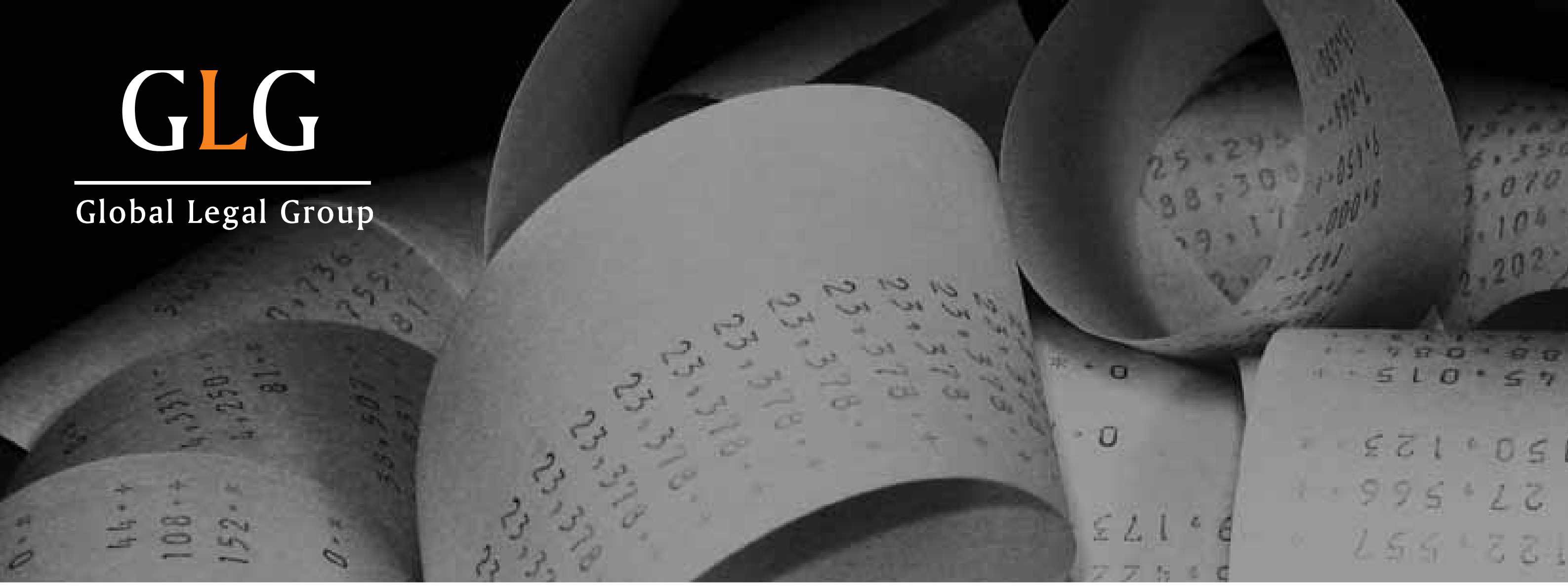

The International Comparative Legal Guide to:
Corporate Tax 2012

A practical cross-border insight to corporate tax work

Published by Global Legal Group with contributions from:

Aivar Pilv Law Office
ALMT Legal
Arqués Ribert Junyer Advocats
Avanzia Taxand Limited
Bugge, Arentz-Hansen & Rasmussen (BA-HR)
Banwo & Ighodalo
B.C. Toms & Co.
Boga & Associates
Bredin Prat
CBA Studio Legale e Tributario
Clifford Chance LLP
Cuatrecasas, Gonçalves Pereira
Debarliev, Dameski & Kelesoska Attorneys at Law
Dorda Brugger Jordis
Dr. K. Chrysostomides & Co LLC
Elvinger, Hoss & Prussen
Georgiev, Todorov & Co.
Gide Loyrette Nouel A.A.R.P.I.
Gide Loyrette Nouel Warsaw Office
Gorrissen Federspiel
Greenwoods & Freehills
Hannes Snellman Attorneys Ltd
Hendersen Taxand
Herzog Fox & Neeman
Juridicon Law Firm
KALO & ASSOCIATES
KGDI Law Firm
Leitner + Leitner, d.o.o.
Lenz & Staehlin
LOGOS legal services
McCann FitzGerald
Nagashima Ohno & Tsunematsu
Negri & Teijeiro Abogados
Nithya Partners
Pachiu & Associates
P+P Pöllath + Partners
Proskauer Rose LLP
Salans
Schulte Roth & Zabel LLP
Slaughter and May
Thorsteinssons LLP
White & Case LLP
Yoon & Yang LLC

The International Comparative Legal Guide to: Corporate Tax 2012

GLG
Global Legal Group

Contributing Editor
William Watson, Slaughter and May

Account Managers
Monica Fuertes, Dror Levy, Florjan Osmani, Oliver Smith, Rory Smith, Toni Wyatt

Sub Editors
Suzie Kidd
Jodie Mablin

Senior Editor
Penny Smale

Managing Editor
Alan Falach

Group Publisher
Richard Firth

Published by
Global Legal Group Ltd.
59 Tanner Street
London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

Cover Design
F&F Studio Design

GLG Cover Image Source
Stock.XCHNG

Printed by
Information Press Ltd
October 2011

ISBN 978-1-908070-11-1
ISSN 1743-3371

General Chapters:

Country Question and Answer Chapters:

Further copies of this book and others in the series can be ordered from the publisher. Please call +44 20 7367 0720

EDITORIAL

Welcome to the eighth edition of *The International Comparative Legal Guide to: Corporate Tax*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of corporate tax.

It is divided into two main sections:

Two general chapters. These chapters outline UK holding companies and CFC reform and the state of Corporate Tax Reform in the United States.

Country question and answer chapters. These provide a broad overview of common issues in corporate tax laws and regulations in 42 jurisdictions.

All chapters are written by leading corporate tax lawyers or tax advisors and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor, William Watson of Slaughter and May, for all his assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk

Alan Falach LL.M
Managing Editor
Alan.Falach@glgroup.co.uk

UK Holding Companies and CFC Reform

Slaughter and May

William Watson

There is one issue which has dominated the UK's corporate tax system for some time now: as the song has it, "Should I stay or should I go?". Many UK groups were asking themselves this question just a few years ago and a surprising number decided it was time to leave.

This did not go unnoticed by the authorities. The UK's Coalition Government, elected in 2010, has said that it aims to make the UK's corporate tax regime "the most competitive in the G20". This article seeks to explain the exodus and then assess the response, with particular reference to the UK as a location for holding companies and the proposed reform of the controlled foreign company (CFC) regime.

Some History

The UK's corporation tax system has had a number of beneficial features for many years. Most tax practitioners would put at the top of the list the absence of dividend withholding tax and a comparatively liberal regime for interest deductions. The particular attraction of the latter for multinational groups is that there is no rule which automatically restricts these simply because the debt is funding overseas operations or the capitalisation of overseas subsidiaries. (Nor has there ever been such a rule. So no change was needed following the landmark judgment of the European Court of Justice (ECJ) in the *Bosal* case (C-168/01, 2003) and, by contrast to countries such as The Netherlands, the UK's tax revenues do not suffer from a "*Bosal* gap".)

To that one can add what is probably the most extensive tax treaty network in the world, which among other things means that withholding tax is not generally a problem in relation to interest either. A "Technical Note" published by Her Majesty's Revenue & Customs (HMRC) on 1 August 2011 threatened a fundamental attack on the efficacy of this network, as it provided for the introduction of a motive test which would allow HMRC to override treaty protections. Happily, this remarkable proposal was withdrawn barely a month later.

A long-standing hole in the system was then plugged in 2002, with the enactment of a participation exemption for share disposals. The exemption is more complex than some foreign equivalents (particularly in its insistence on "trading status" before and after the disposal), but in most cases it does the job. In other respects, too, the UK's rules for the taxation of standard M&A transactions are reasonably simple and generally satisfactory.

Last but not least, it is probably fair to say that taxpayers in the UK face a little less uncertainty when planning their affairs than their counterparts in many other major jurisdictions. A line of cases dating back to *Ramsay v IRC* (1980) allows the courts to treat a substantially preordained series of transactions as a single composite transaction and tax the result accordingly, on the basis of a "purposive" interpretation of the relevant legislation. But this judicial doctrine does not go as far as the nuclear options available to revenue authorities elsewhere. Notable examples include the "economic substance" principle in the US, the general anti-avoidance rules that have been adopted in other common law countries and the concept of "*abus de droit*" that is applied in one form or another by the ECJ and by courts in civil law jurisdictions. (Though the possibility of a GAAR is another current focus of attention in the UK: a GAAR committee is scheduled to deliver its report before the publication of this article.)

Set against this array of advantages, there have been three main drawbacks of the tax system for UK holding companies and their shareholders: no participation exemption for foreign dividends (or business income); stamp duty on share transfers, which is something of a historical relic; and a CFC regime which, while not as fierce as the "subpart F" rules in the US, scores maximum points for complexity and can bring within the corporation tax net activities that have no real UK connection.

Rumblings of Discontent

That was the position half a dozen years ago: some legitimate grounds for complaint, but overall a regime which compared fairly well to the corporate tax systems of other major economies.

However, a number of developments made UK groups begin to question whether the UK was such a good place to be from a tax perspective. A gradual tightening of the CFC noose was followed in 2007 by a proposal for a drastic shift in the direction of the US rules, but without the valuable deferral mechanisms available to US groups that have substantial overseas revenues; this threatened to bring almost all passive income earned abroad within the scope of the CFC regime unless it was taxed at something close to the UK rate. At the same time there was a general move towards lower corporate tax rates around the world, coupled with a determination on the part of HMRC to raise the effective tax rate for UK groups.

But a transaction undertaken for quite different reasons may also have had an impact. In response to various market pressures, the structure of the Shell Group was streamlined in 2005 by the introduction of a single parent company sitting above what had for nearly 100 years been twin holding companies in The Netherlands and the UK. It proved possible to retain a "FTSE" listing for this entity, even though its tax residence and head office were located in The Netherlands.

The combination of full listing in London with tax residence overseas was alluring. Over the next few years, upwards of 20 listed (though considerably smaller) UK groups introduced new holding companies resident outside the UK. The most common choice was a company incorporated in Jersey but resident in Ireland; other groups opted for Luxembourg, The Netherlands, Switzerland (a member of the European Free Trade Association and so to a degree protected from discrimination by other European countries) or, in the insurance sector, Bermuda.

A New Direction

Following publication of its CFC proposals in 2007, HMRC was faced by barely concealed threats from several major UK multinationals to join the tax *émigrés*. Adopting a "fortress UK" approach involving a version of the draconian "anti-inversion" rules in the US did not seem to be a plausible option, if only because of the risk that the ECJ would intervene.

Whatever the reason, there appears to have been a change of heart in 2008, led by the UK Treasury but with the acquiescence and in some cases enthusiastic support of senior personnel in HMRC. Instead of pushing for an increased tax take from a potentially dwindling number of major UK corporate groups, it does now seem to be accepted that "UK PLC" would be better served by a corporate tax system which aims to increase the number of taxpayers. (With the benefit of hindsight, many tax practitioners would say that the period 2005 – 2007 in fact marked a significant shift in the approach to tax cases taken by the ECJ, confronted no doubt by exasperated governments across the continent. The notion that there should be a "balanced allocation" of taxing powers, first appearing in *Marks & Spencer* at the end of 2005 (C-446/03), has allowed the Court to deliver a series of much less taxpayer-friendly judgments in subsequent cases. But it was not quite so clear at the time. In any event the Advocate General's recent opinion concerning the Dutch exit charge, in *National Grid Indus BV* (C-371/10), suggests that the specific issue of corporate migration may still favour the taxpayer.)

Three consequences of the change in approach are particularly evident. First, the decision has been taken to make a historic shift to the "territorial" taxation of UK companies (though not UK individuals). This is shown most obviously in the introduction of a participation exemption for foreign dividends and a regime which allows UK companies to make an irrevocable election that the profits (and losses) of foreign branches should not be taken into account for corporation tax purposes; these developments were covered in our introductory articles for, respectively, the 2010 and 2011 editions of this guide.

The second consequence of the new approach is a logical complement to the first. The Government announced in 2009 that it would start again with the process of CFC reform, abandoning the idea that all passive income should in principle be caught. The latest step along this path was the publication in June 2011 of a long consultation document setting out in some considerable detail the basis for a revised set of rules which would target only foreign subsidiaries earning income that had been "artificially diverted" from the UK. This document is discussed further below.

Finally, the new Coalition Government reduced the headline rate of corporation tax from 28% to 26% and has committed itself to further reductions of 1% per year for the next three years, reaching 23% in 2014/15. This is a direct response to global trends and will produce the lowest rate of corporation tax in the G7. (Or so says the Government, blithely ignoring the possibility that other countries may follow suit.)

In Western Europe, the most enthusiastic exponents of this approach to corporate taxation have to date been Ireland and the Benelux countries. And there are other UK developments which appear to have been inspired by their example. From April 2013, there is to be a "patent box" in place which will apply a special 10% rate of corporation tax to UK profits that are attributable to "qualifying patents". There will also be a partial exemption for the net interest receipts of finance company subsidiaries (again, see below), provided that the payer of the interest is not a UK member of the group such that it is the UK tax base which is being eroded. Presumably the Government has concluded that this is compatible with the EC Treaty, notwithstanding the European Commission's successful campaign against Belgian Coordination Centres and, more recently, the "interest box" in The Netherlands.

Two other changes are worth noting.

On the practical side, there can be no doubt that HMRC has attempted to foster a spirit of collaboration in its dealings with large businesses, facilitating contemporaneous discussion of and, where necessary, clearance for transactions.

The other change is much less welcome, but can also be seen as shifting the balance of advantage towards UK holding companies for UK businesses. Owing to the comparatively light restrictions on interest deductibility, it has for many years been easy enough for overseas multinationals to secure a low effective tax rate for their UK operations by introducing substantial quantities of debt, so long as this complied with the arm's-length principle at the heart of the UK's thin capitalisation code. The use of a hybrid instrument or entity might then allow debt deductions in the UK to be combined with equity treatment in the parent jurisdiction.

The initial attack on such hybrid funding schemes came in 2005, but from HMRC's perspective had only partial success in discouraging what it saw as excessive debt funding of UK subsidiaries by foreign parent companies. So in 2009 it introduced the "worldwide debt cap", which operates whether or not there is any element of hybridity. The principle is, broadly, that interest costs in the UK should not exceed interest costs for the worldwide group; in other words, the target is what HMRC describes as "debt-dumping". The debt cap erodes a potentially significant tax benefit that has been available only to foreign owners of UK businesses.

CFC Reform

The new regime for the taxation of CFCs will not take effect until, at the earliest, enactment of the next Finance Bill in summer 2012. But the document published by HMRC and the UK Treasury in June 2011 contains considerable detail, providing a clear picture of the way in which the revised rules will operate.

Here too, it is necessary to start with a little history. In the *Cadbury Schweppes* case (C-196/04, 2006), the ECJ was asked to decide whether the "motive defence" in the CFC regime was sufficient to make it compatible with the freedom of establishment enshrined in the EC Treaty. On the face of it, the regime is clearly incompatible with the Treaty freedoms: a UK company which establishes a subsidiary in another Member State may find itself subject to UK tax in a way that could not arise if the subsidiary was set up in the UK.

As ever, the ECJ did not rule on the specifics of the case in front of it, which concerned an Irish financing structure that Cadbury was happy to concede it had put in place simply to reduce UK tax for the group. Nor did the Court focus on the wording of the motive defence, which was not of course intended to allow such activity. Instead, the judgment stated that CFC legislation was in principle permissible if it applied "only to wholly artificial arrangements intended to circumvent national law". In addition, the taxpayer must be able to escape an apportionment under the legislation if it could show that the subsidiary "is genuinely established in [its] state of establishment" and that the relevant transactions "reflect the services which were actually carried out in that state and were not devoid of economic purpose with regard to [the parent company's] activities".

The UK legislation was amended following this judgment to exempt subsidiaries in EEA territories, but only for profits representing "economic value" that was "created directly by qualifying work". It was plain to everyone but HMRC that this special exemption did not satisfy the test laid down in *Cadbury* and indeed the legislation was a subject of a formal challenge by the European Commission in May 2011.

The current proposals for reform are a rather more serious attempt to meet the test set by the ECJ. The basic structure for the regime will be the same as at present: a UK company that controls a non-UK subsidiary can be taxed on its profits if those are subject to local tax in an amount that is less than 75% of the tax they would incur on UK principles, unless an exemption applies. Many of the exemptions will be similar too: a list of "excluded countries", an exclusion for certain types of "good" activity (in particular, trading operations) and, in place of the motive defence, a "general purpose exemption".

This last category is key, providing the intended answer to Cadbury. Before moving on to that, though, there are several other aspects of the proposed regime that deserve attention.

As already noted, there is to be a special partial exemption for CFCs that provide finance to other group members. So long as the recipients of the funds are not in the UK, the charge imputed to the UK parent will be only one quarter of the normal UK tax rate; so once this rate has reached 23%, in 2014, the profits of such a finance company will attract a charge in the UK at only 5.75%.

It appears however that there will not be a similar provision for intellectual property, which is the other central cause of dispute in the CFC arena.

Finally, there will be special rules for both banking and insurance activities.

Cadbury and the New CFC Regime

HMRC believes that the new general purpose exemption (GPE) will suffice to make the revised rules compatible with the Treaty freedoms. The intention is that profits accruing to a CFC and falling outside the other exemptions will not be caught so long as they have not been "artificially diverted" from the UK. This is not in fact a new concept: HMRC argued in *Cadbury* that the motive defence had the same effect, or at least should be read as if it did.

The consultation document does not contain draft legislation, but the thrust of the GPE is clear enough. The CFC must be established in its jurisdiction "with sufficient local management". Its profits will then be exempt if they "would more likely than not accrue to the CFC if it was operating under 'uncontrolled conditions'". In principle it will also be possible to rely on the GPE to protect what HMRC describes as "excess" profits, so long as there is no "artificial diversion".

It is at this point that the consultation document takes a surprising turn. It still regards the "tax-driven" diversion of profits from the UK as in itself sufficient basis for a CFC charge. HMRC no doubt appreciates that this will not really do: in *Cadbury*, the ECJ was quite clear that establishing operations in another Member State merely to take advantage of a lower tax rate was acceptable. So the main thrust of HMRC's defence here relies instead on a bold reading of ECJ case law, claiming that the ECJ laid down essentially the same test in *Cadbury* as it did in two later cases concerning thin capitalisation. HMRC considers that it is sufficient if the GPE operates whenever a CFC's profits are "commensurate with" its physical existence, staffing and activity, allowing an apportionment to the UK parent if and to the extent that they are not.

A number of criticisms can be made of this conflation of the CFC and transfer pricing concepts. As one would expect, the ECJ appears to say in *Cadbury* that so long as the CFC is actually established in its jurisdiction and pursuing genuine economic activity there, there will be a proper exercise of the freedom of establishment and no CFC apportionment can be made. There is no separate requirement that its profit be "commensurate with" its degree of establishment or level of activity.

A second difficulty relates specifically to intellectual property. Here, the consultation document says expressly that satisfying the arm's length principle will not suffice. More generally, the continued emphasis on tax motivation does not really fit with the judgment in *Cadbury*.

The overall impression is of a brave but rather ambitious project. There is clearly a desire to have a single regime which gives HMRC adequate weaponry to use against CFCs in tax havens but is at the same time compatible with the Treaty freedoms. It may be that in this one respect the amendment made to the legislation in 2007 got it right, when it opted for a more generous rule applicable only to CFCs in EEA states. Nor can it be said that the new rules do much to reduce complexity, though it will help considerably if HMRC can devise a threshold test analogous to the successful "gateway" for the worldwide debt cap and thereby take most UK multinationals outside the regime altogether.

It remains to be seen whether the new CFC regime really reflects a change of heart on the part of HMRC. The finance company partial exemption is a clear step forward; against that, HMRC seem determined to end the most commonly used technique in CFC planning, under which "bad" passive income is mixed in with and so sheltered by "good" active income in the same entity (a practice known as "swamping"), and it is not clear that the proposed relaxation of some other aspects of the CFC code will fully compensate.

Conclusion

It seems unlikely that the Government will in fact manage to make the UK's corporate tax regime the most competitive in the G20, at least when measured in terms of effective tax rates rather than headline rates. But if the Government gets CFC reform right, the only clear defect in the system for a typical UK multinational will be a minor one, namely the continued imposition of stamp duty on share transfers.

On that basis, if the UK's tax regime may not become a magnet it should at any rate cease to be a problem. UK PLC will of course wait to see the final package before reaching a view, but this piece can end on a positive note. The exodus appears to have ended and, for some, immigration is now a serious option.

William Watson

Slaughter and May
One Bunhill Row
London, EC1Y 8YY
United Kingdom

Tel: *+44 20 7090 5052*
Fax: *+44 20 7090 5000*
Email: *william.watson@slaughterandmay.com*
URL: *www.slaughterandmay.com*

William Watson joined Slaughter and May in 1994 and became a partner in the Tax Department in 2004. His practice covers all UK taxes relevant to corporate, financing and real estate transactions; besides corporation tax, this includes VAT, the various stamp duties and other direct taxes. He also advises regularly on tax disputes.
William's transactional work has to date ranged from cross-border mergers and reconstructions for major corporate groups, through securitisations and structured finance transactions on the financing side to real estate acquisition and development.

SLAUGHTER AND MAY

Slaughter and May is a leading international law firm recognised throughout the business community for its commercial awareness and commitment to clients. We have a diverse and extensive international practice advising on the full range of commercial, financing and other matters. We have a commitment to delivering top quality legal advice, combined with commercial awareness and a "can do" approach.

Our firm is unique among major UK law firms. We:

- are client focused, rather than product focused - we work with our clients to anticipate their business needs and offer solutions;
- place quality of advice before growth in numbers - our measured organic growth is sustained by lawyers recruited, trained and developed within the firm;
- work with the world's best firms internationally, rather than using the services of multiple branch offices; and
- manage large and complex transactions from beginning to end and deliver them on time.

Our tax group is involved both in structuring transactions and in advising on the documentation to implement transactions. We have particular expertise in mergers and acquisitions, flotations and privatisations, demutualisations, company reorganisations, private equity, investment funds, investigations and disputes, transfer pricing, debt and equity capital market transactions, structured finance, asset finance and leasing and securitisations.

"This corporate titan maintains a leading position in the market due to its expertise in the tax dimensions of corporate, financial and commercial deals." Chambers UK, 2011

Gazing in the Crystal Ball: The State of Corporate Tax Reform in the United States

Schulte Roth & Zabel LLP

Dan A. Kusnetz

I. Introduction

Over the past year, several plans that would substantially modify the current system of corporate taxation in the United States have been proposed. Political jockeying over tax reform is part of the *status quo* in United States politics. However, the increasing urgency of the nation's need to address the size of its national debt, the amount of deficit spending by the federal government and the need to spur the domestic economy to produce more jobs and GDP growth, have moved corporate tax reform proposals out of the province of economists and have made them a key factor in the political brinksmanship that has come to define 2011. With a Presidential election looming in 2012 and the House of Representatives under the control of the so-called "Tea Party" freshman representatives, the debate over tax policy has taken on ideological dimensions. Which policies will emerge as politically viable is a question that corporate taxpayers have to face as they plan their business operations for the near and long-term future. While each of the proposals described herein shares many common goals, their methods for achieving these goals differ dramatically. With respect to the current system of corporate taxation, the proposed changes range from modifications of specific provisions of the Internal Revenue Code of 1986, as amended (the "Code"), to the complete elimination of the corporate income tax.

This article will begin by analysing the current treatment of corporations under the Code. Next, this article will examine the treatment of U.S. corporations' domestic activities, as proposed in five of the more prominent plans that have recently been proposed [see Endnote 1]:

- The bipartisan proposals from the National Commission on Fiscal Responsibility, chaired by former Senator Alan Simpson and Erskine Bowles [see Endnote 2];
- The Bipartisan Tax Fairness and Simplification Act of 2011, introduced by Senators Ron Wyden, Dan Coats and Mark Begich [see Endnote 3];
- The proposals from the Bipartisan Policy Center's Debt Reduction Task Force [see Endnote 4];
- Republican Congressman and Chairman of the House Budget Committee, Paul Ryan's "Roadmap to America's Future" [see Endnote 5]; and
- President Obama's revenue proposals for the 2012 fiscal year [see Endnote 6].

Next, moving to the international tax arena, this article will review the taxation of U.S. corporations' foreign-source income, comparing proposals advocating for a territorial tax system versus the current "full-inclusion" system. Finally, this article will contain a discussion of several items that would indirectly affect the business activities of U.S. corporations.

The Current System of Taxing U.S. Corporations

General Corporate Tax Rates and Deductions

Generally, U.S. corporations are taxed at a rate of 35% on their domestic-source taxable income [see Endnote 7]. While corporations are denied certain deductions and exemptions available to individual taxpayers, corporations are not subject to many of the floors, phase-outs or other limitations on the use of itemised deductions which apply to the income taxation of individuals [see Endnote 8].

Treatment of U.S. Corporations' Foreign-Source Income

A U.S. corporation conducting foreign activities through the use of foreign subsidiaries is generally subject to U.S. tax only when the income of such subsidiaries is repatriated into the United States in the form of a dividend or other distribution to its U.S parent or when a gain is realised on the disposition of shares of the foreign subsidiary. Special rules apply to deemed income to have been repatriated in the case of certain foreign corporations with U.S. shareholders if such foreign corporations have certain forms of passive income or other categories of specified income and meet certain other tests. The taxation of U.S. corporations' foreign income is discussed in further detail in Section V.

Rationales Driving Current Corporate Tax Reform Proposals

Increasing Tax Revenue - Reducing the Federal Debt

For much of the past two years, Congress has focused on ways to reduce the U.S. debt burden in both the short and long-term. The Congressional Budget Office ("CBO") found that, as of July 2010, federal debt held by the public stood at a higher percentage of gross domestic product than during the Great Depression, and at its highest point since the Second World War [see Endnote 9]. The CBO attributed this increase in federal debt to three predominant factors: a) the deficit between federal revenues and spending that predated the 2008 fiscal crisis and resulting recession; b) the reduction in federal revenues which occurred as a result of the 2008 fiscal crisis; and c) the costs of stimulus and bailout policies executed to respond to the 2008 recession. As a consequence of the rising national debt, the CBO noted that future private investment in productive uses may be "crowded out", since an increasing portion of Americans' savings will have been directed to the purchase of public debt rather than to funding such investments. Conversely, as U.S. debt is increasingly held abroad, a larger portion of U.S. capital will continue to travel overseas.

To reduce the increasing level of national debt, the twin policies of decreasing government spending and increasing tax revenues have moved to the front of the national debate over fiscal policy. Liberal policy makers have argued that increased tax revenues must be part of the solution, while conservative policy makers have argued that increasing corporate taxes depresses job growth and therefore economic growth in general. Instead, they argue that decreasing the tax rate on corporate income may increase federal tax revenues due to the economic growth and job creation that reduced tax burdens will create [see Endnote 10].

Competiveness of U.S. Businesses in the Global Economy

Cited as a cause for modifying the corporate tax in several of the proposals discussed herein [see Endnote 11] is the decreasing competitiveness, whether real or merely perceived, of U.S. businesses in the global economy. For 2008, a year in which tax revenues were down across the board, the effective corporate tax rate was 23.4% [see Endnote 12]. This effective rate increased to 32.5% for corporations with assets of between $5 million and $100 million, and to 31.7% for corporations with assets between $100 million and $500 million [see Endnote 13].

Among member nations of the Organization for Economic Co-operation and Development ("OECD"), after Japan's reforms to their corporate tax system take effect, the United States will have the highest statutory combined corporate tax rate for 2011 [see Endnote 14]. These statutorily high rates have been blamed for suppressing both domestic and foreign investment in U.S. businesses [see Endnote 15] and thereby depressing economic growth in the United States generally. Bringing down the corporate tax rate has been viewed as a key to restoring U.S. corporate competitiveness in the global economy.

Avoidance of U.S. Tax Through the Use of Offshore Vehicles

Related to the competitiveness concerns described above is the belief that high tax rates on corporate income cause an outflow of both capital investment and economic activity generally. This is due almost entirely to the desire to avoid the higher tax rates on corporate income imposed by the U.S., as opposed to the rates applicable in foreign jurisdictions [see Endnote 16]. Since a U.S. corporation's foreign-source income is generally not subject to U.S. taxation until it is repatriated to the United States, there is a strong incentive for U.S. and multinational corporations to avoid distributing non-U.S. source income to its U.S. corporate shareholders. Reducing the rate at which U.S. corporations are taxed has been argued to lead to a reduction in the incentive of U.S. corporations to send income-producing activities offshore.

II. Reforms Advocating for a Lower Corporate Tax Rate Applied Across a Broader Base

Many of the proposals to overhaul the Code's corporate tax provisions focus on reducing the applicable rates at which corporate income is taxed, while simultaneously broadening the base of corporate income which is subject to tax. Notably, the most publicised of these plans, described below, are based on input from both Democrats and Republicans, but none of them have yet evidenced sufficient political support to give rise to a true front runner. While each of these plans are in many ways similar, they differ sharply in the means of broadening the effective corporate tax base.

A. The Simpson-Bowles Plan

Responding to growing concerns about the long-term fiscal health of the United States, President Obama, in early 2010, created the National Commission on Fiscal Responsibility and Reform (the "Commission") [see Endnote 17]. Chaired by former Senator Alan Simpson [see Endnote 18] and former Chief of Staff to President Clinton, Erskine Bowles [see Endnote 19], President Obama tasked the bipartisan commission with the creation of a proposal that would balance the federal budget by 2015, excluding any interest payments on the federal debt. In December 2010, the Commission released its plan, entitled "The Moment of Truth" [see Endnote 20]. In addition to a comprehensive overhaul of the Code [see Endnote 21], the Simpson-Bowles Plan recommends significant cuts to discretionary spending, containing healthcare and social security costs, and mandatory reform of the budget process, to ensure that its goals are accomplished.

Describing the corporate tax provisions of the Code as "a patchwork of overly complex and inefficient provisions that creates perverse incentives for investment", the Simpson-Bowles Plan cites the necessity of reforming the corporate tax code to maintain the competitiveness of U.S. business, and to prevent the loss of both American jobs and the corporate tax base. Thus, the Simpson-Bowles plan would replace the current corporate tax brackets, taxing corporate income at a single rate to be set between 23% and 29% [see Endnote 22]. To offset this rate reduction, the Simpson-Bowles Plan would eliminate all business tax expenditures, including all currently available corporate tax credits and the domestic oil production deduction [see Endnote 23]. Additionally, the Plan would eliminate the Last-In, First-Out method of accounting for inventory, albeit with an "appropriate" transition period.

On an international level, the Simpson-Bowles Plan advocates the use of a territorial tax system, where income earned by foreign operations located in the U.S. would be exempt from U.S. corporate income tax, and would be taxed solely by their domiciliary countries [see Endnote 24]. However, the drafters would continue the current treatment of taxing passive foreign-source income earned by U.S. shareholders of foreign corporations.

Hoping to ensure the swift passage of its proposals, the Commission included a "failsafe" feature in its Plan. Should Congress fail to pass legislation reforming the Code by 2013, this provision would automatically impose either: a) reductions of all itemised and above-the-line deductions for both individuals and corporations, business credits, domestic production activities deduction, and exclusion from income for employer-provided health insurance; or b) a trigger reducing rates and tax expenditures to certain specified levels by 2015.

B. The Bipartisan Tax Fairness and Simplification Act of 2011

Co-Sponsored by Senators Ron Wyden [see Endnote 25], Dan Coats [see Endnote 26] and Mark Begich [see Endnote 27], the Bipartisan Tax Fairness and Simplification Act of 2011 ("BTFSA") [see Endnote 28] would also replace the current corporate tax brackets with a single rate, in this case 24% [see Endnote 29].

As with the Simpson-Bowles Plan, the BTFSA would impose this lower rate on a broader tax base. This would be accomplished, in part, by eliminating numerous narrowly tailored tax preferences. These industry specific and other niche-based tax breaks, which are not generally available to corporate taxpayers (especially focused on the oil, gas and energy industries), include the following provisions of the Code, and would be effective for tax years beginning after December 31, 2011:

- the enhanced oil recovery credit (Code Section 43);
- the domestic production activities deduction (Code Section 199);
- the bankruptcy exception to the general limitation on net-operating losses for corporations undergoing a change in control (Code Section 382(l)(5));
- the rules concerning sales or dispositions to implement the Federal Energy Regulatory Commission or State electric restructuring policies (Code Section 451(i));
- the dollar limitation (Code Section 453A(b)(1)) and the exception for personal use and farm property (Code Section 453A(b)(3)), which permit deferral of gain recognition for non-dealer instalment obligations;
- the exception from the percentage of completion method of accounting for certain construction contracts (Code Section 460(e)(1));
- the allowance for percentage depletion for certain oil and gas wells (Code Section 613A);
- the deduction for costs relating to the development of certain mines (Code Section 616); and
- the provisions concerning the exceptions to the inventory property sales source rules (Sections 861(a)(6), 862(a)(6), 863(b)(2), 863(b)(3), and 865(b)).

The BTFSA also attacks the usual suspects from a political perspective. Thus, Section 202 of the BTFSA limits deductions taken with respect to taxpayer-owned aircraft to the amounts included as income by that taxpayer from the use or operation of the aircraft. Further, Section 207 of the BTFSA would limit the application of the foreign tax credit for certain large integrated oil companies [see Endnote 30] that are not subject to a generally applicable income tax in the jurisdiction for which the credit is claimed. Corporate interest deductions would be indexed to inflation and the portion of interest expense deductions that is attributable to inflation would be disallowed. In one of its few provisions that would reduce the tax base, the BTFSA would allow small businesses (with gross annual receipts of up to $1 million) to expense purchases of equipment and inventory in a single year [see Endnote 31]. The alternative minimum tax would also be eliminated.

Finally, the BTFSA would require studies to be completed, which would determine whether additional reporting should be required for pass-through entities to reduce possible "tax avoidance" by such entities, and how to reduce the federal government's direct and indirect spending on businesses by at least $230 billion over a ten-year period.

C. The Rivlin-Domenici Plan

In November 2010, the Debt Reduction Tax Force of the Bipartisan Policy Centre (the "Task Force") released a comprehensive plan aimed at boosting the U.S. economy while simultaneously reducing the national debt. Chaired by former Senator Pete Domenici [see Endnote 32] and former Director of the Clinton White House Office of Management and Budget, Dr. Alice M. Rivlin, the Task Force proposes across-the-board reforms of the Code [see Endnote 33].

As with the Simpson-Bowles Plan, the Task Force cites the competitiveness of U.S. businesses in the global economy as the driving force supporting its proposed corporate tax reforms. Additionally, the Rivlin-Domenici Plan notes that the Code diverts the investment and production decisions of U.S. corporations, causing these corporations to invest in less-productive but more tax-friendly operations. In order to eliminate the financial distortion created by corporate tax policy, the Rivlin-Domenici Plan would eliminate most all corporate deductions and tax credits.

Much like the Simpson-Bowles Plan and the BTFSA, the Rivlin-Domenici Plan would lower the corporate tax rate to a single rate of 27%. To broaden the applicable tax base, the Rivlin-Domenici Plan would eliminate "tax expenditures", loosely defined as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction ... or which provide a special credit, a preferential rate of tax, or a deferral of liability" [see Endnote 34]. Although the Task Force found some tax expenditures to be beneficial, it believes that the use of such expenditures is an inefficient means of promoting the activities benefitted by a given expenditure.

III. The Republican "Roadmap": Representative Ryan's Plan

Entitled "Roadmap to America's Future Act of 2010", the Ryan Plan cites similar concerns regarding the ability of American businesses to compete in the global economy as justification for its reforms of the Code. However, unlike the bipartisan proposals described above, Representative Paul Ryan [see Endnote 35] has proposed eliminating the corporate income tax entirely. In its place, the Ryan Plan would impose a "simple and effective" 8.5% business consumption tax ("BCT").

Essentially a value-added tax, [see Endnote 36], the BCT would be imposed by way of a "subtraction method", which would calculate a given business' tax base by subtracting its total purchases from its total sales. A business would then be required to pay to the Federal government 8.5% of this figure each quarter. Significantly, the Ryan Plan rejects the use of a "credit-invoice method" to determine the applicable tax base. Such a method would require a business to calculate its BCT on each individual transaction it entered into, thus requiring a new regime to determine the effective purchase and sale price for every transaction. Because the BCT would be imposed on the gross profits of a "business entity", defined to include both corporations and unincorporated businesses such as partnerships and limited liability companies, the current tax distinction between these entities would be largely eliminated under the Ryan Plan [see Endnote 37].

The focus of the Ryan Plan on consumption instead of income would completely change the current system of taxing mergers of and acquisitions by business entities. Notably, mergers between two business entities, and split-offs and similar transactions dividing a single business entity into one or more entities, would not result in any direct tax consequences [see Endnote 38]. Likewise, a stock acquisition by a business entity would not, of itself, cause any direct tax consequences.

The treatment of asset acquisitions differs from the treatment of corporate reorganisations under the Ryan plan. In an asset acquisition, the consideration paid for the assets of an acquired business would be allocated to those assets as under the current method of Section 1060 of the Code [see Endnote 39]. Where the acquisition is of substantially all of the assets of a business, the acquiring taxpayer could elect to treat the asset acquisition as a stock acquisition, thus avoiding any direct tax consequences [see Endnote 40].

The Ryan Plan would also impose an 8.5% tax on any goods or services imported into the United States [see Endnote 41]. For goods initially exported from the U.S. that subsequently return to the U.S. as imports, this tax would be imposed on the value added from the time that the goods were initially exported to the time of their return to the U.S.

IV. The Obama Administration's Proposed Reforms

Rather than attempting wholesale reforms of the corporate provisions of the Code as the preceding reform proposals would do, the Administration Plan for the 2012 fiscal year would leave the fundamental structure of the corporate tax system intact and would selectively amend Code provisions affecting corporate taxpayers. These proposals can broadly be grouped into: the imposition of new taxes; reforming or eliminating several so-called "loopholes" targeted toward specific industries; eliminating the myriad tax preferences enjoyed by the fossil fuel energy industries; changes to international taxation provisions [see Endnote 42]; and tightening up compliance and reporting rules. The Treasury estimates that the Administration Plan would result in an increase of federal income tax revenues, totaling just under $443 billion from 2012 through 2021, while also increasing outlays by approximately $115.3 billion over that same period.

A. R&D and Energy Policy Based Changes

The Administration Plan would permanently extend the research and experimentation credit currently found in Section 41 of the Code. Currently, this credit is set to expire after December 31, 2011 [see Endnote 43]. Further, the Administration Plan would add an additional $5 billion to the current $2.3 billion limit on the total credits that may be claimed under Section 48C of the Code. This section provides credits for certain "qualified advanced energy projects", defined to include projects used to produce renewable sources of energy, capture and sequester carbon dioxide emissions, and design and produce electric motor vehicles [see Endnote 44]. In the same vein, the current deduction in Section 179D for certain "energy efficient" properties placed in service during the taxable year would be treated as a credit under the Administration Plan.

The outlays that these R&D and "new clean energy" based proposals would cost can be contrasted with the elimination of decades of tax incentives that target the oil, gas and mining industries. Most all of the special tax breaks enjoyed by the fossil fuel extraction markets would be repealed outright. The repeals include: the expensing of intangible drilling costs; the use of percentage depletion for oil and gas wells and coal mining; the expensing of exploration and development costs; capital gains treatment for sales of royalty interests and a host of other fossil fuel based "tax incentives".

B. Financial Crisis Responsibility Fee

Attempting to raise additional revenue for the federal government, the Administration has proposed a "Financial Crisis Responsibility Fee", which would apply to U.S.-based bank holding companies, thrift holding companies, certain broker-dealers and companies controlling such broker-dealers, and insured depository institutions. U.S. companies that own or control such entities would also be subject to the fee. The fee would be imposed on U.S. companies with worldwide consolidated assets of at least $50 billion, as well as on U.S. subsidiaries of foreign firms which meet these requirements. In general, the fee would be imposed at a rate of 7.5 basis points on the difference between the firm's consolidated risk-weighted assets, minus its capital, insured deposits and specified small business loans. Any fees paid under this proposal would be deductible for purposes of calculating such firm's taxable income.

C. General Corporate Tax Changes

Under the Administration Plan, corporations that are currently required to file a Schedule M-3 with the IRS would be required to file all of their tax returns electronically. Corporations that file at least 250 returns (including income tax returns, employment returns, excise tax returns, and information returns, among others) in a taxable year are currently required to file such returns electronically. The Administration Plan would lower this 250-return threshold to an unstated number. The Plan would also require all corporations, without exception, to comply with the quarterly estimated tax payments required by Section 6655 of the Code [see Endnote 45].

The Administration Plan contains several proposals that would affect various provisions of the Code applicable to corporations. For example, the proposal would require a corporation to recognise interest income on a portion of the payment it receives when it enters into a forward sale of its own stock, which is currently not a taxable transaction. Additionally, the Administration Plan would amend the definition of "control" in Section 249(b)(2) of the Code to account for certain indirect control relationships described in Section 1563(a)(1). Finally, the proposals would make permanent the elimination capital gains taxation on investments by non corporate holders of small business stock, in an effort to drive additional capital into the small business markets.

V. International Issues

Overview

The United States bases its jurisdiction to tax foreign source income on the residence of the taxpayer. For purposes of U.S. tax law, a corporation is treated as a domestic corporation if it is incorporated under the laws of the United States [see Endnote 46]. No consideration is given to other factors, such as the location of management activities, employees, business assets, operations, revenue sources, exchanges on which the corporation's stock is traded or the residence of shareholders. Domestic corporations are subject to U.S. tax on their worldwide income. Foreign corporations are taxed only on income that has a sufficient nexus to the United States.

Income earned by a domestic U.S. corporation from foreign activities conducted by its foreign corporate subsidiaries generally is subject to U.S. tax only when such foreign subsidiary earnings are distributed as a dividend or otherwise to the domestic shareholder. Thus, until the income is repatriated, a domestic corporation can defer the U.S. tax liability of the growth in earnings of its foreign subsidiaries unless certain anti-deferral rules apply. When foreign earnings are repatriated, the U.S. corporate shareholder can then claim foreign tax credits for foreign taxes paid by its foreign subsidiaries on the earnings used to pay the repatriated dividends. The principal anti-deferral regimes, which change this general rule of deferring taxation until repatriation, are the rules with respect to controlled foreign corporations ("CFC"s) [see Endnote 47] and foreign passive investment companies ("PFIC"s) [see Endnote 48].

Under the CFC and PFIC rules, a domestic corporate shareholder may be taxed on a current basis in the United States on certain categories of passive (and other) income earned by its foreign corporate subsidiaries, even if such foreign earnings have not been distributed to the U.S. parent corpoarate shareholder. This ability to defer U.S. taxation thus creates an effectively different tax rate on active foreign business income of a CFC than the rate that applies to the CFC's passive income or the U.S. shareholder's own domestic income.

The deferral aspect of the United States' current system of worldwide taxation has been viewed by many as inefficient. Critics contend that it has caused many domestic corporations to move their operations offshore and to sometimes reincorporate offshore (referred to as corporate inversion transactions) to a low tax jurisdiction. Currently, there are two main alternatives to international tax reform being discussed in the United States, and these proposals take diametrically opposed approaches to taxing foreign source income. The first approach is to adopt a territorial system of taxation in which all foreign business income is exempt from U.S. taxation. The second is to move toward a full inclusion system in which all foreign-source income is currently taxed (no deferral) without regard to whether the income is from business or investment, or whether such income is repatriated. The Joint Committee on Taxation ("JCT") recently issued a report detailing these two leading proposals to reshape the way the U.S. taxes foreign source income [see Endnote 49].

Territorial System

A territorial system of taxation generally provides that foreign income earned by a domestic corporation from foreign subsidiaries will be categorised as either: (1) active foreign income earned by a foreign branch or repatriated as a dividend from a foreign subsidiary, which would be exempt from U.S. tax; or (2) passive foreign-source income, which would generally continue to be included in income and taxed under the current anti-deferral tax regimes. The Simpson-Bowles Plan advocates a territorial taxation system for active foreign-source income.

The JCT in a prior report detailed various proposals to exempt foreign business income (the "Exemption Proposals") as part of a territorial system of taxation [see Endnote 50]. Under the Exemption Proposals, a domestic corporate shareholder that owns 10% or more of the stock of a CFC would exclude from income all dividends received from the CFC. Deductions for interest and other expenses of the domestic corporation would be disallowed to the extent allocable to exempt CFC earnings. The symmetrical treatment of income and expenses would be consistent with the Code's general approach of disallowing expenses associated with the earning of exempt income. Further, allocation of expenses between foreign-sources of income may curtail the perceived negative effective tax rates for overseas investments by permitting taxpayers to earn income in low-tax foreign countries while claiming the related deduction in the United States [see Endnote 51]. This approach would be different than what is followed by most foreign jurisdictions. Many foreign jurisdictions allow a deduction for expenses that generate exempt foreign income and instead provide that a small percentage of foreign dividends is taxable.

Moreover, under a territorial system, any gain from a domestic corporation's sale of CFC stock would be excluded from income to the extent of undistributed exempt earnings. Any excess of gain over this amount would be taxable. Deduction for losses on the sale of CFC stock would be disallowed. Rules would be implemented so that all income earned by foreign branches of domestic corporations would be treated in the same manner as income earned by CFCs.

Under the JCT's Exemption Proposals, most foreign business income would no longer be subject to U.S. taxation; regardless of the residence of the parent corporation and regardless of whether such income was repatriated. This is expected to eliminate a key perceived inefficiency in the present system, the incentive that exists now for domestic corporations to "park" and reinvest the earnings of foreign subsidiaries permanently offshore in order to defer the taxation of repatriated earnings.

There is no consensus on the scope of a territorial taxation system or whether it should apply to individuals as well as corporate shareholders. None of the leading proposals have addressed how foreign partnerships would be addressed under a territorial approach. One approach could be to continue to treat foreign partnerships as flow-through entities for purposes of determining the treatment of the partners, including each partner's share of exempt and non-exempt income [see Endnote 52]. Other options include treating an investment in a foreign partnership in the same manner as an interest in a CFC or as a portfolio investment.

There are also transition rule issues that would need to be addressed if the United States were to move to a territorial taxation system. Such issues include the treatment of foreign subsidiaries' existing untaxed earnings, existing tax attributes (e.g., foreign tax credits and net-operating loss carryovers) and the U.S. government's obligations under existing income tax treaties. A reduced tax rate on repatriated earnings may be a good transition step toward the territorial system - one with a permanent zero or very low tax on repatriation. The BTFSA would allow a one-year repatriation tax holiday [see Endnote 53]. It is certain that an implementation of a territorial taxation system would require significant time and resources to ensure that the system would be economically efficient.

Full Inclusion System

The other primary option which has been discussed for fundamental international tax reform is the adoption of a full inclusion taxation system in the United States. There is no prevailing view regarding the mechanisms that should be implemented for such a system, however, it is generally agreed that such a system would have two basic features: (1) U.S. shareholders of a foreign corporation (at least those owning a certain ownership threshold) would be taxed currently on their shares of the foreign corporation's income without regard to the repatriation of such earnings and (2) the foreign tax credit would be retained in some form to mitigate double taxation of foreign source income [see Endnote 54].

The JCT Report analyses three options for implementing a full-inclusion system: (1) treatment of CFCs as pass-through entities, such that each U.S. shareholder is required to include in income currently its share of the CFC's items of income, gain, deduction and loss without regard to the nature of such income as active of passive; (2) expansion of rules relating to the filing of consolidated tax returns to include in an affiliated group a corporation's foreign subsidiaries; and (3) expansion of the existing CFC regime to expand the nature of tax items deemed repatriated.

There are significant differences between these options. Under the consolidation approach, losses of foreign subsidiaries would be included on the U.S. tax return without any basis limitation. Additionally, the consolidation regime would apply only to U.S. corporate shareholders of foreign subsidiaries. For a consolidation regime to work, it is likely that the required ownership threshold for consolidation would be revisited, to perhaps as low as 10%. A U.S. shareholder to which the consolidation rule did not apply (i.e., individuals, minority corporate shareholders, etc.) generally would not be subject to tax on their share of the earnings of the foreign subsidiary until such shareholder received an actual distribution. The PFIC rules could be retained for these shareholders [see Endnote 55].

The foreign tax credit system would likely need to be restructured to accommodate a full inclusion taxation system. Under present law, in very general terms, the foreign tax credit is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income. The JCT Report notes that there is agreement that this limitation should be retained in concept but suggests that modifications to the limitation should be considered. For example, a move to minimise excess foreign tax credits could be through the elimination of deductions for various overhead expenses (including interest expense) incurred by a U.S. parent corporation and attributable to foreign source income. The elimination of the current situation where many taxpayers have excess foreign tax credits is considered important to the goal of eliminating incentives to avoid repatriating foreign earnings. For example, to taxpayers which have excess foreign tax credits, the imposition of foreign withholding taxes on dividend payments may disincentivise the repatriation of foreign earnings, undermining one of the principal benefits of moving a full inclusion system.

In implementing a full inclusion taxation system, it would be necessary to determine how to treat losses of a foreign subsidiary that do not flow through to U.S. shareholders. Allowing losses to flow through would simplify entity choice decisions by removing tax incentives to structure loss operations in branch or partnership form. However, it is likely that permitting the utilisation of foreign losses against domestic source income would significantly reduce U.S. tax revenue [see Endnote 56].

There are also important transition rule issues to address if the United States were to move to a full inclusion taxation system. Although no other major trade partner utilises a full inclusion tax regime, it could be an easier to transition to such a system than to a territorial regime. Current treaties reflect the existing foreign tax credit system, which would continue under the full inclusion system for mitigating international double taxation [see Endnote 57].

The Administration Plan's International Reform Proposals

The Administration Plan addresses international taxation reform on a more piecemeal basis than would occur under a move to either a territorial or a full inclusion system. Addressed below are some of the major reforms in this area proposed by the Administration Plan.

Defer Deductions of Interest Expense Related to Deferred Income

As discussed above, U.S. taxpayers are currently permitted to deduct certain expenses attributable to foreign investments, while deferring U.S. tax on the income from such investments. The Administration believes that this may incentivise U.S. businesses to shift their investments – and jobs – overseas, harming the U.S. economy [see Endnote 58]. The proposal defers the deduction of interest expense that is attributable to exempt foreign-source income, but continues to allow a current deduction for interest expense properly allocated to foreign-source income which is currently subject to U.S. tax [see Endnote 59]. Deferred interest expense would be deductible in a subsequent year in proportion to the amount of the previously deferred foreign-source income that is subject to U.S. tax during such subsequent year.

Under this plan, the amount of a taxpayer's interest expense that is properly allocated and apportioned to foreign-source income would generally be determined under current Treasury Regulations. The Treasury Department, however, would revise such regulations as necessary to prevent inappropriate decreases in the allocation of interest expense to foreign-source income [see Endnote 60].

Pool Foreign Tax Credits [see Endnote 61]

Under current U.S. tax law, a taxpayer may claim a credit against its U.S. income tax liability for income and certain other taxes paid or accrued during the taxable year to any foreign country or any possession of the United States. A domestic corporation is deemed to have paid the foreign taxes paid by certain foreign subsidiaries from which it receives a dividend (the deemed paid foreign tax credit). However, the deemed paid foreign tax credit must be applied separately with respect to income that falls within the passive category and income that falls within the general category.

The proposal would require a U.S. taxpayer to determine its deemed paid foreign tax credit on a consolidated basis by aggregating the foreign taxes, earnings and profits of all of its foreign subsidiaries. The deemed paid foreign tax credit for a taxable year would be determined based on the amount of the consolidated earnings and profits of the foreign subsidiaries repatriated to the U.S. taxpayer in that taxable year.

Eliminate Deferral of Excess Returns Associated with Transfers of Intangibles Offshore [see Endnote 62]

The Administration also proposes expanding subpart F to include excess income from intangibles transferred to low-taxed affiliates. Under current law relating to transfer pricing, the IRS can reallocate gross income, deductions, credits, and other allowances between or among two or more commonly owned or controlled organisations or trades or businesses as necessary to prevent evasion of taxes or to clearly reflect income, using an arm's length standard of pricing [see Endnote 63]. Special rules relate to the pricing of transfers of intangible assets between related taxpayers in order to ensure that the transferor realises income from the transfer that is commensurate with the income earning potential of the transferred intangibles. The Administration is concerned that income shifting is taking place through transfers of intangibles to low-taxed affiliates which has resulted in erosion of the U.S. tax base and the Administration wants to reduce the incentive for such non-economic base-erosion [see Endnote 64].

Under the proposal, if a U.S. person transfers an intangible from the United States to a related CFC, then the CFC would be charged with having realised certain excess income from the intangible. The excess income would be computed with respect to the earnings of the transferee from its exploitation of the intangible asset. The transferee would be entitled to earn an "appropriate" percentage mark-up on the sale, lease, licence or other manner of commercialicing the intangible asset but income earned beyond that mark-up would become subpart F income that would give rise to current U.S. tax liability of the transferor of the intangible asset.

VI. Other Issues

Altering the Treatment of Capital Gains and Dividend Income

Although not affecting the taxation of corporate income directly, several of the proposals would amend the means for taxing individuals' capital gains and dividend income. These changes could affect individuals' incentive to invest in U.S. corporations, thereby increasing or decreasing U.S. corporations' available capital.

For example, the Rivlin-Domenici Plan would eliminate all preferential tax rates for capital gains and dividend income, taxing these sources of income at the plan's reduced rate of 27% for individuals' ordinary income [see Endnote 65]. Likewise, the Simpson-Bowles Plan would tax capital gains and dividend income as ordinary income, at reduced rates for individuals ranging from 12% to 28% [see Endnote 66].

The BTFSA would follow a similar scheme, nominally taxing capital gains and dividend income as ordinary income at a common rate of 35%. However, the BTFSA would exclude 35% of the taxpayer's long-term capital gains (using a modified six-month holding period) and qualified dividend income from the tax base, with the result that such gains and income would only be subject to an effective 22.75% rate [see Endnote 67].

For individuals in the top two tax rate brackets, the Administration Plan would apply a 20% tax rate on long-term capital gains and qualified dividend income. The Administration Plan notes that this would be the same rate at which such income would be taxed for such taxpayers under current law, as applicable after 2012.

Reducing the Tax Preference for Corporate Debt versus Equity

Though not addressed by the proposals highlighted by this article, several authors have advocated for amending the U.S. system of corporate taxation to eliminate corporations' preference for debt over equity [see Endnote 68]. Currently, U.S. corporations may borrow funds without any direct tax consequences, while deducting interest payments made on their debt. However, a corporation's shareholders are subject to a "double tax" on their equity in the corporation, due to entity-level tax on the corporation's income and the subsequent tax on dividends received or capital gains realised by the shareholder. Thus, the difference between the effective tax rate applicable to corporate debt versus the effective tax rate applicable to corporate equity is approximately 70% in favour of equity, which is the highest in the OECD [see Endnote 69].

To offset this distortion, at least one author has advocated for a corporate "cash-flow" tax, under which all depreciation deductions would be replaced by immediate expensing for all tangible investments and net financial investments [see Endnote 70]. Thus, under this system, businesses would be able to take an immediate deduction for tangible investments undertaken in excess in the funds borrowed for such investment (i.e., a net deduction for investments funded by equity), while investments funded by debt would be treated as under current law. The availability of a full deduction for equity investments is thought to help offset corporations' bias for debt.

Conclusion

As described above, the proposed plans to rewrite the U.S. system of taxing corporations vary from a group of disparate additions to and repeals from the Code, to the complete elimination of the corporate income tax as we know it. Importantly, these proposals do not exist in a vacuum, and are often merely a portion of a much broader plan for increasing U.S. domestic economic activity or reducing the federal debt, or both. Further, the likelihood of any of the plans described above being enacted wholesale is slim and any legislative action is likely to include elements from many of the plans.

It is, of course, impossible to predict which, if any, of these proposals for corporate tax reform, or individual elements thereof, have potential for being enacted. The United States is facing an extremely divisive electoral season, rife with ideological disputes between those who view any increase to tax burdens as inherently damaging to the economy and those who view tax increases as a necessary element to reducing the federal deficit. The only conclusion one can draw concerning the outcome of U.S. corporate tax reform is that the last proposal has not been written and that all sides to the debate agree that maintenance of the *status quo ante* is an unacceptable approach. Absent a breakthrough of political *détente* or a crisis that unifies political rivals, corporate tax reform is likely to continue to be debated – but not legislated – until after the 2012 election season has concluded. Nonetheless, being forewarned is being forearmed, and knowledge of which proposals are being debated will help taxpayers to anticipate and to follow along with the coming changes to the Code.

Endnotes

1. Not all of the recent tax reform proposals are described herein. For example due to its perceived lack of viability there is no discussion of Republican presidential candidate Herman Cain's 9-9-9 plan, which would create "flat" taxes of 9% each, imposed on corporate income (gross income reduced only by amounts spent purchasing goods from U.S. businesses and on capital expenditures and excluding export income), personal income (gross income less charitable contributions) and on retail sales. For details on the 9-9-9 plan, see: http://www.hermancain.com/999plan. Perhaps more important an omission is the fact that the recommendations of the United States Congress Joint Select Committee on Deficit Reduction are not scheduled to be released until after the editorial deadline for this chapter. The Joint Select Committee, known as the "supercommittee", was created by The Budget Control Act of 2011 (Pub. L. No. 112-25, S. 365, 125 Stat. 239, enacted August 2, 2011), as a means to stave off a sovereign debt default which was threatened by the inability of Congress to agree to an increase in the nation's debt ceiling. The supercommittee is made up of six members of the House of Representatives and six Senators, evenly divided between Democrat and the Republican members. The supercommittee is charged with issuing a recommendation by November 23, 2011 for at least $1.5 trillion in newly enacted deficit reduction steps to be undertaken over a ten-year period. Undoubtedly, corporate tax reform will figure prominently in the debates and proposals to emerge from the supercommittee's work.
2. http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf (the "Simpson-Bowles Plan").
3. http://www.gpo.gov/fdsys/pkg/BILLS-112s727is/pdf/BILLS-112s727is.pdf (the "BTFSA").
4. http://www.bipartisanpolicy.org/sites/default/files/BPC%20FINAL%20REPORT%20FOR%20PRINTER%2002%2028%2011.pdf (the "Rivlin-Domenici Plan").
5. http://www.roadmap.republicans.budget.house.gov/plan/ (the "Ryan Plan").
6. http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf (the "Administration Plan").
7. For the first $50,000 of taxable income, U.S. corporations are taxed at a marginal rate of 15%. This rate rises to 25% for the next $25,000 of taxable income recognised by the corporation, to 34% for a corporation's taxable income in excess of $75,000 and up to $10,000,000 and to 35% for taxable income in excess of $10 million. In addition, the alternative minimum tax provides

for a "shadow" tax regime which limits or eliminates a substantial number of deductions and credits or limits the extent to which they may be used to reduce regular corporate taxable income and applies a 20% flat rate to the resulting "alternative minimum taxable income".

8. For a more thorough discussion of deductions allowed to corporations, see Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (Thomson Reuters/WG&L, 7th ed. 2006 & Supp. 2011-2), ¶ 5.03.

9. Congressional Budget Office, Federal Debt and the Risk of a Fiscal Crisis, Fig. 1, July 27, 2010.

10. *See generally*, e.g., Chris Edwards, Corporate Tax Laffer Curve, Cato Institute Tax & Budget Bulletin No. 49 (Nov. 2007).

11. See, e.g., Simpson-Bowles, Recommendation 2.2 ("Without [corporate tax] reform, it is likely that U.S. competitiveness will continue to suffer. The results of inaction are undesirable: the loss of American jobs, the movement of business operations overseas, reduced investment by foreign businesses in the U.S., reduced innovation and creation of intellectual property in the U.S., the sale of U.S. companies to foreign multinationals, and a general erosion of the corporate tax base."); The Bipartisan Tax Fairness and Simplification Act of 2011, Two-Pager, available at http://wyden.senate.gov/issues/legislation/details/?id=fb5b603a-ed94-48a8-8ff1-c220c1052b3f ("Currently, the United States' corporate income tax rate is the second highest in the industrialized world, putting American corporations at a competitive disadvantage in the international marketplace."); Representative Paul D. Ryan, A Roadmap for America's Future Version 2.0, A Plan to Solve America's Long-Term Economic and Fiscal Crisis, p. 59 ("[T]he corporate income tax . . . discourages investment and job creation, distorts business activity, and puts American businesses at a competitive disadvantage against foreign competitors.").

12. Tax Foundation, Beyond the Headlines: What Do Corporations Pay in Income Tax? p. 3 (Sept. 2011).

13. *Id.*

14. Taxation of Corporate and Capital Income (2011), Table II.1. Corporate Income Tax Rate, available at http://www.oecd.org/dataoecd/26/56/33717459.xls. As of 2010, Japan's highest combined corporate income tax rate was 39.54%, while the United States' highest combined corporate income tax rate was 39.21%. Due to changes in Japan's system of taxing corporations, their top rate fell to 34.54% in 2011. Tax Foundation, National and State Corporate Income Tax Rates, U.S. States and OECD Countries, 2011, available at http://www.taxfoundation.org/taxdata/show/23034.html.

15. Duanjie Chen & Jack Mintz, New Estimates of Effective Corporate Tax Rates on Business Investment, Cato Institute Tax & Budget Bulletin No. 64 (Feb. 2011), p. 3.

16. See, e.g., Chuck Marr & Brian Highsmith, Centre on Budget and Policy Priorities, Six Tests for Corporate Tax Reform, Feb. 28, 2011, p. 1.

17. http://www.whitehouse.gov/the-press-office/executive-order-national-commission-fiscal-responsibility-and-reform.

18. Republican, Wyoming.

19. Democrat, North Carolina.

20. The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.

21. In addition to comprehensive proposals to reform the corporate tax system, the Simpson-Bowles Plan would reduce tax brackets for individuals, eliminate all but a few "tax expenditures", and tax capital gains and dividend income as ordinary income. Section II of the Plan.

22. In its illustrative proposal, the Simpson-Bowles Plan uses a rate of 28%.

23. Simpson-Bowles Plan, Fig. 9.

24. See Section V, *infra*.

25. Democrat, Oregon.

26. Republican, Indiana.

27. Democrat, Alaska.

28. S. 727, 122 Cong. 1st Session (April 5, 2011).

29. Section 201(a) of the BTFSA, amending I.R.C. § 11(b). In addition to corporate tax reforms, the BTFSA would tax individuals at one of three rates (15%, 25%, or 35%), increase the standard deduction for individuals, repeal all individual miscellaneous itemised deductions, and change the treatment of capital gains and dividend income.

30. The term "large integrated oil company" is defined to include an integrated oil company, as defined in Code Section 291(b)(4), which has gross receipts exceeding $1 billion for the taxable year and which averages a daily crude oil production of at least 500,000 barrels worldwide.

31. The determination of which small businesses are eligible would refer to the gross receipts test of Code Section 448(c) of the Code, adjusting the $5 million figure downward to $1 million.

32. Republican, New Mexico.

33. In addition to corporate tax reforms, the Rivlin-Domenici Plan would create two tax rate brackets of 15% and 27% for individuals, eliminate the Alternative Minimum Tax, eliminate all itemised deductions and the standard deduction (though it would allow taxpayers to claim a 15% credit for certain home mortgage interest expenses), tax capital gains and dividends as ordinary income (at the amended rates proposed by the plan), and introduce a Debt Reduction Sales Tax of 6.5%, among other changes.

34. Citing the Congressional Budget Act of 1974.

35. Republican, Wisconsin.

36. The idea of a national value-added tax is not exclusive to the Ryan Plan; the Rivlin-Domenici Plan would impose a similar, albeit temporary, national Debt Reduction Sales Tax of 6.5%.

37. See HR 4529, Section 602 (proposed Section 206(a)).

38. Ryan Plan, proposed Section 213(a).

39. Ryan Plan, proposed Section 212(a).

40. Ryan Plan, proposed Section 212(c).

41. Ryan Plan, proposed sections 281-282.

42. The Administration Plan's international provisions are discussed at section V(b), *infra*.

43. This proposal is not necessarily a drastic change to the Code. Although the research and experimentation credit is scheduled to expire, the credit has been effectively permanent since its inception, having been extended by legislation on no less than eleven occasions.

44. I.R.C. § 48C(c)(1).

45. The Administration appears to be less concerned with increasing revenues or ensuring compliance with this proposal than it is with ensuring the certainty of the Code's provisions.

46. § 7701(a)(4).

47. See, Subpart F of the Code, Section 951 through 965. A CFC is a foreign corporation that has U.S. shareholders that own (directly, indirectly, or constructively, within the meaning of sections 958(a) and (b)) on any day of the tax year of the foreign corporation, more than 50% of: (1) the total combined voting power of all classes of its voting stock or (ii) the total value of the stock of the corporation.

48. See, Code Sections 1291 through 1298. A PFIC is a foreign corporation that has either 75% or more of its gross income in a year from passive income sources or that owns assets which generate passive income where such passive assets are at least 50% of the corporation's assets. The rules for determining PFIC status are complex and contain a myriad of exceptions.

49. Joint Committee on Taxation, *Present Law and Issues in U.S.Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011 (the "JCT Report").
50. Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005 (the "JCT Options Report") at 186-97.
51. JCT Report, p. 94.
52. JCT Report, p. 92.
53. BTFSA, p. 112.
54. JCT Report, p. 99.
55. JCT Report, p. 101.
56. JCT Report, p. 109.
57. JCT Report, p. 110.
58. Administration Plan, page 40.
59. *Id.*
60. *Id.*
61. Administration Plan, p. 41.
62. Administration Plan, p. 43.
63. Code § 482.
64. Administration Plan, p. 43.
65. The Rivlin-Domenici Task Force noted that "[e]liminating the differential between the tax on capital gains and on ordinary income will establish equal treatment among taxpayers with different sources of income and eliminate the incentive to use tax shelters to convert ordinary income into capital gains". Rivlin-Domenici Plan, p. 38.
66. Simpson-Bowles Plan, p. 31, Fig. 7.
67. BTFSA, Secs. 109, 110. The Simpson-Bowles Plan states that a similar exemption for a portion of capital gains and dividend income may be used as an alternative to the treatment of all capital gains and dividend income as ordinary income. Simpson-Bowles Plan, p. 31, Fig. 7, n.5. However, that plan would require a corresponding increase in the ordinary income rate to offset any revenue lost as a result of such an exclusion.
68. See, e.g., Center on Budget and Policy Priorities, Six Tests for Corporate Tax Reform, Feb. 28, 2011; Alan J. Auerbach, A Modern Corporate Tax, Center for American Progress, December 2010.
69. Marr & Highsmith, *supra* note 16 at 4. See also Auerbach, at 5, fig. 3.
70. Auerbach, at 8.

Acknowledgment

The author would like to acknowledge the assistance in the preparation of this chapter of colleagues Katherine A. Sunderland and Philip Cooke, who are associates in the Tax Department of Schulte Roth & Zabel LLP.

Dan A. Kusnetz

Schulte Roth & Zabel LLP
919 Third Avenue
New York, New York 10022
USA

Tel: *+1 212 756 2095*
Fax: *+1 212 593 5955*
Email: *dan.kusnetz@srz.com*
URL: *www.srz.com*

Dan A. Kusnetz is a partner in the New York office of Schulte Roth & Zabel, where his practice concentrates on tax planning for complex transactions, including mergers & acquisitions, private equity, bankruptcy, workouts, corporate restructuring and distressed asset investing, structured finance and real estate. Dan has been recognised by *The Best Lawyers in America* as a leading tax attorney. He received his B.A., *cum laude*, from Tulane University; his J.D., *magna cum laude*, from Tulane University Law School, where he was Order of the Coif and managing editor of the *Tulane Law Review*; and his LL.M. in taxation from New York University School of Law.

Schulte Roth&Zabel

Schulte Roth & Zabel LLP (www.srz.com) is a full-service law firm with offices in New York, Washington, D.C., and London. As one of the leading law firms serving the financial services industry, the firm regularly advises clients on corporate and transactional matters, as well as providing counsel on securities regulatory compliance, enforcement and investigative issues. The firm's practices include bank regulatory; business reorganization; business transactions; employment and employee benefits; environmental; finance; individual client services; intellectual property, sourcing and technology; investment management; litigation; real estate; regulatory and compliance; structured products and derivatives; and tax.

Every business or investment transaction has tax consequences, and our Tax Group provides planning advice to clients across the spectrum of the firm's practice areas. Our tax attorneys are practical business lawyers who combine knowledge of the law with the deal experience necessary to apply that knowledge to sophisticated commercial transactions. Whether called upon to assist with a cross-border M&A matter, to advise an investor in distressed securities or to structure a private investment fund, the group's acute understanding of tax law possibilities and pitfalls is a critical part of SRZ's ability to advise some of the world's most sophisticated clients.

Albania

Aigest Milo

Ardjana Shehi

KALO & ASSOCIATES

1 General: Treaties

1.1 How many income tax treaties are currently in force in Albania?

Albania has entered into income tax treaties (Double Taxation Treaties) with 36 countries, including most of the Member States of the European Union. However, currently there are no tax treaties in force with the United Kingdom and the United States of America.

1.2 Do they generally follow the OECD or another model?

The DTT's entered into by Albania follow the OECD Model Convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

The Albanian Constitution provides that international treaties (including DTT-s) ought to be ratified by the Parliament. A ratified treaty is published in the Official Gazette and prevails in the case of conflict with the domestic legislation.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Generally, DTT's entered into by Albania do not contain anti-treaty shopping provisions.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Pursuant to the Albanian Constitution which provides for the hierarchy of sources of law, DTT-s (as international treaties ratified by Law) prevail the domestic legislation.

2 Transaction Taxes

2.1 Are there any documentary taxes in Albania?

Albanian legislation does not provide for any documentary tax except for national tax, named as stamp tax.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rate(s)?

Albanian legislation provides for VAT, which is applicable to taxable supplies of goods and services. The Albanian law on VAT provides the following rates:

- A standard rate of 20%.
- A reduced rate of 10% for the supply of drugs and medical services.
- A zero rate for the export of goods and export of services; such services provided outside the country.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

According to Albanian tax legislation, as a general rule, the legal entities which perform an economic activity and have an annual turnover of over ALL 5,000,000, are subject to VAT. However, the main transactions exempted from VAT are as follows:

- The sale and lease of immovable property (for more than 2 months).
- Financial services.
- Supply of gold from Bank of Albania and second-tier banks.
- Supply of post stamps or similar stamps.
- Supply from religious or philosophical not-for-profit organsations, or not-for-profit organisations which have the "public benefit" status and that apply prices lower than the market prices.
- Educational Services.
- Supply of services and goods by and between certified contractors and their subcontractors engaged in the research and development of hydrocarbon operations.
- Printing of newspapers, sale of newspaper, magazines, books and supply of advertisement services for written and electronic media.
- Supply of identity cards.
- Supply of gambling, casino and hippodrome services.
- Supply of international services by a taxable person outside Albanian territory.
- Import of goods by NATO and its own bodies in the framework of operations and pursuant to international agreements.
- Import of goods and services performed by contractors and subcontractors relating to the research and development of hydrocarbon operations.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

VAT is fully recoverable by all VAT taxpayers; Albanian legislation also provides for VAT reimbursement. Albanian tax legislation provides that VAT related to expenses that are not related to the taxpayer's business activity is not recoverable. Further, VAT is not recoverable for some expenses, such as: fuel expenses used for passenger vehicles, marketing and promotions materials, etc.

2.5 Are there any other transaction taxes?

Apart from VAT, Albanian Tax legislation does not provide for a transaction tax of general application, except for a special transfer tax in some transactions of a specific nature, such as: tax on the transfer of immovable properties.

2.6 Are there any other indirect taxes of which we should be aware?

In addition to VAT, another tax is excise tax, which is applied to the sale and/or import of a limited number of goods, such as tobacco, alcoholic drinks, petrol derivatives, etc. The tax is calculated either as a percentage rate or an amount per sold unit.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Albanian legislation provides that all Albanian tax residents have the obligation to withhold, declare and transfer the withholding tax (at the rate of 10%) to Tax Authorities in consideration to payments made to non-Albanian tax residents, unless there is an effective corresponding DTT which provides that dividend is not taxed in Albania.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid to a non-resident taxpayer are subject to Albanian withholding tax (at the rate of 10%) on the gross amount), unless a corresponding effective Double Taxation Treaty provides otherwise.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest paid to a non-resident taxpayer is subject to the Albanian withholding tax (at the rate of 10%) on the gross amount, unless a corresponding effective Double Taxation Treaty provides otherwise.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Albanian Tax Legislation allows the tax deductibility of interest paid in consideration of a loan if such interest does not exceed four times the company's net assets. This rule is not applied for short-term loans (i.e. less than one year).

WHT relief for interest is not restricted by reference to "thin capitalisation" rules.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

Albanian Legislation does not expressly provide for any such rule.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The thin capitalisation rules apply to all debts, regardless of their source.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

The above-mentioned rules also apply to interest payments made by an Albanian taxpayer to non-residents taxpayers. No other related rules/restrictions are provided.

3.8 Does Albania have transfer pricing rules?

Albanian legislation has some provisions related to transfer pricing, but the existing related legal provisions do not provide for transfer pricing to the required standards. However, be informed that a secondary legislation provides that the Transfer Pricing Commission of the General Taxation Directorate, in applying the transfer pricing rules, should refer to the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The rate of the corporate profit tax in Albania is 10% (ten percent).

4.2 When is that tax generally payable?

The corporate profit tax is payable by advance instalments every three months. The payments for each month from January to April are equal to 1/12 of the profit tax due according to the latest tax return (e.g. tax year 2009 for 2011). The payments for the remaining months are equal to 1/8 of the profit tax paid in the previous fiscal year, by subtracting the payments made from January to April. The taxpayer ought to submit to the tax authorities the annual balance sheet by 31 March of the year following the fiscal year and the corporate tax of the previous year is adjusted with the results as stated in that balance sheet.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for Albanian corporate tax is the company's net taxable income. The net taxable income is calculated as the difference between the annual turnover and the tax deductible expenses related to the economic activity of the company.

The taxable income of the company is calculated according to the accounting legislation/rules in force.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Tax deductible expenses are important for the calculation of taxable corporate income.

4.5 Are there any tax grouping rules? Do these allow for relief in Albania for losses of overseas subsidiaries?

Albanian tax legislation does not provide for tax grouping rules.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

There is no difference to corporate profit tax based on whether the profit is distributed or retained.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

A property tax is applied on an annual basis to all residents (including companies registered in Albania) and non-residents who own agricultural land or buildings in Albania.

4.8 Are there any local taxes not dealt with in answers to other questions?

All entities (commercial companies, NGO, etc.) registered in the Republic of Albania are also subject to the following local taxes and fees: Sign Board Tax; Green Tax; and Cleaning Fee.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Albanian legislation provides for the taxation of capital gain related to the transfer of shares/quotas and the transfer of immovable property(ies).

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains are taxed at the rate of 10% and such rate is the same for corporate profit tax.

5.3 Is there a participation exemption?

The taxation of capital gain generated from the transfer of quotas/shares is not exempted due to any participation rule, except for the participation exemption of capital gain for purposes of corporate tax.

5.4 Is there any special relief for reinvestment?

Albanian legislation does not provide any special relief for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed upon the formation of subsidiary in Albania.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

The taxation regime is similar for a locally-formed subsidiary and a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch are determined using the same rules as if it was a locally-formed subsidiary.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

The branch of a non-resident company in Albania is subject to the corporate profit tax at the same rates applicable to locally formed companies.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

The establishment of a branch of a non-resident company constitutes a permanent establishment in Albania, hence the tax treaty provisions apply to the branch too.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

According to strict interpretation of the provisions of the Albanian Legislation, the transfer of profit from the Albanian branch to its non-resident parent company is not taxable with any WHT.

7 Overseas Profits

7.1 Does Albania tax profits earned in overseas branches?

Albanian tax legislation provides that Albanian tax residents are subject to the corporate profit tax for all their profits, generated in Albania and abroad. However, in the case of any applicable Double Taxation Treaty(ies), the provisions of such treaty(ies) will be applied.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

The dividend received by a local company from a non-resident company is calculated for the purpose of taxable income of this local company.

7.3 Does Albania have "controlled foreign company" rules and if so when do these apply?

There are no expressive "controlled foreign company" provisions in Albanian tax legislation.

8 Anti-avoidance

8.1 Does Albania have a general anti-avoidance rule?

Albanian legislation does not provide for general anti-avoidance rules.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There are no requirements to make special disclosure of avoidance schemes in Albania.

Aigest Milo

KALO & ASSOCIATES
Kavaja Avenue, 4th Floor
G-KAM Business Centre
Tirana
Albania

Tel: *+355 4 223 3532*
Fax: *+355 4 222 4727*
Email: *a.milo@kalo-attorneys.com*
URL: *www.kalo-attorneys.com*

Aigest Milo is a lawyer who graduated in Business Law in the "*Paris Ouest Nanterre La Defense*", Paris, France. Mr. Milo joined KALO & ASSOCIATES in 2009 and is practicing with the status of an Associate. The focus of his work mostly relates to tax issues. Mr. Milo has provided some qualitative legal assistance to several local and foreign companies (including Fortune 500 companies).

Ardjana Shehi

KALO & ASSOCIATES
Kavaja Avenue, 4th Floor
G-KAM Business Centre
Tirana
Albania

Tel: *+355 4 223 3532*
Fax: *+355 4 222 4727*
Email: *a.shehi@kalo-attorneys.com*
URL: *www.kalo-attorneys.com*

Ardjana Shehi has over 20 years of experience as a lawyer and an extensive working experience in commercial law and specialises in tax law and bankruptcy law. Mrs. Shehi joined KALO & ASSOCIATES in January 2005 and is practicing at this law office with the status of a partner. She is graduated in 1990 from Tirana University, Law Faculty, holds a MBA Master Degree from the joint program of Nebraska University USA and Tirana Faculty of Economics, and is a Certified Trainer qualified by the Certified Institute for Personnel Development (CIPD) UK. Since 2006, she has been part of teaching team of the School of Magistrates Tirana as Lecturer and as Trainer of continuous training for judges on bankruptcy law and tax law. Mrs. Shehi is co-author of the Manual for Judges on Bankruptcy Law, product of a World Bank project (2005). She was/is a member in several legal and other organisations/bodies within the country and abroad, including the Albanian State Aid Commission.

KALO & ASSOCIATES
ATTORNEYS AT LAW

KALO & ASSOCIATES has long been a leading law practice firm in Albania and in Kosovo. The firm provides a full range of services in all commercial and corporate law for foreign and multinational companies and agencies. The firm delivers exceptional value, providing high quality, efficient and cost-effective legal solutions bringing innovative perspectives to clients' needs.

The firm is very often a first choice as reflected by its impressive client portfolio (including a considerable number of Fortune 500 companies) of such industries as banking and financial services, aviation, energy resources, general manufacturing, healthcare, insurance, commercial property, retailing, sports and entertainment, technology and telecom, and transportation.

Not only a presence in Albania and Kosovo, our firm also enjoys regional recognition in South Europe due to our active involvement with our partner firms in the South East Europe Legal Group an alliance of premier national law firms from 12 jurisdictions providing seamless legal services including cross-border commercial transactions (www.seelegal.org).

Chapter 4

Andorra

Daniel Arqués i Tomàs

Arqués Ribert Junyer Advocats

Mireia Ribó i Bregolat

1 General: Treaties

1.1 How many income tax treaties are currently in force in Andorra?

On 29 December 2010, the Andorran Parliament (Consell General) passed the laws constituting the first generalised system of direct state taxation in the Principality's history. These were the law on income tax for fiscal non-residents (IRNRF), the law on corporate tax (IS), and the law on the taxation of income from business activities (IRAE).

Only the IRNRF has come into force (April 2011), while the IS and IRAE are expected to be implemented from 1 January 2012, for that financial year.

According to the preamble of the IS, the introduction of corporate tax, which should be comparable to that of other countries, will enable the Principality of Andorra to sign double taxation treaties with other states.

Andorra has started talks with Spain and France to begin the formalities of negotiating double taxation treaties.

Apart from these treaties, Andorra signed the Agreement with the European Community, relating to establishing equivalent measures to those provided for in the Directive 2003/48/CE of the Council on matters of taxation of savings income in the form of interest payments, on 15 November 2004. The Agreement has been implemented in Andorra since 1 July 2005.

1.2 Do they generally follow the OECD or another model?

See question 1.1.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

See question 1.1.

Regarding the Agreement with the European Union on the taxation of savings income, the Consell General passed Law 11/2005, on 13 June, to implement the Agreement.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

See question 1.1.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

See question 1.1.

2 Transaction Taxes

2.1 Are there any documentary taxes in Andorra?

Stamp duty is only charged on written documents presented by the applicant in legal proceedings, and depends on the amount of the claim.

Equally, granting, presenting and issuing certain kinds of document may require payment of tax. This is the case for public instruments authorised by a Notary, or applications addressed to the Government or to Comu (Municipality).

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The general indirect state taxation is based on the following taxes:

- The indirect tax on the provision of services (ISI), which taxes the provision of services inside Andorra by businesses or professionals.
- The indirect tax on domestic production (IPI), taxing the production and manufacture of all manner of goods.
- The indirect tax on goods (IMI), taxing imports of all manner of tangible goods into the Principality. This tax is accompanied by the indirect tax on commercial activities (IAC), as an equivalence surcharge applied on the value of the imported goods or the IPI tax liability.

The applicable rates of tax are the reduced rate (1%), the standard rate (4%), the increased rate (7%), and the special rate (12%).

Presently, the Government is finalising the draft bill of the VAT law, which it has announced will be in force from 1 January 2013.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Excluded from the ISI tax are, among others, activities such as reinsurance operations, the insurance of international transport of goods, the provision of public services or those of general interest, and leases of housing, commercial premises or land for agriculture or livestock.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Unlike VAT, the ISI consists of a modular system based on calculating the total added value of services provided inside the Principality. To determine the value of the services provided, the legislator has estimated the added value that each sector involves, based on its activity. The tax liability is therefore determined objectively, from variables and values assigned to each of them.

The system of objective determination can be substituted by the alternative system of direct determination. In the latter, the tax liability allows for the deduction of tax paid as indirect state taxes on the purchase of goods and services necessary or related to carrying out the activity. Although if the amount of tax paid is higher than the amount of tax charged, the tax liability is zero.

2.5 Are there any other transaction taxes?

Property transfer tax is charged on *inter vivos* transfers of real property located in the Principality, and also the establishment and assignment of rights *in rem* over them. The tax rate is presently 4% of the real value of the property or rights, and is payable by the purchaser of the property or the assignee of the right.

The capital gains tax on property transfers taxes the increase in the value of real property resulting from *inter vivos* transfers of real property, or the establishment or assignment of rights *in rem* over the same. The tax is payable by the transferor. The rate varies between 1% and 15% of the increase in value, although transfers of properties which were bought more than 10 years earlier are not subject to any rate.

2.6 Are there any other indirect taxes of which we should be aware?

Notably:

- special taxes, on the manufacture and importation of tobacco, alcoholic products and fuels; and
- local taxes, the most significant being the property tax, the tax on rental income, and the tax on the location of commercial, business and professional activities.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Andorran legislation does not tax dividends and other income from equity participation in entities fiscally resident in Andorra, paid to non-residents. Specifically, the IRNRF law considers that dividends paid to a non-resident individual are not subject, while those paid to non-resident companies are exempt.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

The IRNRF law considers that royalties are not subject to the tax if they are paid to a non-resident individual and considers them exempt if received by a company.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Andorran legislation only imposes withholding tax on the payment of interest by resident companies to non-resident individuals (resident in the EU), within the framework of the EU Agreement on matters of savings tax (see question 1.1). Presently, the withholding tax is 35%. No other withholding taxes are planned.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Andorran legislation does not regulate "thin capitalisation".

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

See question 3.4.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

See question 3.4.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Not beyond those mentioned.

3.8 Does Andorra have transfer pricing rules?

Andorran regulations on business income tax (IS and IRAE) establish that the operations carried out between related persons or entities must be valued at their normal market value, being understood as that which independent persons or entities have agreed under conditions of free competition.

The methods that can be applied to determine the normal market value are the following: i) comparable uncontrolled price method; ii) cost-plus method; and iii) resale price method. The Ministry of Finance can be asked, in advance, for assistance in determining and setting the normal market value of related operations. Equally, it is expected that prior valuation agreements could be established with tax authorities in other countries within the framework of double taxation treaties that may be signed in the future, to jointly determine the normal market value of related operations.

It should be noted that financial expenses incurred by fiscally resident entities relating to operations carried out, directly or indirectly, with related non-resident persons or entities are not considered tax deductible expenses.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The general rate is 10%.

Nevertheless, there are certain special rates:

- Income obtained by non-resident entities deriving from reinsurance operations pay 1.5%.
- The collective investment institutions regulated by Law 10/2008, of 12 June, on the regulation of collective investment schemes under Andorran law, are subject to a rate of 0%.

Equally, the regulations provide for a rate of 5%, applicable up to the base of 50,000 euros, during the first 3 years of activity, for new companies incorporated after the tax comes into force, as long as their income is below 100,000 euros.

4.2 When is that tax generally payable?

The laws on IS and IRAE do not set a deadline for paying the tax, which must be set by the regulations passed by the Government within six months after these laws come into force.

However, it is expected that two payments will be paid, on the last day of June and December, each covering 50% of the tax liability for the previous financial year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base is calculated by adjusting the accounting profit, determined according to the rules provided in Law 30/2007, of 20 December, on business accounts and the Andorran General Accounting Plan.

The following entities benefit from an 80% reduction on the tax base, if they fulfil the requirements set by the law:

- companies carrying out international exploitation of intangible assets;
- companies involved in international trade; and
- intra-group financial management and investment companies.

If the economic activity is carried out by an individual, he benefits from a minimum exemption of 40,000 euros.

Negative tax bases can be offset against positive tax bases concluded in the next 10 years. Although the tax is not yet in force, the opportunity is provided for the future to offset negative tax bases in financial years after 1 January 2010.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main tax adjustments to be made on the accounting profit are:

- The depreciation of assets (amortisation) is limited to an annual maximum depending on the type of asset.
- Provisions for the insolvency of debtors are normally tax deductible if six months have passed since the maturity date. In the case of debts with a specific guarantee, a legal claim must be made in order to be able to make the deduction.
- Losses from deterioration in equity securities in entities not listed on a regulated market and losses from deterioration in debt securities listed on regulated markets, are tax deductible, within limits.
- The contributions from promoters to welfare schemes, whenever the legal requirements are met, are tax deductible.
- Certain expenses are not deductible for tax purposes (e.g. those representing equity compensation, donations, fines, etc.). Nor are payments to employees in the form of equity instruments.

4.5 Are there any tax grouping rules? Do these allow for relief in Andorra for losses of overseas subsidiaries?

Andorran regulations provide for the possibility of tax consolidation in companies forming part of a tax group. In order to be able to adhere to the tax consolidation system, it is necessary to fulfil the following requirements: i) that the parent company holds, directly or indirectly, at least 75% of the capital of the other companies or their voting rights, without interruption and during the whole tax period; ii) that all the companies in the group are subject to and not exempt from the tax; iii) that all the companies agree to join the tax group and consolidate their accounts; iv) that the tax period for all the companies in the group coincides with that of the parent company; and v) that the parent company communicates this to the Ministry of Finance before the start of the tax period in which the tax consolidation system will be applicable. Companies which, at the end of the tax period, are in a position of suspension of payments or bankruptcy, or have negative equity, cannot form part of the tax group.

The tax base of the tax group is determined according to the provisions of the regulations on preparing annual consolidated accounts, taking into account the international accounting regulations provided for in Law 30/2007, of 20 December, on business accounts. Negative tax bases of any company pending offsetting at the time of incorporation into the tax group can be offset in the tax base of the tax group.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Corporate tax is imposed at the same percentage (10%), whether profits are distributed to shareholders or retained.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Until the IS derogating this tax is not in force, companies are charged the tax on the register of owners of economic activities; the annual rate being 201.80 euros.

4.8 Are there any local taxes not dealt with in answers to other questions?

The main local taxes are:

- Tax on the location of commercial, business and professional activities: this is annual, taxes the operation of an activity, and takes into account the type of activity, the location and surface area of the business to make its calculation. The maximum tax payable is 300,000 euros.
- Tax on rental income: annual, imposed on income from leases of real property. Set as a percentage that can vary between 0.4% and 4% of the total rents obtained in a year.
- Tax on construction: imposed on the construction or extension of buildings, the rate varies between 10 and 50 euros per square metre built.

The amount paid for the location tax and the tax on rental income is deductible from the payment of the IS and IRAE.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There are no special rules for taxing capital gains and losses incurred by companies; these will be incorporated into the tax base of this tax and therefore pay a general rate of 10%. In the case of individuals, these gains are not subject to tax.

If the gains come from the transfer of real property acquired less than 10 years before, these are subject to capital gains tax, mentioned in question 2.5. The amount paid for this tax will be deductible in any case from the payment of the IS and IRAE.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

See question 5.1.

5.3 Is there a participation exemption?

The following are exempt of tax, on the terms and within the limits set by the IS:

a) Dividends or participations in profits from entities resident or non-resident in Andorra, and also income obtained from share transfers, winding up a company or withdrawal as a shareholder, if the following requirements are fulfilled:
    - That the non-resident participant company is subject to and not exempted from a tax of a similar nature to the Andorran IS. If it is a resident entity, that it has paid the IS.
    - That the percentage of participation, whether direct or indirect, in the capital, own assets, equity or voting rights of the resident or non-resident entity is equal or greater than 5%.
    - That the participation has been held without interruption for a year, prior to the day on which the profit is payable, the participation is transferred, or withdrawal or winding up occurs. The time in which related persons have held the participation is counted for this purpose.

b) Income obtained overseas through a permanent establishment (PE) located outside Andorra, if this PE has been subject to a tax with similar characteristics to those of the Andorran IS.

The regulations provide, equally, for a special system applicable to companies holding foreign securities (which must have a minimum share capital of 120,000 euros and their participation must be in nominative securities), in which dividends and participations in profits received from non-resident companies, as well as the transfer of these participations, benefit from exemption, on the terms set by the law, if the following requirements are fulfilled:

- That the percentage of participation, whether direct or indirect, in the capital or own assets of the non-resident entity, is at least 3%.
- That the participation has been owned without interruption for 1 year before the profit is distributed or otherwise the said term is completed afterwards.
- That the subsidiary has been charged a foreign tax of a similar nature to the Andorran IS in the financial year in which the dividends are allocated.

Concession of the special system for companies holding foreign securities is dependent on a prior application to the Ministry of Finance.

5.4 Is there any special relief for reinvestment?

Andorran legislation does not provide any tax incentive for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Prevailing Andorran legislation, except for specific, fixed exceptions, does not allow for the incorporation of companies with wholly foreign capital, nor therefore subsidiaries. Foreign participation cannot exceed 49% of the share capital, although the Government announced that it would open up all economic sectors to foreign capital by 2012.

Branches in Andorra of a non-resident company are considered PE and therefore are subject to the IRNRF. In contrast, subsidiaries pay tax through the IS. Both pay tax at the rate of 10%.

The incorporation of a subsidiary or PE is not subject to the payment of taxes. Nevertheless, the contribution of real property involves payment of the property transfer tax, consisting of 4% of the value of the contributed property.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no significant differences between the rates and taxes that must be paid by a PE and a subsidiary.

6.3 How would the taxable profits of a local branch be determined?

The tax base of a branch is determined by similar rules to those applicable to Andorran companies. The tax base is determined by the profits obtained by the branch and specific tax adjustments are applied.

Nevertheless, there are limitations on the deduction of tax for specific branch expenses. The main ones are summarised below:

- Payments made by the branch to the parent company, or to the other related branches or entities, as royalties, interest and commission, paid in return for technical assistance services or for the use or assignment of property or rights, are not deductible.
- Interest paid by foreign bank branches to the parent company or other branches, for carrying out their activity, are deductible.
- The reasonable part of the expenses of directors and general management relating to the branch are deductible, as long as the following requirements are fulfilled:
    - they are reflected in the branch's financial statements;
    - there is a record in the informative report presented with the declaration, of the amounts, criteria and allocation modules; and
    - there is rationality and continuity in the chosen allocation criteria.
- The cost of own capital destined, directly or indirectly, from the entity to the branch, is not deductible.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Profits obtained by the branch, like those obtained by Andorran companies on the terms we have indicated in previous sections, are taxed at the rate of 10%. There is no additional duty or tax for branches of non-resident entities.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

See question 1.1.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

The remittance of profits to the parent company is not subject to withholding tax or the payment of any tax in Andorra.

7 Overseas Profits

7.1 Does Andorra tax profits earned in overseas branches?

Income obtained overseas through a branch located outside Andorra is exempt from tax if that branch has been subject to a tax of a similar nature to the Andorran IS.

If, in previous tax periods, the branch has obtained negative income which was included in the entity's tax base, the exemption is only applied to the positive income obtained thereafter, from the time when the amount of the negative income is exceeded.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by Andorran companies from fiscally non-resident entities are exempt of tax in Andorra, on the terms we stated in question 5.3.

7.3 Does Andorra have "controlled foreign company" rules and if so when do these apply?

Prevailing legislation provides that the difference between the normal market value and the accounting or tax value of the following assets and liabilities must be included in the IS tax base:

- Those that are the property of an entity that is fiscally resident in Andorra that transfers its residence overseas, unless they remain attached to a PE located in Andorra.
- Those that are the property of an entity resident in Andorra that transfers its effective headquarters outside Andorra and in accordance with an international treaty could be considered a tax resident in the other state, unless they are attached to a PE located in Andorra.
- Those transferred to a PE overseas, when the asset or liability has been attached to the headquarters of an entity fiscally resident in Andorra.

8 Anti-avoidance

8.1 Does Andorra have a general anti-avoidance rule?

Andorran regulations rule that operations carried out with persons or entities resident in countries or territories that apply a tax 50% below that which would be applicable if the Andorran IS was applied, should be valued at their normal market value, apart from the operations between persons or entities related to those that we have already referred to in question 3.8.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

The tax regulations enable Andorran tax authorities to verify the transactions carried out by taxpayers according to the legal nature of the act or business, the circumstances and real facts, irrespective of the form or name used by the parties.

Daniel Arqués i Tomàs

Arqués Ribert Junyer Advocats
C/ Bra. Armengol, 6-8
Ed. Crèdit Centre, 4art.
Andorra la Vella
Andorra

Tel: +376 809 000
Fax: +376 861 924
Email: daniel.arques@arj.advocats.ad

Daniel Arqués i Tomàs is a Managing Partner of the firm Arqués Ribert Junyer Advocats. He obtained his degree in Law at the University of Navarra (Spain) and joined the firm in 1989, of which he is today responsible for the mercantile - tax area. His professional training also includes the certificate of trademark agent (Government of Andorra - 1996), a module of international taxation (ESADE - 2000), and a postgraduate in financial management (Uda and UdL - 2007/8). Mr Arqués has served at the Governing Board of the Andorran Bar from 1995 to 2002 and has been a contributing professor of the postgraduate course in Andorran Law since 2002. He speaks Catalan, Spanish and English.

Mireia Ribó i Bregolat

Arqués Ribert Junyer Advocats
C/ Bra. Armengol, 6-8
Ed. Crèdit Centre, 4art.
Andorra la Vella
Andorra

Tel: +376 809 000
Fax: +376 861 924
Email: mireia.ribo@arj.advocats.ad

Mireia Ribó joined the firm Arqués Ribert Junyer Advocats in 1995. She has experience in advising companies and individuals within the mercantile - tax area. She graduated in Law at the University of Barcelona (1994); she has a postgraduate in Andorran Law (2002); a master's degree in tax and tributary management by the Polytechnic University of Catalonia and the School of Business Administration (2005); and a postgraduate course in financial management by the universities of Andorra and Lleida (2008). She speaks Catalan, Spanish, English and French.

arj arqués ribert junyer
advocats

Arqués Ribert Junyer Advocats was established in Andorra la Vella in 1964 by the attorney Josep Maria Arqués Campillo. The firm is run by three managing partners and has a team of 13 lawyers and legal advisors. The firm has been yearly ranked by Chambers Global and Chambers Europe as the leading company in General Business Law since 2006, being its three managing partners ranked likewise. The firm mainly advises companies and family assets, and provides them with advice in Corporate, Tax, Mercantile, Town Planning, Labour, IP, Financial and Corporate Finance areas. Among the international clients of the firm there are banks, financial institutions and multinational corporations with interests in the Principality as well as other law firms which act on behalf of their clients.

Argentina

Guillermo O. Teijeiro

Negri & Teijeiro Abogados

Ana Lucía Ferreyra

1 General: Treaties

1.1 How many income tax treaties are currently in force in Argentina?

Argentina has treaties in force with Australia, Bolivia, Brazil, Belgium, Canada, Chile, Denmark, Germany, Finland, France, Italy, The Netherlands, Norway, Spain, Sweden, Switzerland, and the United Kingdom.

1.2 Do they generally follow the OECD or another model?

Most treaties currently in force are structured along the lines of the OECD Model Convention (OECD MC). Exceptions are the tax treaties entered into with Bolivia and Chile, which are patterned after the model tax treaty approved by Decision 40 of the Andean Group, and the treaty with Brazil, which, although following the formal structure of the OECD MC, has certain unique provisions.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Under the Argentine constitutional and legal system, the power to conclude tax treaties lays on the Executive Branch; however, treaties need to be ratified by Congress. Thus, they become laws only upon congressional approval. The congressional ratification must be notified to the other contracting country and the treaty enters into effect as from the date provided therein.

Consistent with the provision contained in Section 25 of the Vienna Convention, Argentine law authorises the Executive Branch to decide the provisional application of signed treaties before the actual effective date. So far, however, the Executive Branch has made use of this prerogative in only two cases (the existing treaty with Switzerland and the amending protocol to the Chilean treaty, dated April 23, 2003).

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Besides a general beneficial ownership rule included in certain treaties, Argentine tax treaties do not specifically address treaty shopping. They are similarly silent on the use of domestic anti-avoidance rules to combat treaty shopping. The only conditions for treaty benefits to apply are those stated in a domestic resolution, holding that persons benefiting from a withholding tax reduction in Argentina under the provisions of a tax treaty must submit an affidavit to the local withholding agent to prove entitlement. The affidavit must include the name and tax address of the effective beneficiary, the origin of the income and a declaration that it has no permanent establishment in Argentina. Additionally, the beneficiary must furnish the withholding agent with an affidavit issued by the home country's tax authorities, confirming its status as resident for purposes of the relevant treaty. This regulation was enacted to attain a minimum degree of control over the use of treaty benefits.

Nonetheless, certain (restricted in scope) limitation of benefits clauses exist under some treaties. For instance, the treaty signed with Spain contains an ownership test to condition specific benefits (i.e., tax sparing). Thus, Spanish residents deriving royalties from the transfer of technology or technical assistance to Argentina are deemed subject to a 15% Argentine withholding (when, in fact, such withholding under the treaty is 10%), as long as the Argentine payor of the royalties neither holds directly or indirectly an equity interest in a third country's company exceeding 50%, nor is controlled directly or indirectly by a corporate shareholder residing in a third country.

The treaties in force with the UK and Sweden provide a broad limitation of benefits provision in connection with interest and royalty payments. Thus, if the parties to the loan or licence agreements intend to capitalise on treaty benefits, the source-based tax reduction shall not apply. Furthermore, Article 9 of the treaties in force with Canada, Finland, Sweden, Denmark, The Netherlands, Norway, and Switzerland states that correlative adjustments otherwise available for the application of transfer pricing rules are not allowed in the cases of fraud, negligence or intentional omission.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The Argentine Constitution sets forth the principle that international treaties approved by Congress prevail over domestic laws, so that tax treaties enjoy a well-settled legal status in Argentina. Based on this constitutional provision, a subsequent statute (for instance, domestic income tax amendments) may not override the provisions of an existing tax treaty.

The Argentine treaty provisions are silent on applying the "economic reality" principle (Argentine general anti-avoidance rule) or preventing treaty-partner countries from doing so. As a result, Argentine courts and tax authorities would not be limited in applying these domestic rules in a treaty-ruled scenario. Nonetheless, due to the constitutional status of tax treaties, if a limitation of benefits clause is included, the application of domestic anti-avoidance rules in conflict with that treaty clause would not prevail.

There are a couple of precedents from the Argentine Competent Authority on treaty interpretation that are worth highlighting. The first case (Memorandum 64/09) involved an Argentine resident holding stock in an Austrian company. 99% of the assets of the Austrian company were, in turn, shares in an entity located in the British Virgin Islands (BVI) and owned entirely by the Austrian Company (100% participation). According to the terms of the then in force Argentine-Austrian double tax treaty, the jurisdiction to tax personal assets, income and dividends was exclusively granted to the State in which the company was a resident. Therefore, the Argentine resident's holding in the Austrian Company and dividends received therefrom were not taxable in Argentina by personal assets and income tax, respectively. In addition, Argentine fiscal transparency rules were circumvented by the interposition of the Austrian company.

The Argentine Competent Authority qualified the situation as an abuse of the Treaty and made reference to the possibility of applying general anti-avoidance rules in that context, in accordance with: (i) the opinion of the U.N. Expert Committee on International Tax Cooperation, Subcommittee on Improper Use of Treaties; and (ii) the Commentaries to article 1, OECD model, 2008 text. By applying general anti-avoidance rules in the case, the Argentine Competent Authority disregarded the interposed company in the treaty country jurisdiction (Austria) and treated the holding of the shares in and income obtained by the BVI company as if the interposed company did not exist.

In an even more recent precedent (Memorandum 799/10), the same Competent Authority analysed the application of the Argentine-Chilean treaty in a case that involved an Argentine parent company holding stock in two subsidiaries in Uruguay and Peru, through a Chilean Platform company (specific type of Chilean holding company). Under the rules of the treaty, exclusive jurisdiction to tax the dividends received by the Argentine parent company was given to Chile; Chile, in turn, did not tax these dividends as a result of the provisions of the platform company regime.

The Competent Authority held that treaties should not be used by taxpayers to ameliorate or eliminate the tax burden through legal forms that would not be adopted but for the tax advantages deriving therefrom. As a result, domestic anti-avoidance rules (i.e., the economic reality principle) may and should be applied to avoid abusive schemes in a treaty scenario.

It was further sustained that the reason to interpose the Chilean holding company was to deviate income (dividends) coming from Uruguay and Peru that would otherwise be taxed in Argentina, with the end result of benefiting from a double non-taxation. This end result contradicted the purposes of the treaty and implied an abusive use of the treaty, challengeable under the economic reality principle which allowed to pierce the corporate veil to assess the true intention of the parties.

2 Transaction Taxes

2.1 Are there any documentary taxes in Argentina?

In Argentina, stamp taxes are provincial levies imposed on written contracts and other instruments documenting transactions entered into for consideration, if: (i) executed in the province; or (ii) performed in the province. The taxable event arises from the execution of the document itself, despite eventual circumstances that may modify the transaction in the future. Applicable stamp tax rates vary depending on the taxing jurisdiction and the type of transaction.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

- Value Added Tax

Value-added tax ("VAT") is levied on three different classes of transactions, namely: the sale of tangible personal property within Argentina; the import of tangible personal property and services into Argentina; and the provision of services within Argentina. Taxable services include financial services. The general VAT rate is 21%, although certain sales and services may be subject to a reduced 10.5% rate or exempted altogether.

- Gross Turnover Tax

Gross turnover tax is a provincial tax. Argentine provinces and the Autonomous City of Buenos Aires levy this tax on the gross turnover of companies conducting business activities within their jurisdictions. The applicable tax rates vary depending on the specific jurisdiction and the activities concerned. In addition, certain provinces exempt from this tax specific economic activities.

If a company engages in business activities in more than one province, it would likely be subject to gross turnover tax in each of them. In that case, it would have to allocate its gross receipts among the relevant provinces, based on a formula that considers the amount of revenues and expenses and the places where obtained or incurred respectively. The gross turnover tax is deductible for Argentine federal income tax purposes.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The sale of books and aircrafts and the rendering of certain educational, medical and transportation services, among others, are transactions exempted from VAT.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

VAT-registered taxpayers are required to pay VAT to their suppliers (input VAT) and to collect VAT from their customers (output VAT). Input VAT is credited against output VAT within the relevant period. Any excess input VAT in a given period may be carried over and credited against future output VAT. This feature makes the VAT a neutral tax on consumption, effectively borne only by final consumers. The tax loses its neutral character if a single participant in the production chain is not a VAT registered taxpayer (e.g., they are a non-resident). In this case, the VAT charged to the participant that is not a VAT registered taxpayer may not be treated as a credit either by it or by the subsequent participant. Thus, the VAT paid becomes an additional cost.

Exports of tangible personal property and services are subject to a zero-rate system. This means that Argentine exporters are allowed to recover, by way of refund, VAT paid to their suppliers for the inputs utilised to manufacture or perform exported goods or services.

Services rendered by Argentine-registered VAT taxpayers to non-residents are subject to VAT if they are utilised by the latter in Argentina. Non-residents cannot request a refund for the VAT charged in these situations, and, hence, the VAT becomes an additional cost.

Services rendered by non-residents to Argentine-registered VAT taxpayers are always subject to VAT. A reverse charge system is applied in these cases. Argentine purchasers of services provided by non-residents must pay the corresponding VAT directly to the Argentine tax authorities, and an equivalent input VAT credit is available to the taxpayer the month following that, in which the VAT-taxable event occurred.

2.5 Are there any other transaction taxes?

- Financial Transactions Tax

All credits to and debits from bank accounts held at Argentine financial institutions, as well as certain cash payments, are subject to a financial transactions tax, which is assessed at a rate of 0.6%. A credit against the income tax and/or the minimum presumed income tax is granted at 0.2% of this financial transactions tax. Argentine financial institutions are required to withhold the tax from both the transferor and the transferee when a transfer of funds is effected. In the case of international wire transfers, this tax applies only to the Argentine transferor or transferee, as the case may be.

2.6 Are there any other indirect taxes of which we should be aware?

Excise duties are levied on particular types of goods and services (e.g., alcoholic beverages, soft drinks, tobacco, automobiles, cellular telephone services, and certain technological products, as well as other luxury items). Customs duties are generally payable on exported and imported goods.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends distributed by Argentine companies are non-taxable, regardless of the shareholder's residence. However, distributions of untaxed corporate earnings and profits are subject to a 35% withholding tax (*i.e.*, the equalisation tax). This equalisation tax applies whenever accounting profits exceed taxable income at the corporate level.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Foreign-domiciled entities and non-resident individuals without presence in Argentina (i.e., a branch or permanent establishment) are taxed on Argentine source income by way of withholdings at source, to be made by the local payor of the income. The statutory withholding rate currently stands at 35%. However, as a general rule, foreign beneficiaries are not taxed on an actual net income basis, but rather on a presumed net income basis, which varies depending on the type of income. Thus, as a general rule, actual expenses or other deductions otherwise allowable in determining net taxable income may not be claimed in the case of foreign beneficiaries.

Unless otherwise provided in a tax treaty, royalty payments are subject to an effective withholding tax rate of 28% (35% of a presumed net income of 80%), in the case of a registered trademark, industrial know-how and other technology transfers. Payments made in consideration for technical assistance, engineering and consulting services not obtainable in Argentina are subject to a 21% (35% of a presumed net income of 60%) effective withholding rate.

To apply the reduced withholding tax rates of 21% and 28%, the agreements must be registered with the Argentine Trademark and Patent Office, which will issue a certificate indicating, among other considerations, that the agreement complies with the Technology Transfer Act and, if applicable, that the technical assistance cannot be obtained in the country. Otherwise, a 31.5% effective tax rate would apply.

To clarify the registration procedure to qualify an agreement for the tax benefits, the Argentine Trademark and Patent Office issued Resolution P-328/2005. According to the resolution, technical assistance, consulting and licensing of know-how, in each case if related to financing, sales and marketing unconnected to a local "productive activity", do not qualify. Agreements to acquire products, the licensing and updating of software, the repair and maintenance of equipment (unless coupled with training of personnel) all similarly fail, as do general services related to the current or ordinary business of the Argentine company.

Resolution P-328 does provide a three-prong test of technical assistance to help determine if the agreement qualifies. First, the technical assistance must benefit the local company's productive activity. Further, the transfer must be made through recommendations, guidelines, procedures, plans, or studies. Finally, the consideration paid for the technical assistance must be proportional to the services performed. Resolution P-328 excludes services related to unspecified or contingent needs, as well as those services compensated through royalties or other revenue-based fees.

Licence agreements that provide the right to use a software programme registered in Argentina, as well as those allowing the sub-licensing of software in Argentina, derive from Argentine source income.

An effective withholding rate of 12.25% (35% of a presumed net income of 42%) is levied if: (i) the agreement and the software are registered with the National Copyright Bureau (*Dirección Nacional de Derechos de Autor*); (ii) profits derive from the exploitation of software; (iii) income tax is levied on the authors or their successors (*derechohabientes*); and (iv) the software is not developed upon demand.

If the above-mentioned requirements are not satisfied, software royalty payments made to a foreign beneficiary would be subject to the maximum (31.5%) withholding tax rate.

The tax authorities have held that the term "successor" is a synonym of "inheritor". Therefore, under this interpretation, foreign purchasers or licensees of the original author are not successors and, hence, not entitled to the reduced withholding tax rate. In addition, the tax authorities limit the special tax treatment only to "authors". As a result, lower withholding rates are denied by the tax authorities under software licence agreements when payments are made to foreign legal persons other than the author. This interpretation has been recently confirmed by the Argentine Supreme Court of Justice in *re Application Software* (February 11, 2011).

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Non-resident lenders are subject to Argentine withholding tax on interest paid by an Argentine resident. The general withholding tax rate on interest is 35% (e.g., this rate applies to interest on inter-company loans). However, the 35% withholding tax rate applies on a presumed net basis of 43% (resulting in a reduced effective rate of

15.05% on gross payments) if payments are made: (i) by Argentine financial institutions; or (ii) to non-resident suppliers of capital assets, non-resident financial institutions, and certain non-resident investors in corporate bonds.

Interest paid to a non-resident financial institution will benefit from the reduced presumed net basis to the extent that the recipient meets the following requirements: (a) it is overseen by a Central Bank or an equivalent agency; (b) it is resident in a jurisdiction that is not a tax haven for Argentine tax purposes, or, if so, the jurisdiction has entered into an information exchange treaty with Argentina; and (c) it is not exempt from providing information to its tax authorities due to bank secrecy or other type of privacy laws.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Thin capitalisation rules apply to interest payable to "foreign related lenders" (as defined by the statute), when the Argentine borrower's debt-to-equity ratio exceeds 2:1. Should that be the case, the full interest expense accrued on the debt exceeding that ratio would be disallowed as a deduction and recharacterised as a dividend distribution. For the thin capitalisation rules to apply, interest must be subject to withholding tax at an effective rate of 15.05% under domestic law (35% tax rate on a 43% presumed net basis; see question 3.2 above). A foreign lender is considered "related" if any of the following conditions are met: (i) it directly or indirectly manages or controls (or is managed or controlled by) the Argentine borrower; or (ii) it has the decision-making power to influence or define the activity or activities of the Argentine borrower, or *vice versa*, as a result of the level of equity participation, intercompany debt financing, or functional equivalent.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

See question 3.4 above.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

There are no statutory rules providing the application of thin capitalisation rules to debt advanced by a third party but guaranteed by a parent company. However, under specific circumstances, Argentine courts and tax authorities may apply the economic reality principle (general anti-avoidance provision) to recharacterise the transaction as if it were entered into between the local subsidiary and the foreign parent company. Facts generally determinative of these cases might include: the absence of credit risk by the third party lender and its sole compensation by a fee or commission for acting as intermediary; the lack of borrowing capacity of the subsidiary; absence of a standard credit risk analysis of the borrower; first demand guarantees, etc. (e.g., *in re Autolatina*, Argentine Supreme Court of Justice, March 15, 2011).

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Besides thin capitalisation and transfer pricing rules, there are no specific restrictions on tax relief for interest payments to non-residents.

3.8 Does Argentina have transfer pricing rules?

Argentine transfer pricing rules are generally based on the arm's-length principle. Methods expressly contemplated include the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit-split method, the residual profit-split method, and the transactional net margin method. These methods are defined, in general terms, consistently with the OECD Guidelines on Transfer Pricing to Multinational Enterprises and Tax Administrations.

As transactions between related parties are concerned, if and when they do not meet the arm's-length standard, an adjustment to the transaction's price, or to the income, loss or expenses allocated to the Argentine party should be made according to the most appropriate of the transfer pricing methods referred to in the preceding paragraph. Transfer pricing rules also apply to transactions entered into between an Argentine branch and its foreign head office (or another entity related to the foreign head office), and *vice versa*.

Furthermore, transactions entered into by an Argentine company, trust, or permanent establishment with related or unrelated entities incorporated or located in low- or no-tax jurisdictions (i.e., tax havens) are not deemed to comply *per se* with the arm's-length standard. Consequently, Argentine taxpayers are required to demonstrate the arm's-length character of this type of transaction, based on the most appropriate of the aforesaid transfer pricing methods.

In addition, since 2003 a new method (though arguably contrary) to the arm's-length principle has been employed to assess Argentine source income deriving from exports of commodities sold to foreign related intermediaries that fulfil a three-prong-test. The method applies as long as the foreign intermediary: (i) does not have real presence in its residence country with a permanent establishment where the business is managed; (ii) its principal activity consists of either the production of passive income or the trading of goods from or to Argentina or with other members of the same economic group; and (iii) its international trade transactions with members of the same economic group are higher than 30% of the total amount of operations carried out during the year. In those cases, the statute deems the "best method" to assess the Argentine source income from exports to be the market price prevailing as of the date in which the goods are shipped, regardless of the price effectively agreed upon at the time of execution. Nonetheless, if the agreed-on price is higher than the price prevailing as of the date of shipping, the higher price will determine the value of the transaction.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax on corporate profits is 35%.

4.2 When is that tax generally payable?

Corporate taxpayers are required to make ten estimated advance income tax payments during the fiscal year. Filing of the annual income tax return and payment of the income tax owed in excess of advanced payments (and withholding at source, if applicable) is due approximately five months after the end of the entity's fiscal period.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Corporations are taxed on their taxable income. Taxable income is assessed by deducting from gross income ordinary business expenses and other allowable deductions. Gross income for corporate tax purposes involves all income from whatever source it derived regardless of its character - whether passive (investment) or active (business income) - unless expressly excluded or exempt.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

See question 4.3 above.

4.5 Are there any tax grouping rules? Do these allow for relief in Argentina for losses of overseas subsidiaries?

Tax consolidation or other group relief is not permitted in Argentina.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Tax is not imposed at a different rate upon distributed, as opposed to retained, profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Argentina levies a minimum presumed income tax ("MPIT") on Argentine corporations (e.g., an Argentine subsidiary of a foreign corporation) and non-residents that maintain a permanent establishment in Argentina (e.g., a branch). The MPIT is levied on the taxpayer's total assets (with certain exceptions) at a rate of 1%, to the extent that the value of total assets within Argentina (inventories included) exceeds AR$200,000 (approximately US$50,000).

The corporate income tax paid by the Argentine taxpayer may be credited against its MPIT liability. If the taxpayer's MPIT liability is greater than its corporate income tax liability, it is required to pay the excess MPIT. This tax may be carried over and credited against its income tax liabilities arising in future years for a maximum 10-year period.

Notwithstanding the above, in re Hermitage, the Supreme Court of Justice has recently challenged the application of this tax under certain circumstances.

In addition, foreign entities and individuals owning stock in an Argentine corporation are subject to a personal assets tax at a rate of 0.5% on the proportional net-worth value (*valor patrimonial proporcional*) of their participation. The tax is assessed and collected by the Argentine issuing corporation.

4.8 Are there any local taxes not dealt with in answers to other questions?

A tax on real property (real property tax) is also imposed by each of the provinces. Applicable real property tax rates vary depending on the taxing jurisdiction.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There is no special rule for capital gains in Argentina. Gains from the sale or exchange of real estate and other capital assets (whether short or long-term) are taxed at the ordinary corporate income tax rate (35%).

Notwithstanding the above, capital gains from the sale of stock in Argentine corporations are generally exempt from tax in Argentina (unless realised by an Argentine corporate taxpayer).

Corporate taxpayers are not allowed to offset operating income with losses arising from the disposition of certain securities or derivative instruments. Such losses may only be applied against income from the same type of transactions.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

See question 5.1 above.

5.3 Is there a participation exemption?

Although Argentina does not have a participation exemption regime, dividends from Argentine companies are generally non-taxable in Argentina (see question 3.1 above). The exemption applies to local and foreign shareholders, regardless of their equity participation in the distributing entity. In addition, foreign entities and individuals are not taxed on capital gains realised from the sale of stock in Argentine corporations (see question 5.1 above). The exemption is not available to corporate resident taxpayers. Dividends distributed by non-resident companies are - as a general rule - subject to income tax in Argentina (see question 7.2 below).

5.4 Is there any special relief for reinvestment?

No, there is not. However, the potential application of the equalisation tax rules (see question 3.1 above) upon a profit distribution may act, indirectly, as an incentive for reinvestment. In addition, Argentine income tax law provides for a roll-over regime applicable to capital assets used in the business.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The subsidiary's deed of incorporation or articles of incorporation may be subject to stamp tax, depending on the taxing jurisdiction where the subsidiary is incorporated. In those cases, the tax is assessed by taking into account the corporate capital. No other taxes are imposed upon the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no other tax that would be incurred by locally formed subsidiary but not by a local branch. Both local branches and subsidiaries pay income tax on a worldwide income basis at the same 35% corporate income tax rate.

6.3 How would the taxable profits of a local branch be determined?

Taxable income of local branches is determined on the basis of separate accounting and following the same rules concerning taxable income, exclusions, and allowable deductions as those applied to domestic taxable entities. Transfer pricing rules are applied as if the branch were a separate entity from the foreign head office. Moreover, if the local branch's accounting records are inadequate or do not accurately reflect net income of the branch, the tax authorities may treat the branch and the foreign head office (including its other branches or subsidiaries, if any) as a single economic unit, and determine taxable income of the local branch as a portion of the unit's aggregate income, at its own discretion.

There is no "force of attraction" rule under Argentine income tax law. Therefore, income attributable to the foreign head office for works, services or other activities carried out directly by the foreign head office without intervention by the local branch would not be taxable at the latter's level. Such income is subject to the withholding tax at source provided for in the case of on non-residents generally. Most tax treaties signed by Argentina provide for a limited force of attraction rule (i.e., Australia, Belgium, Canada, Denmark, Finland, Norway, Spain, Sweden, Switzerland and The Netherlands).

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Local branches of non-resident companies are only subject to the ordinary 35% corporate income tax rate on their worldwide income.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Local branches of foreign entities are deemed Argentine residents under the Argentine income tax law. Therefore, they are generally entitled to the benefits of the tax treaties signed by Argentina.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

As explained above in question 6.3, local branches are subject to the ordinary 35% corporate income tax on their worldwide income. To the extent accounting profits do not exceed taxable profits at the branch's level, no additional tax would apply on the remittance of funds to the head office. (Otherwise, a 35% would apply on the excess [see question 3.1 above].)

7 Overseas Profits

7.1 Does Argentina tax profits earned in overseas branches?

Argentine corporations are subject to income tax on the profits obtained by their foreign branches or permanent establishments. As a general rule, these profits are deemed foreign source income attributable to the Argentine head office on a current basis (in the fiscal year in which the foreign branch or permanent establishment's closes its taxable period), unless under the income tax law provisions profits so obtained qualify as Argentine source income. In that case, the foreign branch or permanent establishment would be deemed a foreign beneficiary and taxed pursuant to the specific rules applicable thereof.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As a general rule, dividends received by a local company from a non-resident company are subject to income tax in Argentina. As a result, Argentine shareholders in foreign corporations which, in turn, are shareholders in Argentine companies, could in principle be taxed on the dividends distributed by those foreign corporations, notwithstanding the possibility that those dividends had been distributed out of earnings consisting of non-taxable dividends or other profits distributed by Argentine companies.

To avoid that end result, however, Argentine shareholders are allowed to subtract from the amount of dividends received from the foreign corporations their *pro-rata* share of dividends and other profits distributed by Argentine companies. Thus, they remain subject to Argentine income tax only on the amount of dividends distributed by foreign corporations out of non-Argentine earnings. This special treatment, however, is not available to dividends distributed by tax haven corporations.

7.3 Does Argentina have "controlled foreign company" rules and if so when do these apply?

Argentina does have anti-deferral rules, under which Argentine taxpayers that are shareholders in passive income companies located in tax havens (i.e., black-listed jurisdictions) are required to include their *pro-rata* share of such income on a current basis rather than when dividends are actually distributed.

A minimum percentage of ownership if not required for the anti-deferral rules to apply; moreover, they are not conditioned on control of the foreign tax haven entity by Argentine shareholders as a group.

Passive income activity comprises: (i) rents and leases of real property (unless they constitute the lessor's trade or business, which is complemented with the management of the real property leased); (ii) loans and investments in bonds; (iii) holdings and dispositions of equity interests in corporations, partnerships, and other similar entities; (iv) deposits in financial institutions; (v) licences of intangibles or other transactions that generate royalties; and (vi) derivative financial instruments entered into for speculative purposes.

Argentine shareholders are not required to include income derived from an active trade or business in which case income must be recognised by the Argentine shareholders only when it is actually distributed as dividends, so that the deferral principle applies with respect to operating income even though obtained by a tax haven corporation. The same rule applies to Argentine shareholders in tax haven corporations whose passive income represents less than 50% of their total gross income (*de minimis rule*).

8 Anti-avoidance

8.1 Does Argentina have a general anti-avoidance rule?

Argentine general anti-avoidance rules are contained in sections 1 and 2 of the Tax Procedural Law (Law 11,683, as amended, TPL). Although in a different context, both sections describe the so-called *economic reality principle*, a term more familiar among Argentine scholars and tax practitioners than *substance over form* or similar terms frequently used in Anglo-Saxon tax circles. Section 1, TPL, mandates the application of the economic reality principle to the construction of tax law. Section 2, TPL, provides for the application of the principle to the characterisation of the acts and transactions of taxpayers, i.e., to the assessment of facts.

Section 1, TPL, sets forth the principle that tax provisions must be construed in accordance with their purpose and economic meaning, adding that whenever it is not possible to ascertain the meaning or the scope of application of a tax rule based on its wording or intent, the interpretation may be made resorting to private law rules, concepts, and principles.

Section 2, TPL, in turn, directs consideration of the acts, situations, and economic relations actually performed, pursued or created by taxpayers to determine the true nature of the taxable event. Under this rule, when a taxpayer's chosen legal form does not coincide with a structure offered or authorised by law to properly shape actual economic objectives, the chosen form may be discarded. In its stead, the law requires that the actual economic situation be considered within the structures provided by private law and the most natural form applied consistently with the taxpayer's actual intention.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Argentina does not have specific rules requiring the disclosure of avoidance schemes in advance of the company's tax return being submitted or otherwise.

Guillermo O. Teijeiro

Negri & Teijeiro Abogados
Corrientes 316, piso 4°
C1043AAQ Ciudad de Buenos Aires
Argentina

Tel: *+54 11 5556 8000*
Fax: *+54 11 4328 5628*
Email: *guillermo_teijeiro@negri.com.ar*
URL: *www.negri.com.ar*

Guillermo O. Teijeiro, a Harvard University graduate (LL.M. 1984) and visiting scholar (1988), worked in the International Tax Group of Caplin & Drysdale under the tutelage of H. David Rosenbloom (1984-85).
Mr. Teijeiro is recognised as a leading Argentine tax lawyer by the latest editions of several international publications (PLC, Which Lawyer, Who's Who Legal, Chambers Latin America, Best Lawyers, Latin Lawyer 250 and World Tax). He is the only Latin American tax specialist ranked in LMG-Euromoney, Expert Guides "The Best of the Best 2010" a list encompassing less than thirty tax experts worldwide.
Mr. Teijeiro maintains an active academic life. He was Professor of Corporate Income Taxation at Universidad Torcuato Di Tella until 2006, and Corporate Income Taxation at the Argentine Catholic University until 2009. He is currently Professor of International Taxation (Masters Programme in Taxation) at the Argentine Catholic University and also Director of the Research Group on Corporate Income Taxation at the Tax Law Specialisation, Austral University.
A former President and currently a member of the Tax and Customs Law Committee of the Buenos Aires Bar Association, Mr. Teijeiro was a member of the Board of Directors of the Buenos Aires Bar Association (2004-2009), and a member of the Board of the Argentine Association of Fiscal Studies --IFA Branch-- (2009-2010). Mr. Teijeiro is also a member of the International Fiscal Association, where he participated as Argentina's Reporter (Cancún 1992, Kyoto 2007) Panelist (Toronto 1994, Sydney 2003), and a member of the Permanent Scientific Committee for the period 2006-2014.

Ana Lucía Ferreyra

Negri & Teijeiro Abogados
Corrientes 316, piso 4°
C1043AAQ Ciudad de Buenos Aires
Argentina

Tel: *+54 11 5556 8000*
Fax: *+54 11 4328 5628*
Email: *ana_ferreyra@negri.com.ar*
URL: *www.negri.com.ar*

Ana Lucía Ferreyra, a William J. Fulbright Scholarship (2002-2003) and University of Florida graduate (LL.M. 2003), joined N&T in October 2003. She works in the N&T's tax department primarily in the international field. She is a member of the International Bar Association where she was distinguished as runner-up of Tax Scholarship Programme in 2004 and appointed to act as Argentine's Reporter for the 2005 Prague Conference and 2005 Chicago Conference. She is currently Professor of International Taxation (Masters Programme in Taxation) at the Argentine Catholic University.

N&T
NEGRI & TEIJEIRO
ABOGADOS

Negri & Teijeiro is a full-service law firm with over 35 legal professionals. N&T offers its clients high-quality advice and service commensurate with international standards. The firm's culture is largely defined by professionals trained abroad and used to working with international clients. The firm provides comprehensive legal services focused on business activities in Argentina. Its senior attorneys have particular expertise in international banking and finance, debtor-creditor proceedings, labor and administrative law and business litigation. The Tax Department combines local savvy with expertise in the areas of tax planning, general tax advice and tax litigation.

Tax planning services emphasise advising clients on federal and local Argentine taxes and developing efficient structures for business activity in Argentina. The group has vast experience in advising on cross-border investments, transfer pricing and qualifying businesses for special sector regimes (*e.g.* software, mining, agricultural, infrastructure projects). The tax litigation practice involves representing businesses and individuals in disputed federal, provincial and municipal claims for the payment and collection of taxes, as well as the reimbursement of taxes paid in excess at every level of government. Partnered with white-collar criminal defence counsel, the tax department has also successfully defended taxpayers against federal and provincial tax fraud claims.

Australia

Adrian O'Shannessy

Andrew Mills

Greenwoods & Freehills

1 General: Treaties

1.1 How many income tax treaties are currently in force in Australia?

Australia has comprehensive income tax treaties with 44 countries, including the US, UK, most Western European countries, most East and South-East Asian countries and New Zealand. Australia has also concluded or is concluding a number of Tax Information Exchange Agreements with a number of countries, including some low tax jurisdictions.

1.2 Do they generally follow the OECD or another model?

Australia's tax treaties generally follow the OECD model. However, the US treaty follows the US model and some differences exist in some other treaties. In particular, some treaties allocate rights to tax land rich entities in the same way as rights to tax real property.

The US, UK, Finnish, New Zealand, Norwegian and Japanese treaties provide withholding concessions and exemptions for interest paid to unrelated financial institutions and dividends paid to holding companies and significant corporate shareholders. For details, see questions 3.1 and 3.3.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Treaties must be incorporated into Australia's domestic law before they take effect. Each time a treaty is concluded, the International Tax Agreements Act 1953 (Agreements Act) is amended to give force of law to the treaty with the treaty incorporated as a schedule to that Act.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Australia's tax treaties traditionally did not incorporate anti-treaty shopping rules. However, limitation of benefits articles are included in some of Australia's more recently negotiated treaties, including its treaties with the US and Japan. Other new treaties contain specific provisions within the dividend, interest, and royalty articles.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Yes, occasionally. The Agreements Act gives treaties the force of Australian law. To the extent a treaty provision conflicts with domestic legislation, the treaty provision takes precedence. However, specific override provisions can also be found in the Agreements Act. These include the preservation of Australia's general anti-avoidance rule.

2 Transaction Taxes

2.1 Are there any documentary taxes in Australia?

Yes. Stamp duty is a documentary tax.

Stamp duty is levied by the various Australian States (and Territories). Although largely aligned, the duty regimes differ between the States (and Territories).

Stamp duty is levied on transfers of interests in land, the creation of beneficial interests in land, transfers of shares and units in land rich entities, motor vehicle transfers and insurance contracts at rates up to 7.00%. One State (New South Wales) applies lesser rates of duty to mortgage documents and two States and one Territory (New South Wales, South Australia and the Australian Capital Territory) impose stamp duty on transfers of shares in private companies at 0.6%. New South Wales and South Australia propose to abolish these share transfer duties on 1 July 2012. A nominal amount of duty also applies to some documents such as trust deeds.

While stamp duty was historically a documentary tax, avoidance-type rules can also apply duty to transactions effected without documents.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes. Since 1 July 2000, goods and services tax (GST) has been imposed on supplies that are connected with Australia, and on goods imported into Australia. The GST rate is 10%. GST is similar in scope and operation to the Value Added Tax systems of European Union Member States.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Supplies that are classified as "GST-free" do not attract GST. These supplies include education, health-related services, most basic types of food, exports (of goods and services), and certain supplies of businesses.

Other supplies that do not attract GST are known as "input taxed" supplies. These include financial supplies, residential rent and the sale of some residential premises.

The distinction is important because while neither class of supply is subject to GST, input tax credits cannot be claimed for acquisitions that relate to input-taxed supplies.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

An entity is broadly entitled to claim input tax credits for things acquired in the course of its business, except to the extent that the acquisition relates to input-taxed supplies (for example, financial supplies such as money lending or other dealings with debt or equity interests). Input tax credits are offset against the taxpayer's GST liabilities so that only a net GST amount is payable. Apportionment for "mixed use" acquisitions is required.

2.5 Are there any other transaction taxes?

Various States impose minor licensing fees.

2.6 Are there any other indirect taxes of which we should be aware?

Yes. Australia also imposes the following indirect taxes.

Excise duty

Excise duty is levied on some goods manufactured in Australia, including alcohol, tobacco and petroleum.

Land tax

Land tax is imposed by each State and the Australian Capital Territory on the value of commercial real estate. Agricultural land is excluded. Broadly, the liability for land tax rests with the land owner and the rate differs depending on the jurisdiction.

Customs duty

Goods imported into Australia may be subject to customs duty.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends are subject to 30% dividend withholding tax, unless the rate is reduced under an applicable treaty (generally to 15%). However, Australia operates under an "imputation system", whereby dividends paid by an Australian resident company out of post tax profits may carry a franking credit (essentially a tax credit) for the tax already paid by the company. "Fully franked" dividends are exempt from dividend withholding tax.

Under the US, UK, Japanese, Finnish, New Zealand and Norwegian treaties (generally Australia's recently concluded or renegotiated treaties), dividend withholding tax is reduced to nil where a beneficially entitled company holds at least 80% of the voting power in the company paying the dividends, and a 5% rate applies where the recipient is a company and holds at least 10% of the voting power. The second concession also applies under the French and South African treaties (which are also recently renegotiated treaties).

Unfranked dividends will not be subject to dividend withholding tax where they are paid out of "conduit foreign income". Conduit foreign income is essentially foreign income of the Australian company that is not subject to Australian tax (for example, non-portfolio dividends) and is paid on to a foreign resident as a dividend rather than accumulated in Australia.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties are subject to 30% royalty withholding tax. If a treaty applies, royalty withholding tax is usually reduced to 10%. Royalty withholding tax is reduced to 5% under the US, UK, New Zealand, Finnish, South African, Japanese, Norwegian and French treaties.

The term "royalty" is broadly defined in Australia's domestic legislation and includes fees paid for the use or supply of commercial property and rights. The term royalty is also defined in Australia's treaties and can differ from Australia's domestic legislation. In those cases, the treaty definition prevails.

More recently negotiated treaties exclude natural resource payments and equipment royalties from royalty withholding tax. However, withholding tax applies to rental payments to non-residents under arrangements in which cross-border leases are structured as hire-purchase arrangements.

Royalties that are effectively connected with an Australian branch of a non-resident are treated as business profits and taxed on an assessment basis (that is, they are not subject to withholding tax).

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest is generally subject to 10% interest withholding tax. This rate may be reduced under an applicable treaty.

Exceptions apply to interest paid on Eurobonds and other debt instruments offered publicly. Under Australia's recently concluded and renegotiated treaties (e.g. the US, UK, French, Japanese, Finnish, New Zealand, Norwegian and South African treaties), interest paid to an unrelated financial institution is exempt from withholding tax.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Australia's thin capitalisation rules apply to foreign controlled Australian groups (inward investors) and Australian groups that invest overseas (outward investors). The rules restrict interest deductions when the amount of debt used to finance the Australian operations exceeds specified limits (please see question 3.5 below).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

A safe harbour is provided under *de minimis* exemptions and three maximum allowable debt tests.

***De mimimis* exemptions**

Exemption from the thin capitalisation rules applies to:

- taxpayers with interest deductions of less that $250,000; and
- outward investors whose Australian assets make up 90% or more of total assets by value.

Maximum allowable debt tests

Thin capitalisation rules will not apply to deny any portion of an entity's interest deductions provided that debt is within the maximum allowable, as shown by one of the following three tests:

- For inward and outward investors, the "safe harbour test" prescribes a maximum debt to equity ratio of 3:1.
- For inward and outward investors, the "arm's length debt test" prescribes a maximum level of debt that is referable to the level of debt that could reasonably be borrowed from commercial lenders, but judged according to strict statutory criteria.
- For outward investors only, the "worldwide gearing test" allows gearing of Australian operations up to 120% of the overall worldwide gearing applied by the group it controls.

Significantly greater debt levels to those set out above are afforded to financial institutions, including a 20:1 safe harbour.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The thin capitalisation rules apply to all debt interests, including debt advanced by related and unrelated parties, whether an Australian or foreign resident, and in the case of debt advanced by an unrelated party, whether or not supported by a related party.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Any interest withholding tax due on interest payments by a local company to a non-resident must be remitted to the Tax Office before the local company is entitled to a tax deduction for interest payments.

The Tax Office maintains at present, somewhat controversially, that Australia's transfer pricing rules (see question 3.8 below) require Australian operations to have an arm's length capital structure and can therefore restrict interest deductions beyond the restrictions imposed by the thin capitalisation rules.

3.8 Does Australia have transfer pricing rules?

Australia has transfer pricing rules that are modelled on the OECD Transfer Pricing Guidelines. The rules are contained in Australia's domestic legislation and its tax treaties. The rules apply to "non-arm's length" cross-border transactions. Guidance on what is considered "arm's length" is provided by the Tax Office via a number of public rulings.

The rules give the Tax Office the discretion to adjust non-arm's length pricing of transactions to increase taxable income in Australia. Conversely, treaties can require Australia to reduce taxable income.

The preferred methods applied in Australia to determine the appropriate arm's length pricing of cross-border transactions are:

- Comparable Uncontrolled Price method.
- Resale Price method.
- Cost Plus method.
- Profit Split method.
- Transactional Net Margin method.

To confirm that international prices are arm's length, entities can apply for an advanced pricing agreement with the Tax Office.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of company tax is currently 30%. The government proposes to reduce this rate to 29% from 2013 (2012 for companies with associate inclusive aggregated turnover of less than A$2 million), but the change has not yet been legislated.

4.2 When is that tax generally payable?

Companies are generally required to pay tax under a "Pay As You Go" (**PAYG**) collection system. This requires large companies (and most other large taxpaying entities) to pay quarterly instalments of estimated tax, calculated by reference to the amount of income derived during that quarter. The instalments are due on the 21st day of the month after the end of each quarter. Any difference in tax payable from the estimate is due, in the case of a company, 5 months after the year's end.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Australian taxpayers are taxed on their worldwide "taxable income", typically for a year ending 30 June.

Taxable income comprises "assessable income", as defined by statute less allowable tax deductions. The amount of assessable income and tax deductions often varies from the amount of income and expenses recognised for accounting purposes. Tax adjustments often therefore produce differences between a company's taxable income and its reported profits.

Australia also has complex rules to attribute certain underlying income earned by foreign entities to Australian owners. Generally, active business income earned by a controlled foreign company is not attributed to the Australian controller, and profit distributed to the Australian controller as a dividend is exempt from tax. Foreign active business income derived directly is also generally exempt. These rules are currently being revised.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Taxable income often differs from commercial accounting profit because of:

- different tax depreciation rates for plants and equipment;
- differences in the timing of recognition of income and deductions for tax purposes compared to revenue and expenses for accounting purposes;
- tax concessions which allow greater than 100% depreciation for certain research and development expenditure;
- special tax incentives available from time to time, for example an additional capital expenditure deduction ("investment allowance") to encourage investment during the "global financial crisis";
- recognition of some taxable capital gains not recognised for accounting purposes;
- capitalisation of some expenses for tax purposes;
- in the case of consolidated groups, different calculations of the tax cost of assets; and
- elimination from taxable income of impairment, fair value

and mark-to-market type adjustments made for commercial accounting purposes.

4.5 Are there any tax grouping rules? Do these allow for relief in Australia for losses of overseas subsidiaries?

Special grouping rules apply in respect of income tax and GST.

Income tax consolidated group

An Australian resident head company may irrevocably elect to form an income tax consolidated group. A consolidated group consists of a head company and all its wholly owned Australian subsidiary companies and eligible trusts and partnerships. The consolidated group is taxed as a single entity and intra-group transactions are ignored. The head company is primarily liable for the group income tax and subsidiaries may be jointly and severally liable if it fails to pay. Broadly, the tax consolidation regime allows group restructuring, pooling of losses and tax free movement of assets within the group, without tax consequences. The tax costs of a subsidiary member's assets are set at the time of joining the group and the tax cost of shares in the subsidiary are set on leaving the group. Non-income tax matters are outside the scope of the consolidation regime.

Losses made by overseas subsidiaries cannot be brought onshore. This is the case irrespective of income tax consolidation.

Top tier Australian companies in a wholly owned multi-national corporate group that has multiple entry points into Australia may irrevocably elect to form a Multiple Entry Consolidated (MEC) group for income tax purposes.

GST Group

As a separate election, groups with 90% common ownership may be registered as a GST group. A GST group must nominate a representative member who is responsible for the GST liabilities of the whole group. Subsequent supplies and acquisitions made within the group are ignored for GST purposes. Non-GST matters are outside the scope of the GST group regime.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Australian tax is generally imposed on company profits, regardless of distributions. However, there is an exception for "conduit foreign income", which is exempt from Australian tax if distributed as a dividend to a foreign entity.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Fringe benefits tax

Fringe benefits tax (**FBT**) is a tax on employers on the value of non-cash "fringe benefits", provided to their employees. Fringe benefits typically include the provision of motor vehicles, expense payments and low interest loans.

The FBT rate is 46.5% of the "grossed-up" value of benefits (that is, grossed-up so that the tax payable is equivalent to the tax that would be payable on an equivalent amount of salary).

Petroleum resource rent tax

Petroleum resource rent tax is imposed on income from the recovery of petroleum products from offshore petroleum projects. Various other natural resource royalties are also applied.

Mineral resource rent tax

The government proposes to apply a new "minerals resources rent tax" to iron ore, coal and onshore petroleum, from 1 July 2012. This tax has not yet been legislated.

Luxury car tax

Luxury car tax is levied at 33% of the excess over $57,466 (indexed) of the retail value of a new car sold in or imported into Australia.

Wine equalisation tax

Wine equalisation tax is levied at 29% of the wholesale value of wine for consumption in Australia.

4.8 Are there any local taxes not dealt with in answers to other questions?

Payroll tax

Payroll tax is a tax imposed by each State and Territory on wages, salaries and other employee benefits, up to a rate of 6.85% (depending on the State or Territory).

Gaming licences

Each State has a regime for the imposition of gaming licence fees in one form or another.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

A comprehensive set of statutory rules within the income tax legislation include capital gains (after netting off capital losses) in assessable income.

These rules also contain capital gains tax exemptions and concessions, including the ability to index cost basis until 19 September 1999 and, alternatively, reductions of taxable gains made by individuals and complying superannuation funds on assets held for at least 12 months.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No. The rate of tax imposed on capital gains made by a company is the same 30% tax rate imposed on income. Companies are not eligible for the gain reductions ("CGT discounts") available to individuals and complying superannuation funds.

5.3 Is there a participation exemption?

Different exemptions from capital gains tax apply to non-resident and resident investors.

Non-resident investors

Since 12 December 2006, non-residents are broadly only subject to capital gains tax on assets that are "taxable Australian property", as defined. These assets include direct and indirect interests in Australian real property and the business assets of Australian branches. A non-resident investor is not subject to capital gains tax on a sale of shares in an Australian company, unless its holding exceeds 10% and the Australian company's value is mostly attributable to Australian real property.

Resident investors

Australian resident companies are *prima facie* subject to Australian tax on their worldwide income. However, a capital gain or loss made by a resident company on shares in a foreign company may be reduced (in some cases to nil) under a specific "participation exemption". The resident company must have held a 10% or greater direct voting interest in the foreign company for a continuous period of 12 months in the last 2 years. In that case, the capital gain or loss is reduced by the value of the foreign company's active business assets as a percentage of the value of its total assets.

5.4 Is there any special relief for reinvestment?

Relief for reinvestment is not available in Australia *per se*. However, the CGT provisions contain some "replacement asset" rollovers which allow deferral of tax on capital gains. They are generally targeted at restructures and takeovers. A commonly used rollover ("scrip-for-scrip" rollover) is available for scrip exchanges where the bidder acquires at least 80% of the shares in the target company. A limited rollover is available where the ownership of a capital asset ends due to compulsory acquisition by the government.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There is not any tax imposed on the formation of a subsidiary. A nominal administrative charge is levied by the Australian corporate regulator (**ASIC**) on incorporation of a company and also applies to the registration of a branch of a foreign company.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Australia's tax rules generally do not differentiate between conducting Australian operations through a subsidiary or a branch. Both forms of operation are subject to the same 30% corporate tax rate.

However, an Australian resident subsidiary with offshore investments would *prima facie* pay Australian corporate tax on its worldwide income (subject to the conduit foreign income rules mentioned in question 3.1 above), whereas a branch of a non-resident company would be taxed only on its Australian-sourced income.

Subsidiary company profits on which tax has been paid in Australia are able to be repatriated as dividends free of Australian dividend withholding tax.

6.3 How would the taxable profits of a local branch be determined?

A foreign company with an Australian branch is taxed on its Australian sourced income that is attributable to that branch. Arm's length transfer pricing rules apply to transactions between a branch and its offshore head office or other foreign branches.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Australia does not impose branch profits tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Generally yes, but Australia's tax treaties broadly allow full taxing rights to the source country where a treaty resident company carries on business through a permanent establishment in Australia. The treaties do invariably require arm's length principles to be applied in determining the taxable income of the branch. In these respects Australia's treaties broadly follow OECD treaty principles. However, the branch of a non-resident generally would not be able to take advantage of Australia's treaties with a third country.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There is not any withholding tax or other tax imposed on the remittance of profits by a branch.

7 Overseas Profits

7.1 Does Australia tax profits earned in overseas branches?

Income derived by an Australian resident company in carrying on business at or through a permanent establishment in a foreign country generally will not be subject to Australian tax. Likewise, a capital gain or loss made by an Australian resident company on an asset used in carrying on business at or through a permanent establishment in a foreign country generally will be disregarded.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

A "non-portfolio" dividend paid by a foreign company to an Australian resident company not acting in the capacity of a trustee is not subject to Australian tax. A non-portfolio dividend is a dividend from a company in which you hold at least 10% of the voting power. Other dividends received from non-resident companies are taxed in Australia, subject to a credit for any foreign income tax paid.

7.3 Does Australia have "controlled foreign company" rules and if so when do these apply?

Australia does have "controlled foreign company" rules that attribute Australian resident companies shares of income earned or gains made by foreign companies they control, even though the foreign income or gains may not be distributed.

A foreign company is a "controlled foreign company" if:

- a group of 5 or fewer Australian entities, each individually controlling at least 1% of the company, collectively control at least 50% of the company;
- a single Australian entity controls 40% or more of the company, unless it is controlled by another person or group; or
- a group of 5 or fewer Australian entities control the company.

Attributable taxpayers are 1% interest holders within a group of 5 controllers, and other 10% interest holders.

8 Anti-avoidance

8.1 Does Australia have a general anti-avoidance rule?

Australia has a general anti-avoidance rule contained in Part IVA of the tax legislation. It supplements other more specific anti-avoidance rules dealing with, for example, franking credit streaming and dividend stripping.

The provisions of Part IVA are extremely broad and extend to schemes entered into with the sole or dominant purpose of obtaining a tax benefit. A tax benefit is essentially a reduction of assessable income, an increase in allowable tax deductions (including tax deferral beyond what would be reasonably expected) or access to a tax credit. The application of Part IVA is dependant on the Commissioner's discretion, which is generally reserved for schemes that the Commissioner considers artificial or contrived.

Part IVA prevails over other provisions of the Australian tax legislation and Australia's tax treaties. Where it is applied, the tax benefits are denied and administrative penalties are generally imposed.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Australia does not have a special disclosure rule imposing a requirement to disclose avoidance schemes to the Tax Office in advance of the company's tax return being submitted. However, taxpayers may seek a Tax Office ruling for assurance about the tax treatment of a potentially contentious transaction.

Adrian O'Shannessy

Greenwoods & Freehills
101 Collins Street
Melbourne VIC 3000
Australia

Tel: +61 3 9288 1723
Fax: +61 3 9288 1828
Email: adrian.o'shannessy@gf.com.au
URL: www.gf.com.au

Adrian's practice involves advising public and multinational companies on all aspects of domestic and international tax planning, with a focus on corporate issues such as capital raisings and structured finance, mergers & acquisitions and corporate restructures, and employee share and dividend reinvestment plans.

Key areas of practice include:

- domestic and offshore debt capital raising;
- dividend and capital return strategies;
- capital gains tax and other reorganisation issues associated with mergers and acquisitions and corporate restructures;
- the taxation of public and private trusts and alternative structures such as stapled vehicles, partnerships and unincorporated joint ventures;
- employee share and option plans;
- structuring for inbound investment into Australia, particularly from the United States, and structuring for outbound investment; and
- tax litigation.

Andrew Mills

Greenwoods & Freehills
Lvl 39, MLC Centre, Martin Place
Sydney NSW 2000
Australia

Tel: +61 2 9225 5966
Fax: +61 2 9225 5901
Email: andrew.mills@gf.com.au
URL: www.gf.com.au

Andrew is the managing director of Greenwoods & Freehills. Andrew rejoined Greenwoods & Freehills in 2002 after having spent three and a half years as Chief Tax Counsel for a major wealth management firm.

Prior to this Andrew was a director of Greenwoods & Freehills, having joined the firm in 1990 after spending nine years in various sections of the Australian Taxation Office and two years as a senior tax specialist with a major financial services corporation. Andrew has had over twenty-five years' experience in tax, the last eighteen specialising in insurance, superannuation and funds management in both domestic and international tax contexts. He has advised clients on a range of tax matters including mergers and acquisitions, due diligence, tax audits, tax litigation, structured finance, capital raisings, domestic and international investments as well as corporate and fund restructuring both in Australia and cross-border.

Greenwoods & Freehills

We are a team of highly experienced taxation specialists focused on developing deep relationships with clients to fully understand their business needs. Our philosophy is for directors to be actively involved in advising clients to ensure the highest standards of technical expertise and provide the experience necessary for creative yet highly practical solutions. In recognition of the success of our approach we were awarded Australian Tax Firm of the Year for 2007 by International Tax Review and the 2011 BRW/Beaton Client Choice Awards Best Tax Advisor. Our first tier performance has been consistently recognised in league tables, tax guides, and industry-related awards.

Chapter 7

Austria

Paul Doralt

Dorda Brugger Jordis

Martina Znidaric

1 General: Treaties

1.1 How many income tax treaties are currently in force in Austria?

Currently, there are 90 tax treaties in force in Austria.

1.2 Do they generally follow the OECD or another model?

Generally, they follow the OECD model, although some of the older treaties significantly deviate from the OECD model. Important examples of treaties which do not follow the OECD model in essential points are those with Brazil, France and Japan.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Treaties become effective upon their ratification by the two governments or representative houses of the two parties to the treaty. Formal incorporation into Austrian legislation is not required.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Generally, Austrian tax treaties do not incorporate anti-treaty shopping rules. The most notable exemption from this principle is the tax treaty with the United States, which has a strict "limitation of benefits" article.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In principle, tax treaties are considered to be international law and as such should be protected from being overridden by national Austrian tax law. Nevertheless, in practice the Austrian tax authorities often deny treaty benefits to entities resident within treaty jurisdictions if these entities have a low degree of substance. Technically, the denial of treaty benefits in such situations is achieved by applying the general anti-abuse rule of Section 22 of the General Austrian Tax Code (*Bundesabgabenordnung* – BAO).

2 Transaction Taxes

2.1 Are there any documentary taxes in Austria?

The most significant documentary tax is provided for in the rather formalistic and old-fashioned Austrian Stamp Duty Act ("*Gebührengesetz* – GebG"). According to section 33 of the Austrian Stamp Duty Act, stamp duties are levied on certain types of transactions if these transactions are documented in writing. Generally, all parties entering into the agreement which triggers stamp duty are jointly and severally liable for these stamp duties.

In practice, the most important transactions which are subject to stamp duty under the Stamp Duty Act in the context of international business transactions are:

Lease and Rental Agreements

Lease and rental agreements are subject to stamp duty if a written rental or lease agreement is made. The stamp duty amounts to 1% of the annual sum of the rental payments multiplied by the duration of the contract (1% of 18 annual payments at the maximum). If there is no definite lease period, the stamp duty amounts to 1% of three times the annual value of the contract.

Agreements on the Assignment of Rights and Receivables

The assignment of rights and receivables is generally subject to stamp duty if a written agreement is made. The stamp duty amounts to 0.8% of the purchase price or of the fair value of the assigned receivables. Exemptions apply for assignments of receivables to special purpose securitisation vehicles.

<u>Technique for avoiding stamp duties</u>

Generally, Austrian stamp duty law is very formalistic and follows a rather old-fashioned "form over substance" approach. The law provides that in general all stamp duties arise upon either of the two following alternatives:

i) the agreement subject to stamp duty is concluded in writing on Austrian territory, or the written agreement (or a certified copy of it) is brought into Austrian territory at any later stage; or

ii) the contract is entered into abroad (and not brought to Austria), but the parties to the contract are Austrian residents and the legal obligations / transactions (payments) resulting from this contract are to be fulfilled in Austria.

On the basis of this legal environment, Austrian stamp duty in the context of international business transactions (with one party not being Austrian resident) can therefore be avoided using offshore signing schemes. If both parties to the agreement are Austrian residents, the stamp duty can only be avoided if no written document is signed by both parties.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Austria has a VAT system which follows the 6th EC VAT Directive. The generally applicable VAT rate is 20%. Lower rates apply to a few selected goods and services of public interest in the food, health and cultural sectors.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In principle, the supply of goods and services in any transaction is subject to VAT.

In the context of international business transactions, in practice, the most relevant VAT exemptions are the following:

Share Deals

The transfer of shares in a corporation is always exempt from VAT. Please note that in contrast to the treatment of shares in corporations, the transfer of partnership interests is treated for VAT purposes as an asset deal, i.e. VAT applies to the supply of all goods owned by the transferred partnership.

Financing

As in most other countries, the supply of financing services by banks and finance institutions is exempt from Austrian VAT. As a consequence of this exemption, banks are not entitled to claim input VAT refunds in Austria.

Real Estate Transactions

In the case of the transfer of real estate property, the seller has an optional right to treat the sale as being subject to or exempt from VAT. Generally, in business transactions the option to subject the sale to VAT is elected in order to not retroactively lose input VAT refunds claimed by the seller prior to the sale. If the sale is subject to VAT, the buyer can claim an immediate VAT refund if he is an entrepreneur for VAT purposes.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

There are certain business sectors, most notably the banking sector, the services of which are exempt from VAT and which are accordingly not entitled to recover VAT under the input VAT system. Other examples besides the banking and finance sectors are holding companies (with no other activities except holding participations) or medical services.

2.5 Are there any other transaction taxes?

The transfer of Austrian real estate property in an asset deal or the transfer of all of the shares in an Austrian corporation which owns real estate property triggers a real estate transfer tax of 3.5%. The real estate transfer tax in the case of a share deal may be avoided if not 100%, but only 99% of the shares in the company holding the real estate are transferred.

2.6 Are there any other indirect taxes of which we should be aware?

In the context of business transactions, the capital duty (1% levied on equity contributions to corporate entities) is of high practical relevance.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Under Austrian national tax law, dividends are subject to a 25% dividend withholding tax. This withholding tax is reduced by most tax treaties. In addition, no withholding tax will be imposed at source on intra-group dividends to EU-resident parent corporations, in compliance with the EC Parent Subsidiary Directive, if the following requirements are met:

- the parent company directly and continuously holds at least 10% (in some countries 25% is required under the principle of reciprocity) in the distributing Austrian company for a period of one year;
- the Austrian company is in the legal form of an AG or a GmbH, i.e. a corporation;
- the parent company is a corporation as listed in Art. 2 of Directive 90/435/EC;
- the parent corporation provides a residency certificate issued by the foreign tax authorities which is issued within one year before or after the dividend is paid; and
- the parent company provides confirmation to its subsidiary that it has active business income, employees and its own office premises.

If any of these requirements are not met, withholding tax has to be withheld and the foreign parent can apply for a refund. During the course of this refund procedure, the Austrian tax authorities will verify whether the foreign parent is entitled to the withholding tax reduction or whether the structure is abusive. Pure holding companies, as foreign shareholders, will only be able to rely on the withholding tax reduction at source if it is clear that the structure was not set up purely for tax-avoidance reasons.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid by an Austrian corporation to a non-resident are subject to a 20% withholding tax. However, under most of the tax treaties in force, this withholding tax is reduced to a rate of between 0% and 15%.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Austria does not levy any withholding tax on interest paid to a foreign or domestic corporate party. Treaty relief is not required. However, if debt is reclassified as hidden equity and, in consequence, interest payments are regarded as hidden dividends, the withholding tax rates for dividends may apply to interest payments.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Austria does not have statutory thin capitalisation rules or safe harbour debt/equity ratios. However, depending on the economic situation of a company, the tax authorities may reclassify parts or all of a company's debt into equity on a case-by-case basis. From a practical point of view it is thus definitely advisable to adhere to industry standards.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There is no statutory safe harbour. However, generally speaking, a debt/equity ratio of 70:30 per cent should usually be acceptable to the Austrian tax authorities. The debt/equity ratio is always measured on a consolidated basis. In the case of a leveraged acquisition, this usually means that the debt incurred by the acquisition vehicle has to be consolidated with the already-existing debt of the target.

Besides thin capitalisation, in order to avoid a reclassification of debt into hidden equity for tax purposes, the Supreme Administrative Court and the Ministry of Finance stress the importance of relatively formal issues, such as written loan agreements with arm's length terms regarding interest payments and repayment of loan principals.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, these informal thin capitalisation rules also extend to debt guaranteed by a related party.

3.7 Are there any restrictions on tax relief for interest payments by a local company to a non-resident?

In general, expenses are not deductible if they are directly related to tax exempt income. Exemptions from this principle may apply.

3.8 Does Austria have transfer pricing rules?

Austria does not have statutory transfer pricing rules. Nevertheless, transactions between related parties have to comply with the arm's length principle. In enforcing the arm's length principle, the Austrian tax authorities in 2010 published transfer pricing guidelines which use the OECD transfer pricing guidelines as a reference.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Austria has a flat corporate tax rate of 25%.

4.2 When is that tax generally payable?

The tax is in general payable within one month after receipt of the tax assessment, which is usually issued a few weeks after the filing of the tax return. A corporation generally has to file its corporate income tax return within four months after the end of the fiscal year. If the corporation is represented by a certified tax adviser, the filing date may be routinely extended by up to another year. Apart from the final tax payment, the corporation is subject to quarterly prepayments of corporate income tax on the basis of preliminary estimates issued by the tax authorities. Final tax payments made later than nine months after the end of the fiscal year are subject to interest. Interest is levied for the period starting on 1 October for the final tax payments of the previous fiscal year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In principle, the tax base for corporate income tax is the corporation's annual profit on the basis of the statutory commercial accounts. However, significant deviations and adjustments from the commercial accounts are required, according to the Austrian tax accounting rules.

The most significant of theses adjustments are:

- the treatment of provisions (in the case of most provisions, deductibility for tax purposes is limited to 80% of the provision);
- the treatment of depreciation periods (for tax purposes, only straight line depreciation is accepted; goodwill has a standard tax depreciation period of 15 years); and
- the treatment of national or international dividend income (national dividend income is always tax-exempt on a corporate level; international dividend income is exempt if the requirements of the international participation exemptions are met).

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Differences between the profits shown in the commercial accounts and the tax accounts are based on tax accounting rules as provided in the General Income Tax Act (*Einkommensteuergesetz* – EStG) and the Corporate Income Tax Act (*Körperschaftssteuergesetz* – KStG). Examples of important differences between statutory commercial accounting and tax accounting are the treatment of provisions, the treatment of depreciation periods and the treatment of dividend income or capital gains.

4.5 Are there any tax grouping rules? Do these allow for relief in Austria for losses of overseas subsidiaries?

In 2005, Austria introduced a modern group taxation regime. The group taxation regime allows the integration of non-Austrian corporations into an Austrian tax group, which allows the cross-border of losses within the group.

The requirements for an Austrian tax group are the following:

- the group parent must be either an Austrian corporation or an Austrian registered branch of an EU resident corporation. Several companies may jointly act as a group parent, provided that at least one company holds at least 40% and the other companies hold at least 15% in the prospective group member;
- **Austrian or foreign companies** which are in a legal form comparable to an Austrian corporation may participate as group members. **Foreign companies** can only be a member of the group if they are directly held by the Austrian group parent or if they are a member of an Austrian group;
- to qualify as a tax group, the group parent has to hold a direct or indirect participation of more than 50% in the share capital as well as a majority of the voting rights of the Austrian or the foreign subsidiary ("financial integration"). The requirement of financial integration must be met during the entire business year of the participating subsidiary;
- the group parent and the group members must file a written application for group taxation with the revenue office. The application is binding for at least three years; and
- group taxation is optional. The option can be exercised separately by each company that is a potential group member.

Under the new rules, all taxable profits and losses of the Austrian group members are attributed to the group parent, whereas in the case of foreign group members, only losses and no profits will be attributed to the group parent. If – in the years to follow – the foreign group member in its jurisdiction obtains a credit for the loss which is carried forward, the loss previously used in Austria must be recaptured at the level of the Austrian group parent in order to avoid the double use of losses. Should the foreign member cease to be a member of the tax group for any reason but insolvency, losses previously used in the Austrian tax group are to be recaptured as well.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, there is no such differentiation in corporate tax law. The model exists, however, in the field of small-sized one-person businesses and small-sized partnerships with a profit of less than EUR 100,000.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Real estate property located in Austria is subject to property tax. The tax base for property tax is the historically-assessed standard value of the respective property, which is generally substantially below its actual fair value. The property tax is levied at a basic federal rate multiplied by a municipal coefficient. The basic federal rate is 0.2% of the historically assessed standard value; the municipal coefficients range up to 500%.

4.8 Are there any local taxes not dealt with in answers to other questions?

No, all taxes on corporate (as opposed to individual) taxpayers are levied at a federal level.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There is a special set of rules regarding capital gains and losses incurred with international participations in non-Austrian corporations exceeding a minimum shareholding of 10%.

Capital gains or capital losses realised upon both the sale of such participations as well as depreciations of the participation are in principle not tax-effective. In the past (i.e. up to 2004), such capital gains were tax-exempt, whereas capital losses were deductible. Due to EU pressure, both capital gains and capital losses are now tax-neutral (i.e. gains are exempt and losses are not deductible).

Only losses realised upon the liquidation or insolvency of a foreign subsidiary are still tax-deductible to the extent that they exceed tax free dividends received in the five years before the liquidation or insolvency.

As an alternative to the "tax-neutral statues" of international participations, an option model is available, as follows:

Any corporate holder of a foreign participation can opt out of the tax neutrality of foreign participations. If such opt-out is chosen, capital losses and write-downs are fully tax deductible (however, they have to be depreciated over a fixed period of seven years), and on the other hand capital gains will be fully taxable. Dividends, however, are not covered by this option and remain tax-exempt under the participation exemption.

It is possible to choose one of the two aforementioned options for each international participation. However, once the choice is made it cannot be revoked.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No, the corporate tax rate imposed on capital gains is not different from the regular corporate tax rate of 25%.

5.3 Is there a participation exemption?

As already indicated, there is an international participation exemption which applies to dividends and capital gains received from foreign subsidiaries, as opposed to the national participation exemption which only applies to dividends.

According to the Austrian international participation exemption, dividends received by an Austrian holding company from a subsidiary, or capital gains incurred by an Austrian company upon the sale of a foreign subsidiary, are not subject to corporate income tax in Austria if the following requirements are met:

- the Austrian company must hold at least 10% of its foreign subsidiary (in the case of EU jurisdiction the 10% threshold is not required any more);
- the foreign subsidiary must be comparable to an Austrian AG or GmbH (i.e. it must be a corporation); and
- the participation in the foreign company must be held at least for one year (the holding period).

The international participation exemption is subject to a set of specific "anti-abuse of law" rules. Under these anti-abuse rules, the Austrian participation exemption does not apply if:

i) The subsidiary is located in a low-tax jurisdiction.

A jurisdiction is deemed to be a low-tax jurisdiction if the effectively applicable tax rate under Austrian tax accounting rules amounts to less than 15%.

ii) The subsidiary generates primarily passive income.

A foreign subsidiary is considered to earn mainly passive income if the passive part of its operations constitutes more than 50% of its total activity (calculated on the basis of assets, employees and profits). The passive part is defined as activities in connection with interest income, income from licences or leasing, or the sale of participations, etc.

5.4 Is there any special relief for reinvestment?

For corporations there is no such relief. A relief for reinvestment exists only for individuals and private foundations.

6 Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The formation of a subsidiary triggers a capital duty of 1% on the basis of the contributed equity (nominal capital plus share premium).

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

The transfer of equity to the Austrian branch of a non-Austrian parent company in principle also triggers the 1% capital duty. However, this capital duty does not apply if the parent company is resident in an EU Member State.

6.3 How would the taxable profits of a local branch be determined?

In principle, Austrian branches are not treated differently from Austrian resident subsidiaries. They are subject to Austrian tax accounting rules even though the statutory accounting is prepared at the level of the foreign parent company. The debt-equity ratio of a branch is measured on a stand-alone basis, i.e. the strong or weak equity position of the parent company is not relevant to the Austrian tax position.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Austria does not have the concept of a branch profits tax (such as for instance the United States). Branches are subject to Austrian corporate income tax on the basis of the assumption that the branch constitutes a permanent establishment in Austria of its non-Austrian parent. Thus the non-Austrian parent company becomes subject to Austrian corporate income tax on all profits that can be allocated to the Austrian permanent establishment.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

In principle, a branch is transparent for tax treaty purposes and is thus not entitled to treaty benefits, such as reductions of withholding tax on dividends, interest or royalties. From a tax treaty perspective, a branch generally is to be treated as a permanent establishment, whose income is either exempt or credited in the jurisdiction of the parent company depending on the relief method article of the respective tax treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, there is no withholding tax levied on the remittance of profits from a branch to its parent.

7 Overseas Profits

7.1 Does Austria tax profits earned in overseas branches?

Generally, Austria levies corporate income tax on worldwide profits. However, profits earned in overseas branches usually – according to double tax treaties – are either exempt from Austrian tax or foreign taxes are credited in Austria.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As already indicated, there is an international participation exemption which applies to dividends and capital gains received from foreign subsidiaries, as opposed to the national participation exemption which only applies to dividends (see question 5.3 above).

According to the Austrian international participation exemption, dividends received by an Austrian holding company from a subsidiary, or capital gains incurred by an Austrian company upon the sale of a foreign subsidiary, are not subject to corporate income tax in Austria if the following requirements are met:

- the Austrian company must hold at least 10% of its foreign subsidiary (in the case of EU jurisdiction the 10% threshold is not required any more);
- the foreign subsidiary must be comparable to an Austrian AG or GmbH (i.e. it must be a corporation); and
- the participation in the foreign company must be held at least for one year (the holding period).

The international participation exemption is subject to a set of specific "anti-abuse of law" rules. Under these anti-abuse rules, the Austrian participation exemption does not apply if:

i) The subsidiary is located in a low-tax jurisdiction.

A jurisdiction is deemed to be a low-tax jurisdiction if the effectively applicable tax rate under Austrian tax accounting rules amounts to less than 15%.

ii) The subsidiary generates primarily passive income.

A foreign subsidiary is considered to earn mainly passive income if the passive part of its operations constitutes more than 50% of its total activity (calculated on the basis of assets, employees and profits). The passive part is defined as activities in connection with interest income, income from licences or leasing, or the sale of participations, etc.

7.3 Does Austria have "controlled foreign company" rules and if so when do these apply?

Austria does not have "controlled foreign company" rules. This applies with the exception of the look through approach for investments in non-registered foreign investment funds.

8 Anti-avoidance

8.1 Does Austria have a general anti-avoidance rule?

The Austrian General Fiscal Code (*Bundes abgabenordnung* - BAO) contains a general anti-abuse provision. The provision – Art 22 – incorporates the substance-over-form principle into Austrian tax law and generally allows the tax authorities to disregard transactions or structures which have been chosen solely for the purpose of avoiding or reducing.

Apart from this general provision several more specific anti-abuse provisions can be found in a variety of Austrian tax laws. Examples are the principle of "actual place of management" in the field of corporate taxation, anti-abuse rules in the participation exemption, which take away the benefit of the participation exemption from dividends received from passive tax haven companies, or CFC legislation for offshore investment funds etc.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There are no specific disclosure rules for avoidance schemes. Avoidance schemes are usually challenged by the tax inspectors in the course of tax audits.

Dr Paul Doralt, LL.M.

Dorda Brugger Jordis
Dr Karl Lueger-Ring 10
1010 Vienna
Austria

Tel: +43 1 533 4795 101
Fax: +43 1 533 4795 50101
Email: paul.doralt@dbj.at
URL: www.dbj.at

Paul Doralt draws on extensive experience in tax matters (corporate tax, mergers & acquisitions, private client) and is also an expert in trusts and estates, corporate restructurings and structured finance. He is admitted to the Austrian Bar and also a certified tax advisor. He graduated from the University of Vienna (Dr iur 1996) and from the University of London, King's College (LL.M. 1997).

Paul Doralt has been a partner at Dorda Brugger Jordis since 2006. Prior to joining the firm, he was head of the tax department at another leading, internationally active law firm in Austria. Prior to that, he worked as a senior tax manager in corporate tax and head of the Austrian tax desk at KPMG in New York City (2001-2003) and as a tax manager at KPMG in Vienna (1998-2001).

He is author of numerous publications on tax law and private trusts. Paul Doralt is a member of the IFA (International Fiscal Association) and of the Austrian Chamber of Professional Accountants. He is also a member of IBA, where he was recently elected to the board of the Global Tax Committee. He has already been IBA´s Austrian national reporter on tax issues since 2007.

Martina Znidaric

Dorda Brugger Jordis
Dr Karl Lueger-Ring 10
1010 Vienna
Austria

Tel: +43 1 533 4795 101
Fax: +43 1 533 4795 50101
Email: martina.znidaric@dbj.at
URL: www.dbj.at

Martina Znidaric has more than 14 years of experience in tax matters (corporate tax, mergers & acquisitions, private client) and is also an expert in trusts and estates. She is a chartered public accountant and also a certified tax advisor. She holds an MBA degree from Vienna University of Economics and Business Administration (Mag rer soc oec 1990).

Martina Znidaric is Of Counsel as certified tax advisor at Dorda Brugger Jordis since 2006. Prior to joining the firm, she worked as a a chartered public accountant and also a certified tax advisor at a renowned Vienna-based auditing firm, gmc-unitreu Wirtschaftsprüfungs- und SteuerberatungsgmbH (2002-2005). Prior to that, she worked as certified tax advisor at another Viennese auditing firm (1996-2001). She also gained valuable international experience working in London at the renowned firm Alliotts Chartered Accountants and Registered Auditors (1996).

She is author of numerous publications on tax law and private trusts. Martina Znidaric is a member of the Austrian Association of Chartered Public Accountants and of the Austrian Chamber of Professional Accountants.

DORDA BRUGGER JORDIS ATTORNEYS AT LAW

Dorda Brugger Jordis is a leading law firm in Austria, providing legal services in all areas of corporate, civil and commercial law. The firm's activities focus on corporate and M&A, banking, finance, capital markets, tax, CEE projects and real estate.

For projects in Central and Eastern Europe, the Dorda Brugger Jordis 'Best Friends' Network, a close cooperation with independent top-tier law firms in the CEE region, has well proven its worth. All law firms participating in this network share the same high standards of quality and provide in-depth regional expertise. Clients thus have access to top legal know-how in the following countries: Austria, Bosnia, Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Serbia, Slovakia and Slovenia.

The tax department of Dorda Brugger Jordis is outstanding in the Austrian legal market. The team comprises of seven individuals, three of them qualified as certified tax advisors (*Steuerberater*). In cooperation with other practice groups, such as M&A, banking or real estate the experienced tax team provides high level tax advice in the fields of international tax planning, M&A taxation, structured finance, corporate restructurings, tax litigation and trust and estate tax planning.

Chapter 8

Belgium

Thierry Blockerye

Clifford Chance LLP

Pierre-Olivier van Caubergh

1 General: Treaties

1.1 How many income tax treaties are currently in force in Belgium?

About one hundred bilateral income tax treaties that have been concluded by Belgium are currently in force. Belgium concluded treaties with most European countries and the majority of the developed countries in the world, notably those in the Asia-Pacific Region. Belgium was the first State to conclude a bilateral tax treaty with Hong Kong, which offers an interesting route for structuring investments from Chinese investors in Europe and the other way around. A new treaty with the United States of America was signed on 27 November 2006, and entered into effect on 28 December 2007.

1.2 Do they generally follow the OECD or another model?

Generally, the bilateral income tax treaties concluded by Belgium follow the OECD Model Convention. However, almost all those treaties deviate to a certain extent from the Model Convention. Some of those deviations relate to the specific characteristics of the Belgian income tax system (e.g. article 16 relating to Directors' fees in most recent treaties) or to the specific needs or concerns of the other contracting state (e.g. limitation on benefits, exchange of information and administrative assistance provisions in the new US treaty). The Draft Model Convention published in June 2007 by the Belgian tax authorities should be used as the basis for (re)negotiating future bilateral tax treaties to be concluded by Belgium.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes, they do. Any bilateral tax treaty signed on behalf of the Belgian State needs to be formally approved by the Parliament before entering into force on the date specified in the treaty. This approval is incorporated in a formal statute.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Usually, the bilateral tax treaties concluded by Belgium do not include anti-treaty shopping provisions, except for the reference to "beneficial ownership" which is required to invoke the treaty benefits in respect of dividends, interest income and royalties, that has been systematically included in the treaties concluded by Belgium after 1977 (i.e. the bilateral treaties based on the 1977 OECD Model Convention). Some treaties include a limitation on benefits provision (e.g. treaties concluded with Switzerland and with the US) or expressly exclude certain entities from their personal scope of application (e.g. the Luxembourg 1929 holding company).

The treaties concluded with Luxembourg and Germany (and more recently the treaty concluded with Hong Kong) provide that the treaty does not prevent the application of domestic anti-abuse provisions in both contracting states.

Finally, a general anti-treaty shopping provision has been included in article 27 of the Belgian Draft Model Convention.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In general, neither domestic law which is in force when the relevant treaty enters into effect, nor any subsequent domestic legislation, can overrule a bilateral tax treaty. This general principle was confirmed by the Belgian Supreme Court in 1971 in its ruling on the "*Franco Suisse Le Ski*" case. Furthermore, a more recent attempt by the Belgian legislator to still levy income tax on pension capital amounts paid to beneficiaries who emigrated from Belgium prior to their retirement (article 364 *bis* of the Belgian Income Tax Code (BITC)), has also been rejected by the Belgian Supreme Court in a treaty context, on the basis of the general "*pacta sunt servanda*" principle.

An exception to this principle are the rules included in the Belgian Constitutional Code that, in theory, in the opinion of the Belgian Constitutional Court, can overrule treaty provisions. In practice, however, the Belgian Constitutional Court has never condemned an international treaty entered into by Belgium, based on a constitutional infringement.

2 Transaction Taxes

2.1 Are there any documentary taxes in Belgium?

Yes. Documentary taxes are due in Belgium on certain formal documents and duplicates thereof, such as notarial deeds or a bailiff's summons. Legislation in this matter changed in December 2006, which has replaced stamp duties per page with lump sum duties per deed or document, and has facilitated payment thereof through "modern" payment facilities, such as wire transfer. The lump sum duties per document range from €0.15 per document (bank transcripts) to €95 (certain notarial deeds).

Registration duties apply to certain types of transactions, provided that they are subject to the formality of registration (whether or not compulsory):

(i) Real estate transfer tax

Transfer of real property in Belgium is subject to a registration tax, the rate of which is equal to 12.5% in the Walloon and Brussels Regions. In the Flemish Region, that transfer tax rate is reduced to 10%. In the event of a resale of the real property within 2 years, part of this transfer tax (up to 60%) can be recovered by the taxpayer.

Provided that certain conditions are respected, a professional real estate trader can benefit from a reduced rate of transfer tax, which varies between 4% and 8%, depending on the Region in which the real estate is located.

The real estate transfer tax can, subject to certain conditions set forth by the Belgian Ruling Commission, be reduced to a mere 0.69% through a "split sale" structure, which implies the vesting of a long lease right (0.2% registration tax; see below), followed by the sale of the freehold to another (related) person (10%-12.5% transfer tax on a reduced base).

The transfer of buildings that are considered to be "new" (until 31 December of the second year following the year in which the building is used for the first time) and that are subject to VAT, will be exempt from transfer tax.

(ii) Rental and leasehold contracts

Rental and leasehold contracts in respect of real estate in Belgium, as well as the transfer thereof, are subject to a 0.20% registration duty on the total sum of rental payments and charges to be borne by the lessee during the (remaining) term of the contract.

(iii) Other registration duties

The grant or transfer of a mortgage on real estate asset situated in Belgium will in principle trigger a 1% registration tax due on the amount guaranteed by the mortgage. Reduced registration tax may be applicable for registration of certain types of security documents.

As from 1 January 2006, contributions in cash or in kind to the capital of a Belgian company are no longer subject to a capital duty. The contribution by an individual of residential real property in Belgium, however, will trigger real property transfer tax.

Transactions that are exempt from proportional registration duties are still subject to a fixed duty of €25 upon fulfilling the registration formality.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Belgium has adopted a VAT system in conformity with the relevant EU Directives. Currently, three rates apply:

- 6% on necessities and services of a social nature (e.g. food and water), pharmaceutical products and, subject to certain conditions, work related to real estate;
- 12% on fuel and the supply of social housing (if not exempt) and works related thereto. As of 1 January 2010, the 12% rate also applies to catering and restaurant services, with the exception of beverages; and
- 21% (general rate): on all other goods and services.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Generally, VAT is due in Belgium on: (i) the delivery of goods or services supplied by a VAT-registered person that take place in Belgium for VAT purposes; (ii) the import of goods into Belgium; and (iii) acquisitions of goods from another EU Member State (intra-Community acquisitions) that take place in Belgium for VAT purposes.

However, exemptions apply for:

- some social services (among others: medicine; elderly homes; and education);
- supply and leasing of real estate (with the exception of a supply of a "new" building (see *supra*));
- insurance, banking and other financial services;
- management of a collective investment fund, or a pension fund that has been set up or converted in a specific legal form;
- legal services (lawyers, notaries, bailiffs); and
- a transfer of a universality of goods or a business unit (in the context of corporate reorganisations), subject to certain conditions.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input VAT is only recoverable by a VAT taxpayer. Deduction of input VAT from output VAT due, or refund of excess input VAT, is limited to supplies of goods or services that are acquired by the VAT taxpayer for the performance of services and/or supply of goods that are subject to VAT. No such deduction or refund is allowed for goods or services that are used for other (exempt) activities. If a VAT taxpayer engages in VAT and non-VAT activities, the amount of deductible or refundable input VAT is determined proportionally to the turnover that arises from the VAT activities, compared to the overall turnover. Alternatively, the VAT taxpayer may apply (and the VAT authorities may also oblige him to do so) for permission to deduct input VAT based on the actual use that is made of the relevant goods and services. In that case, goods and services that are not attributable to a specific activity (e.g. overhead costs), must be attributed based on an allocation key that reflects reality as closely as possible.

In April 2007, a VAT consolidation system has entered into effect in Belgium. Subject to the fulfilment of certain conditions and formalities, a group of Belgian enterprises may decide to form a so-called "VAT-unit". Transactions between members of such unit generally are outside the scope of the VAT system. Any restrictions on the deduction of input VAT is measured at the level of the VAT-unit as a whole.

2.5 Are there any other transaction taxes?

Stock market transactions are subject to a transaction tax of 0.07%, 0.17% or 0.50% (depending on the type of securities and the type of transaction), due by both buyer and seller, with a maximum of €500, and in some cases €750, per transaction and per party.

Some market participants, such as non-residents (under specific conditions) and some institutional investors, are exempt from this tax. Further to a decision of the European Court of Justice in 2004, subscription to newly-issued securities is not subject to this stock market tax.

Physical delivery of securities, as a result of: (i) their acquisition (for consideration); (ii) conversion of registered securities into bearer securities; or (iii) withdrawal of securities that have been deposited with a financial institution, is subject to a tax of 0.6% on their value. No maximum applies. However, the Belgian legislature has issued legislation providing for the abolition of bearer securities in Belgium. Such securities may no longer be issued as of 1 January 2008 and all existing bearer securities must be converted into registered or dematerialised securities by 2014.

2.6 Are there any other indirect taxes of which we should be aware?

An indirect tax is levied on premiums related to insurance contracts, including most collective life and pension insurance agreements that cover a risk located in Belgium. The rates vary from 1.1% to 9.25%. Numerous exemptions exist, among others for reinsurance, labour accident insurance, and individual or collective pension savings accounts.

Customs duties are generally payable on goods imported from outside the EU. Excise duties are levied on specific types of goods (e.g. alcohol and tobacco) upon their distribution in Belgium.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Belgian domestic tax law provides that dividend distributions are generally subject to a 25% withholding tax in Belgium. This tax rate may be reduced to 15% for dividend distributions on certain qualifying shares (so-called "VVPR"-shares) issued after 1993, and to 10% for liquidation and share buy-back bonus distributions. Full withholding tax exemption can be obtained for:

- dividends paid by a Belgian resident company to a non-resident legal entity which does not exercise a business or professional activity and is exempt from income tax in its state of residence (e.g. a foreign pension fund);
- dividends paid by a Belgian resident company to a parent company resident in another EU Member State, that holds a stock participation of at least 10% in the capital of the former for not less than 12 months; and
- dividends paid by a Belgian resident company to a parent company resident in a jurisdiction with which Belgium has concluded a bilateral tax treaty, subject to the same participation requirements as for parent companies resident in the EU (see *supra*), provided that this treaty (or another separate treaty) provides for the exchange of information for purposes of applying domestic tax law between the treaty states.

Generally, most bilateral tax treaties concluded by Belgium provide for a reduction of the Belgian dividend withholding tax rate to 15% and even 10% or 5% in the case of a substantial participation in the capital of the Belgian company (often 25%), held by a company resident in the other contracting state. Most recent treaties (e.g. the treaty with Hong Kong and with the US) and the Belgian Draft Model Convention provide for a 0% rate for dividends on such substantial participation.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

According to Belgian domestic tax law, Belgian source royalty payments are subject to a withholding tax of 15%. However, in many bilateral tax treaties to which Belgium is a party, royalty payments must be exempt from income tax in the source state. In some treaties, however, this is limited to specific types of royalty payments.

In execution of the EU Interest and Royalty Directive, royalty payments by a Belgian resident company to a related company in another EU Member State are exempt from withholding tax, provided that, during the period to which the royalty income relates, the underlying assets or intellectual property for which the royalties are paid are not connected to a permanent establishment of the beneficial owner of the royalty income located outside the EU territory. Companies are considered to be "related companies", provided that either:

(i) one of these companies directly or indirectly holds a participation of at least 25% in the capital of the other company, during an uninterrupted period of at least 1 year; or

(ii) a participation of at least 25% in the capital of both companies is directly or indirectly held by an EU resident company during an uninterrupted period of at least 1 year.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

According to domestic tax law, Belgian source interest payments are generally subject to a 15% withholding tax. Some bilateral tax treaties to which Belgium is a party (e.g. treaties with Germany, Luxembourg and the Netherlands) provide for an exemption from interest withholding tax in the source state. Other treaties limit the withholding tax to be levied in Belgium to 10%. Belgian domestic tax law also provides for a withholding tax exemption for certain interest payments to non-residents, such as:

- interest payments on receivables (other than bonds) that are paid by Belgian companies or professionals (including permanent establishments of non-resident companies or physical persons) to non-resident credit institutions located in a Member State of the European Economic Area, or in a country with which Belgium has concluded a bilateral tax treaty;
- interest payments on receivables (other than bonds) that are paid to non-residents that do not use the receivables for professional activities in Belgium, by Belgian financial enterprises, including certain listed holding companies and intra-group financing companies, subject to certain conditions;
- interest payments on registered bonds that are paid to non-residents that do not hold the bonds for professional activities in Belgium, subject to certain conditions;
- interest payments to the Belgian permanent establishment of foreign banks; and
- interest payments between two non-residents through the intermediation of a group finance or cash pooling centre located in Belgium (under certain conditions).

Moreover, in execution of the Interest and Royalty Directive, interest payments by a Belgian resident company to a related company in another EU Member State are exempt from withholding tax, provided that, during the period to which the interest income relates, the underlying receivable is not held through a permanent establishment of the beneficial owner of the interest income located outside the EU territory. We refer to question 3.2 above for the definition of "related companies".

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Belgian tax law includes 2 specific rules aimed at avoiding thin capitalisation:

- **the "7:1" rule:** according to this rule, interest payments, other than those on bonds or similar publicly-issued debt

Belgium

securities, to beneficiaries that are not subject to income tax or benefit from a substantially more favourable tax regime in respect of such interest income compared to the normal tax treatment in Belgium, are not tax-deductible to the extent that they relate to that part of the loans granted by such beneficiaries which exceeds seven times the paid in capital and (non-exempt) reserves of the Belgian borrowing company; and

- **the "1:1" rule:** this rule applies to interest payments on loans, excluding bonds or similar publicly-issued debt securities, granted by shareholders/physical persons or directors of the company, to the extent that the total amount of these loans exceed the company's paid-in capital and (non-exempt) reserves. In that case, the excess interest is recharacterised as a (non-deductible) dividend distribution, (generally) subject to a 25% withholding tax.

Both thin capitalisation rules are also applicable to cross-border interest payments, in which case their compatibility with both the "arm's length" article in the relevant bilateral tax treaty and EU law needs further attention. More specifically with respect to the application of the 1:1 rule on interest on loans granted by foreign companies acting as the director of the Belgian borrowing company, the ECJ has ruled that it is contrary to the European freedom of establishment (*Lammers & Van Cleef*, case C-105/07, d.d. 17 January 2008).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

Naturally, the above risk of denial of the deductibility of interest payments can be avoided by respecting the 7:1 or 1:1 debt/equity ratio, respectively. In addition, the 1:1 rule can be easily avoided in a cross-border intra-group financing context by not making the lender a member of the board of directors of the Belgian company.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The 7:1 rule is applicable to interest payments to both related and unrelated parties.

The 1:1 rule is only applicable to interest payments to:

(i) an individual shareholder, his spouse and minor children, provided that the shareholder or spouse, respectively, have the legal benefit of the latter's income;

(ii) an individual director, his spouse and minor children, under the same provision as (i) above; or

(iii) a foreign corporate director (the 1:1 rule explicitly excludes a resident corporate director from its field of application).

However this difference in treatment has been condemned by the ECJ (*cf.* question 3.4 above). Whether or not the loans are guaranteed by a parent company is not relevant for the application of the above thin capitalisation rules.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Interest payments that are made directly or indirectly to a non-resident or to a foreign establishment of a Belgian resident, which, according to the tax legislation of the state in which it is established, is not subject to income tax or benefits from a tax treatment which is significantly more favourable than the Belgian income tax regime applicable to such interest income, are in principle not tax deductible, unless the taxpayer can prove that the interest expenses relate to a genuine financing transaction and that its terms and conditions do not deviate from "at arm's length" conditions.

Moreover, interest payments in general only qualify as tax-deductible professional expenses to the extent that the interest rate does not exceed the normal market interest rate in that specific situation and that they are made in order to realise or maintain taxable income.

3.8 Does Belgium have transfer pricing rules?

Yes. Belgian tax law allows upward corrections of taxable income in Belgium when a transaction with a foreign person deviates from "arm's length" conditions. Such corrections generally apply to transactions between related parties, but can also apply to transactions with non-related foreign parties that are not subject to any income tax in their jurisdiction of residence or to an income tax regime that is substantially more beneficial than the normal income tax regime in Belgium.

Furthermore, income arising from gratuitous or benevolent advantages received by a Belgian resident enterprise from a transaction that did not meet the "arm's length" criterion cannot be offset by the tax losses and other specific tax deductions available to that enterprise.

The "arm's length" concept (with reference to the relevant OECD guidelines in this respect), was formally introduced into Belgian tax law in 2004. At the same time, the Belgian legislature has also established a procedure for corresponding downward adjustments of taxable income in Belgium, pursuant to article 9, §2 of the OECD Model Convention.

It is also possible to obtain an advance formal ruling in respect of the "arm's length" nature of a certain transaction from the Belgian Ruling Commission.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of corporate tax is 33.99% (33% + 3% surcharge). Reduced rates apply to companies with annual taxable profits which do not exceed €322,500 (subject to certain additional conditions).

The effective tax rate is generally further reduced to 25-26% by the application of the notional interest deduction; i.e. an annual tax deduction of a (deemed) cost of equity (see *infra*). The recently introduced deduction for patent income may further reduce the effective tax rate for qualifying companies.

4.2 When is that tax generally payable?

Corporate tax is due on an annual basis and must be paid in advance through quarterly instalments that are offset against the final tax charge due. The absence of sufficient tax prepayments will give rise to an increase of the final tax charge.

The final tax charge is payable within 2 months after the tax assessment has been sent to the taxpayer. Income tax is generally assessed before 30 June of the year following the assessment year.

In other words, a company that closes its accounting year on 31 December of year N will have to pay its final corporate tax before the end of August of year N+2, without taking possible extended tax return and/or assessment periods into consideration.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Corporate income tax is generally based on worldwide income reported in the company's annual statutory financial statements, in accordance with Belgian GAAP principles, and includes all profits and losses. This initial taxable base is then adjusted by specific tax law corrections, such as restrictions on deductible expenses and the exemption of certain capital gains (see *infra*).

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The profit or loss recorded in the commercial accounts is subject to certain technical tax adjustments. Differences between the final result for accounting and income tax purposes are mainly due to:

- non-deductibility of certain expenses, such as corporate income tax or withholding taxes, a certain percentage of car-related expenses, fines or capital losses and reductions in value of shares;
- certain restrictive conditions for the deductibility of depreciations of receivables;
- tax exemption of realised capital gains on shares (see *infra*);
- tax deduction of 95% of qualifying dividend income (see *infra*); and
- deduction of a notional interest amount, calculated as a percentage of the preceding year's equity (after certain adjustments). This percentage is based on the preceding year's average yield of a long-term (10-year) government bond, amounting to 4.473% in the assessment year 2010, but has been capped to 3.8% for the assessment years 2011 and 2012 (for assessment year 2012, the percentage of the deduction amounts to 3.425%).

4.5 Are there any tax grouping rules? Do these allow for relief in Belgium for losses of overseas subsidiaries?

No tax consolidation or other form of group relief is applied in Belgium. Only profits of foreign permanent establishments of a Belgian resident company (provided that the PE is not located in a treaty country) or losses of such foreign establishments (whether or not they are in a country that has concluded a tax treaty with Belgium), are taken into consideration to determine the Belgian corporate income tax base.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

As a general rule, distributed profits are taxed at the same corporate tax rate as retained earnings. However, in some cases, profits are temporarily exempt from corporate income tax, provided that they are recorded on an unavailable equity account on the balance sheet (e.g. revaluation gains on fixed assets).

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

A real estate tax is annually due on property located in Belgium. It is calculated on a deemed rental income attributed to such property when it is used for the first time (which is generally considerably lower than its fair rental value). The tax is assessed separately, and it cannot be offset against final corporate income tax. The real estate tax rate amounts to 2.5% in the Flemish region and 1.25% in the Walloon and Brussels regions, but due to provincial and municipal surcharges, the effective rate is a multiple thereof.

4.8 Are there any local taxes not dealt with in answers to other questions?

The different Belgian Regions, provinces, municipalities and "agglomerations" have power to levy taxes on a wide-range of matters. The Flemish and the Walloon Regions have used this power to introduce a tax on unoccupied business premises. Most municipalities impose a variety of (non-substantial) business taxes, but there is some federal pressure to reduce the number of such local business taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Generally, capital gains are taxed at the same corporate income tax rate as ordinary business income, whilst capital losses are also fully deductible from ordinary business income. However, capital gains realised on shares are tax exempt, provided that certain "subject to tax" requirements are fulfilled at the level of the subsidiary. No minimum threshold or minimum holding period requirement applies for this exemption. Capital losses on shares are not deductible, unless they are realised upon the subsidiary's liquidation, limited to the actual capital amount represented by these shares. There is no restriction to the deductibility of interest expenses for borrowings related to such share investments.

Capital gains realised on certain intangible and tangible fixed assets can benefit from a tax deferral, provided that the sales proceeds are fully reinvested in qualifying (depreciable) assets. Reinvestment should in general take place within 3 years, unless the proceeds are reinvested in a building, a ship or an airplane, in which case the reinvestment period is 5 years. If all conditions are fulfilled, the capital gains tax will become due in accordance with the tax depreciations on the qualifying reinvestments.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No, the rate imposed for capital gains is the same as that imposed for business profits.

5.3 Is there a participation exemption?

As far as capital gains exemption in respect of share investments is concerned, please refer to question 5.1. Moreover, Belgian resident companies are entitled, under certain conditions, to deduct 95% of the gross amount of dividends received from their corporate income tax base. The remaining 5% is subject to tax, but ordinary expenses, losses or interest payments can be deducted from this taxable margin, even if such expenses, losses or interest payments directly relate to the share investment from which the dividend income has arisen. As a consequence, tax-efficient leveraged acquisitions through a Belgian company are possible. So-called "excess" dividend received deduction, i.e. the amount of the deduction that cannot be effectively used to offset taxable income (e.g. because of an operating loss), could not, before 2010, be carried forward to the following taxable periods, by virtue of

Belgian domestic tax law. However, the ECJ has decided that this legal restriction violated the EU Parent-Subsidiary Directive, so that the excess dividend received deduction relating to dividend income from EU subsidiaries can effectively be carried forward (*Cobelfret v. Belgium,* C-138/07, d.d. 12 February 2009).

Following this decision, with effect as of 1 January 2010 the Belgian Income Tax Code expressly stipulates that the excess dividend received deduction, relating to dividend income from EU subsidiaries, can be carried forward.

The question remains whether this jurisprudence also applies to dividend income from non-EU subsidiaries based on the freedom of capital movements, which, subject to certain restrictions, also applies in relation to non-EU states. The ECJ refrained from taking a clear decision on this issue in the *KBC Bank NV v. Belgium* case (C-439/07), and also the Belgian legislator did not provide for a clear answer. The Belgian tax administration issued a circular containing a number of guidelines to be taken into account to determine whether an excess dividend received deduction relating to dividend income from a non-EU subsidiary can be carried forward.

Certain participation requirements must be respected by the Belgian company in order to benefit from this dividend received deduction. Its investment should: (i) at least correspond to a 10% share in the capital of the dividend generating company, or have an acquisition value of at least €2.5 million; and (ii) be held in full ownership for at least 1 year, which must not necessarily have been completed at the time of dividend distribution.

In addition, the dividends received must meet detailed "subject to tax" requirements, which ensure that subsidiaries (with no tier limitation) are subject to a normal corporate tax regime.

Both the dividend-received deduction and capital gains exemption on share investments (see *supra*), together with the extension of the dividend withholding tax exemption to all foreign parent companies that are residents of a treaty state, result in a very attractive regime for holding companies established in Belgium, which could serve as an important incentive to structure investments through Belgium.

5.4 Is there any special relief for reinvestment?

There is no specific relief for reinvestment, apart from the reinvestment relief with respect to capital gains on certain intangible and tangible fixed assets, as mentioned in question 5.1 above.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Generally, no taxes are imposed upon the formation of a subsidiary (apart from a fixed registration duty of €25 and limited stamp duties).

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no other such significant taxes or fees.

6.3 How would the taxable profits of a local branch be determined?

The profits of a Belgian branch, provided that the branch can be considered as a "permanent establishment", as defined in the relevant bilateral tax treaty, are determined by treating it as a separate enterprise for tax purposes. Most times, separate accounting records and separate financial statements are drawn up in respect of the Belgian branch, although this is not always obligatory. In absence of separate accounting records and separate financial statements, taxable income is generally fixed on a lump sum basis (e.g. €22,000 per employee in the chemical industry), with a floor of €19,000. Income realised through transactions with third parties is attributed to the Belgian branch, provided that it has intervened in realising such income. Accordingly, expenses are deemed to be borne by the branch, provided that they have been made for the benefit of the branch's business operations. The same goes for income or expenses derived from assets or liabilities that are allocated to these operations. However, this fiction of "independence" of the branch for tax purposes is mitigated in respect of transactions between the branch and the non-resident company to which it relates. More specifically, interest, royalty or rental payments by the branch to the non-resident parent company are not accepted as deductible expenses by the Belgian tax authorities, unless (for interest payments) it is a branch of a non-resident bank. For the rest, the Belgian branch's taxable base is determined following the same corporate income tax principles, being entitled to the same tax deductions (including the notional interest deduction on the "equity" of the branch) and exemptions as apply to resident Belgian companies.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no "branch profits tax" or other form of withholding tax in Belgium on the branch profits that are repatriated to the non-resident company. The non-resident company doing business in Belgium through a branch will be subject to non-resident income tax, which implies in practice that it will end up paying Belgian corporate income tax on the income realised through such branch.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Generally, only resident companies can invoke the provisions of a bilateral tax treaty to which Belgium is a party. The foreign company which has a branch in Belgium can also invoke the treaty that its country of residence has concluded with Belgium in order to protect the branch from discriminatory tax measures. In a decision d.d. 26 November 2006, the Brussels Court of First Instance granted the benefit of a tax-sparing credit, provided for in the bilateral tax treaty between Belgium and India, to a Belgian branch of an Indian company with respect to its Indian source interest income, on the basis of the PE non-discrimination provision in that treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Repatriation of profits is not a dividend, and therefore is not subject to Belgian dividend withholding tax, nor any other tax in Belgium.

7 Overseas Profits

7.1 Does Belgium tax profits earned in overseas branches?

In principle, Belgian tax resident companies are subject to tax on their worldwide income. However, bilateral tax treaties concluded by Belgium usually provide that the profits earned by a branch situated in the other contracting state are only taxable in that state.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

No withholding tax is due in Belgium upon receipt by a Belgian tax resident company of dividends paid by a foreign tax resident company.

The dividends will be subject to Belgian corporate income tax in the hands of the Belgian tax resident company at a rate of 33.99%. Those dividends may however benefit from the dividend received deduction (see question 5.3 in this respect), in which case only 5% of the received dividend will be subject to corporate tax in Belgium.

7.3 Does Belgium have "controlled foreign company" rules and if so when do these apply?

No, it does not.

8 Anti-avoidance

8.1 Does Belgium have a general anti-avoidance rule?

With respect to income tax and registration tax, the Belgian legislator introduced in 1993 a general anti-abuse provision, which allows the tax authorities to recharacterise a series of legal actions into another (single) legal action, if the taxpayer has set up such series in order to avoid tax. The taxpayer may rebut this recharacterisation by demonstrating the legitimate economic or financial needs for the chosen legal characterisation of the transaction. The Belgian Supreme Court has however mitigated its effectiveness by requiring that the new characterisation by the tax authorities covers all (relevant) legal consequences arising from the transaction.

For VAT purposes, a general anti-abuse provision has entered into effect in August 2006 and is based on recent case law of the ECJ in this respect. Abuse is defined as a series of transactions which aim at and give rise to a tax advantage which is contrary to the objectives of the VAT system. It is penalised by a rejection of input VAT deduction.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no legal obligation to disclose anti-avoidance schemes in advance of the company's tax return being submitted, but companies can still choose to do so in order to obtain an advance ruling from the Belgian Ruling Committee.

Note

The present contribution is an update of the contribution written by Mr Philippe Hinnekens for the International Comparative Legal Guide to: Corporate Tax 2011.

Thierry Blockerye

Clifford Chance LLP
Avenue Louise 65 box 2
1050 Brussels
Belgium

Tel: *+32 2 533 5061*
Fax: *+32 2 533 5959*
Email: *thierry.blockerye@cliffordchance.com*
URL: *www.cliffordchance.com*

Partner with Clifford Chance since 2001. Former tax partner at PricewaterhouseCoopers since 1996, Thierry Blockerye specialises in tax law, with a strong focus on real estate and taxation issues of mergers and acquisitions. He teaches the course "Mergers & Acquisitions" at the "Ecole Supérieure des Sciences Fiscales". He is also speaker at various seminars and conferences dealing with tax optimisation of M&A transactions. Highly recommended Belgian tax lawyer in the latest editions of Chambers Europe, Legal 500, PLC Which Lawyer?, International Tax Review, Tax Directors Handbook and European Legal Experts. He is also a recommended real estate lawyer by PLC Which Lawyer?. Co-author of the book "*Sicafs immobilières, Dix ans d'application de l'A.R. du 10 avril 1995*", published by Larcier in 2005; also co-author of the book "*Plus-values et moins-values*", published by Larcier in 2009.

Pierre-Olivier van Caubergh

Clifford Chance LLP
Avenue Louise 65 box 2
1050 Brussels
Belgium

Tel: *+32 2 533 5910*
Fax: *+32 2 533 5959*
Email: *pierre-olivier.vancaubergh@cliffordchance.com*
URL: *www.cliffordchance.com*

Pierre-Olivier van Caubergh is an associate in the tax group of Clifford Chance Brussels since October 2005. He graduated in law from the University of Louvain and obtained a special degree in tax law from the University of Leuven as well as an LL.M. from University College London.

CLIFFORD
CHANCE

International law firm Clifford Chance combines the highest global standards with local expertise. Leading lawyers from different backgrounds and nationalities come together as one firm, offering unrivalled depth of legal resources across the key markets of Europe, Asia, the Americas and the Middle East. The firm focuses on the core areas of commercial activity: capital markets; corporate and M&A; banking and finance; litigation and dispute resolution; real estate, and tax, pensions and employment.

Clients include top local organisations - private or governmental - as well as international companies. Through working regularly with the clients we serve across different regions and legal areas, we share our sector knowledge and insights, helping them to respond quickly to changes in the legal and regulatory environment, to manage risk and to achieve business success. We also invest heavily in talent, technology and know-how, leveraging resources globally in fielding some of the world's market leading legal teams.

Our Belgian tax team was appointed "Tax Law Firm of the Year" in 2009 and 2010 by the Belgian Legal Awards.

Bulgaria

Georgiev, Todorov & Co.

Georgi Kostolov

1 General: Treaties

1.1 How many income tax treaties are currently in force in Bulgaria?

The Republic of Bulgaria has entered into 68 income tax treaties.

1.2 Do they generally follow the OECD or another model?

They all follow the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

No, they do not.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

No, they do not.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

No. According to the Bulgarian Constitution, any international instruments which have been ratified by the constitutionally established procedure, promulgated and entered into force with respect to the Republic of Bulgaria, shall be considered part of the domestic legislation of the country. They shall have priority over any domestic legislation stipulating otherwise.

2 Transaction Taxes

2.1 Are there any documentary taxes in Bulgaria?

No, there are not.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes, transactions are subject to the following VAT:

- 20% regular tax rate;
- 9% reduced rate for hotel accommodation; and
- 0% for exports and certain other exempt activities.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The Bulgarian VAT legislation is based on the EU VAT rules and Directive 2006/112/EC.

VAT rates:

- 20% for domestic supplies, intra-community acquisitions and importation from non-EU countries; and
- 9% for hotel accommodation services.

Exemptions:

- With the right to deduct input VAT - intra-community supplies, exportation to non-EU countries, international transport of goods and passengers, certain supplies related to international transport, sale of duty free goods under certain conditions, certain transactions related to international trade, specific supplies under international treaties, etc.
- No right to deduct input VAT - transfer or rental of land or rights *in rem* over land (except for building land and land adjacent to new buildings), the transfer of old buildings or parts thereof, rental for residential purposes to individuals (an option to tax these transactions is available); financial and insurance services; gambling; certain services related to health, education, religion, culture, etc.; and other specific supplies (e.g. importation of certain goods and up to a limit, etc.).

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

No. The VAT should be paid with respect to subsequent VAT taxable supplies.

2.5 Are there any other transaction taxes?

Yes, transfer tax upon sale of real estates and vehicles.

Between 0.1% - 3% on the higher of the sales price or the tax value of the transferred real estate / on the insurance value of cars. The exact rate is determined by each municipality.

2.6 Are there any other indirect taxes of which we should be aware?

Yes, excise duties. The Bulgarian excise duties legislation is based on the EU rules.

Excise duties are applicable for certain products including:

- Electricity and energy products (motor fuels, coal, etc.).
- Alcohol.
- Tobacco products.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends are subject to 5% withholding tax when distributed to non-residents (except for EU / EEA entities).

The withholding tax rates may be reduced under an applicable tax treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties are subject to 10% withholding tax when distributed to non-residents:

- 5% on royalties accrued to related party legal entities resident in the EU (under certain conditions); and
- 10% on the gross amount for all other recipients.

The withholding tax rates may be reduced under an applicable tax treaty.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest is subject to 10% withholding tax when distributed to non-residents:

- 5% on interest accrued to related party legal entities resident in the EU (under certain conditions); and
- 10% on the gross amount for all other recipients.

The withholding tax rates may be reduced under an applicable tax treaty.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

If the debt to equity ratio of the company exceeds 3:1, (some of) the interest expenses may not be tax deductible in the current year.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

Further to the answer to question 3.4, interest expenses may become tax deductible in the following five consecutive years under certain conditions.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, there is no such exception.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

The interest should be accrued at arm's length prices.

4.5 Does Bulgaria have transfer pricing rules?

The Bulgarian transfer pricing rules require that taxpayers apply arm's length prices in their related party transactions. Arm's length prices are those which unrelated parties would have agreed in similar circumstances. This requirement is imposed both to cross-border and domestic transactions.

Largely based on the 1995 OECD Guidelines, the Bulgarian transfer pricing rules envisage 5 methods for determining arm's length prices:

- The Comparable Uncontrolled Price Method.
- The Resale Minus Method.
- The Cost Plus Method.
- The Transactional Net Margin Method.
- The Profit Split Method.

A taxpayer is obliged to prove the arm's length character of their related party transactions during a tax audit by applying one of the above methods.

The legislation does not include specific requirements as to the format and contents of transfer pricing documentation which taxpayers can produce as evidence for arm's length pricing. All kind of evidences are admissible.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate is a flat rate of 10%.

4.2 When is that tax generally payable?

Corporate tax is payable on annual basis. Annual corporate tax return has to be submitted by 31 March of the following year. The tax year is the calendar year.

The corporate tax also has to be paid by 31 March. Quarterly or monthly advance instalments are due during the year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base is taxable profit pursuant to commercial accounts and subject to adjustments.

4.5 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The taxable profit is the financial result adjusted for tax purposes.

Tax adjustments: E.g., non-business related or not duly documented expenses; interest restricted under the thin capitalisation rules; expenses for impairment of assets; and dividends received from local or EU-based companies.

Tax depreciation rules: Maximum annual tax depreciation rates between 4% and 50%, depending on the type of asset.

4.5 Are there any tax grouping rules? Do these allow for relief in Bulgaria for losses of overseas subsidiaries?

This is not applicable in Bulgaria.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, but there is an additional withholding tax at the rate of 5% if dividends are distributed to individuals and non-EU / EEA entities.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Yes, they are.

One-off tax on certain expenses

Expenses subject to one-off tax:

- "Representative" expenses.
- "Social" expenses provided in-kind to the employees (e.g. fringe benefits), except for food vouchers and voluntary insurance contributions (social, health and life insurance) up to BGN 60 each per employee per month.
- Expenses related to the use of vehicles for management purposes.

The tax rate is 10% on the accrued expenses. Both the respective expense and the one-off tax applicable to it are deductible for corporate income tax purposes.

Special corporate tax regimes

Applicable to:

- Commercial maritime shipping companies.
- Gambling businesses.
- Some other (e.g., state organs, etc.).

Social security and health insurance

These require mandatory insurance contributions of between 30.7% - 31.4%, paid by both the employer and the employee in a certain ratio. These include:

- 12.8% - pensions fund;
- 5% - universal pensions fund;
- 0.4% - 1.1% - occupational accident and professional disease fund (rate depending on the field of activity);
- 3.5% - general illness and maternity fund;
- 1% - unemployment fund; and
- 8% - health insurance fund.

Insurance base. Gross remuneration less statutory deductions in some cases. The insurance base is capped at BGN 2000 (approximately EUR 1000) monthly.

Social security treaties. Foreigners may be exempt from social security contributions in Bulgaria or the contributions they make may be recognised in their home country under an applicable bilateral or multilateral social security agreement.

Environmental fees

The producers or importers (or the entity performing an intra-community acquisition) of products, the use of which leaves large amounts of waste, have to pay a product fee based on the type of waste.

The entities can avoid paying the product fee if they collect or recycle certain amount of the waste produced by their products either on their own or through a licensed collective waste management organisation.

Scope

The products which are subject to the product fee include:

- Certain motor vehicles and tyres.
- Goods with plastic, paper, metal, glass, wooden, textile, etc. packaging.
- Batteries.
- Motor oil.
- Electric or electronic apparatus and appliances.

4.8 Are there any local taxes not dealt with in answers to other questions?

Real estate tax

Between 0.01% - 0.45% annually on the higher between the gross book value and the tax value of the immovable property. The exact rate is determined by the municipality in which the real estate is situated.

Garbage collection fee

Determined by each municipality. Generally levied on the gross book value of the real estate. Alternatively, it may be determined on the basis of the number and volume of waste containers used.

Vehicle tax

Depending on the type and characteristics of the vehicle. Applies to cars, ships and airplanes. The tax rate is determined by each municipality within ranges stipulated in the law.

Donation tax

Between 3.3% - 6.6% on the value of the donation. The exact rate is determined by each municipality. Lower rates and exemptions apply to donations between relatives.

Inheritance tax

Inheritance by a spouse, children and their descendants are exempt.

The tax is between 0.4% - 0.8% on inheritance exceeding BGN 250 thousand (approximately EUR 128 thousand) in favour of brothers, sisters and their descendants (between 3.3% - 6.6% for other heirs).

The exact rate is determined by each municipality.

Tourist tax

Between BGN 0.2 - 3 (approximately EUR 0.1 - 1.5) per night. The exact rate is determined by the municipality in which the accommodation facilities are located.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

No. Capital gains and losses are included in the taxable profit of the company, in accordance with the applicable fiscal and accounting rules.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

This is not applicable in Bulgaria.

5.3 Is there a participation exemption?

This is not applicable in Bulgaria.

5.4 Is there any special relief for reinvestment?

The law provides a form of state aid. The corporate tax can be remised by the state and used for reinvestments in assets under certain conditions.

There is no relief directly connected to reinvestments but there are certain other tax relieves.

50% of the corporate tax due shall be assigned to the social and health insurance funds, created by virtue of law, for activity that is either directly connected with or helpful to the performance of their basic activity.

The corporate tax on tax profit shall be assigned in amount of up to 100% in cases where the taxable person carries out production activities only in municipalities in which during the year preceding the current year the unemployment rate was at least 35% higher than the country's average unemployment rate for the said period and if some other conditions are met.

There is a relief for companies which hire disabled people under certain conditions.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Subsidiaries are subject to the same tax treatment as the local companies.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, branches are subject to the same tax treatment as the local companies.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch shall be determined as the taxable profits of a local company.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

No, it would not.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Yes, a branch is deemed to be a permanent establishment and shall benefit from the provisions of tax treaties.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Yes, the branch is treated as a local company and upon distribution of dividends the rules regarding distribution of dividends shall be applied.

7 Overseas Profits

7.1 Does Bulgaria tax profits earned in overseas branches?

Yes. Local legal entities shall be taxed with taxes under the domestic law on their profit and income from all sources within the Republic of Bulgaria and abroad.

In cases where the provisions of an international treaty do not apply, the taxable persons shall be entitled to recognition of tax input in accordance with certain conditions. When determining the local corporate tax or the alternative taxes, the taxable persons shall be entitled to the recognition of tax input regarding any tax which is similar to the corporate one or has been levied instead of it and has been paid abroad.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Only if dividends are distributed by non-EU / EEA companies. The taxable persons shall be entitled to the recognition of tax input for the tax levied abroad on the gross amount of dividends.

7.3 Does Bulgaria have "controlled foreign company" rules and if so when do these apply?

This is not applicable in Bulgaria.

8 Anti-avoidance

8.1 Does Bulgaria have a general anti-avoidance rule?

Yes, where one or more transactions, including those between unrelated persons, have been effected under conditions which lead to tax evasion, the taxable basis shall be determined without taking into consideration the said transactions, or certain conditions thereof, or the legal form thereof, and what is taken into consideration shall be the taxable basis that would have been achieved if a customary transaction of the respective type has taken place at arm's length prices and being aimed at achieving the same economic result, without leading to tax evasion.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Yes, the companies are obliged to increase their financial result for tax purposes and report the adjustment in their annual tax return.

Georgi Kostolov

Georgiev, Todorov & Co.
27 Parchevich Str.
Sofia 1000
Bulgaria

Tel: *+359 2 937 6541*
Fax: *+359 2 937 6526*
Email: *kostolov@georg-tod.com*
URL: *www.georg-tod.com*

Georgi Kostolov graduated from Sofia University, in the faculty of Law. He joined the team of Georgiev, Todorov & Co. in 2007. He specialises in the area of tax law. His recent experience includes tax consultancy and litigation on tax cases for some of the largest Bulgarian companies, structuring the sale of shares of CSKA (the biggest Bulgarian football club) etc. He has also done analysis of the tax consequences in case of transfer of shares and assets and acquisition of land plots by foreign investors, distribution of dividends, etc. Before joining the team he was consultant in the Tax and Legal Department of Deloitte Bulgaria where he has prepared legal advices, tax structuring and tax due diligence for major international clients on VAT and direct tax issues. His experience also also participation in EU Accession Project for Kremikovtzi AD (the biggest Bulgarian metal factory) - providing tax analysis of the company's activities, structuring of HP's Bulgarian Call Centre - new unit for help-desk services, determining the proper tax treatment of IBM warranty services and repairing and maintenance supplies, VAT registration of foreign entities.

GEORGIEV, TODOROV & CO.
LAW OFFICES

Established in 1991 Georgiev, Todorov & Co. is a leading Bulgarian law firm providing legal services in corporate and commercial law, with a particular focus on the financial sector, foreign investments and privatisation. With 7 partners and 52 lawyers Georgiev, Todorov & Co. is amongst the largest practices in the country, with a proud culture of service excellence. The firm is a member of Lawyers Associated Worldwide, an organisation with members located in 44 states, which gives the firm access to a powerful information network.

Georgiev, Todorov & Co. has worked on the major privatisation deals in Bulgaria, including the privatisation of the Bulgarian Telecommunication Company, Boyana Film, DSK Bank, Bulgarian Maritime Fleet, Bulgaria Air - the National Air Carrier, Burgartabac Holding etc. The firm worked also on the European Bank for Reconstruction and Development's very first investments in Bulgaria. Georgiev, Todorov & Co. has also provided consultancy to Fraport AG, the owner and operator of Frankfurt Airport . The firm is a preferred choice by Microsoft.

The firm has worked for about 10 years on complex international projects and, as a result, has developed considerable expertise. Lawyers of Georgiev, Todorov & Co. have been involved in various assignments in the filed of energy, telecoms, M&A and banking acting for clients such as: the consortium of Mitsui & Co. Ltd., Toshiba Corp. and the Japanese Bank of International Cooperation with respect to the rehabilitation of six units of Maritza Iztok 2 thermal power plant, Bulgarian Telecommunication Company, Raiffeisen Zentralbank Osterreich AG and Alpha Airport Services, among others.

Chapter 10

Canada

Michael Colborne

Thorsteinssons LLP

Michael McLaren

1 General: Treaties

1.1 How many income tax treaties are currently in force in Canada?

Canada currently has 89 treaties that are in force, 6 treaties are signed but not yet in force and 16 treaties that are either under negotiation or re-negotiation. In addition, Canada currently has 3 tax information exchange agreements that are in force; 12 that are signed but not yet in force and 14 under negotiation.

1.2 Do they generally follow the OECD or another model?

Canada's tax treaties generally follow the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

In order to come-into-force, a treaty must be incorporated into domestic law by way of a bill passed in Parliament.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Canada's tax treaty with the U.S. has a specific limitation of benefits rule that is derived from the limitation of benefits rule in the U.S. model treaty. Additionally, some of Canada's treaties have narrow limitation of benefits provisions, e.g., benefits are not available to certain types of entities.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

While treaties cannot be overridden by domestic legislation, the general anti-avoidance rule in the Income Tax Act can be applied to eliminate treaty benefits if a court concludes that a tax treaty has been abused.

2 Transaction Taxes

2.1 Are there any documentary taxes in Canada?

There are no documentary stamp taxes in Canada.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Canada has a 5% federal VAT, called the goods and services tax (GST). Many provinces have harmonised their commodity tax regime with the GST. In the "harmonised" provinces, an additional provincial tax is collected alongside the GST at rates, ranging between 7% and 10%. The combined tax is referred to as the "Harmonised Sales Tax". However, some provinces retain a transactional sales tax at between 5% and 10%. Quebec's sales tax mirrors the federal GST, but is imposed by separate provincial statute. The province of Alberta does not levy any type of VAT or sales tax.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

While the GST is a comprehensive tax on goods and services, like many countries it does not apply to all transactions. The legislation lists a variety of sectors where, for policy reasons, no tax is charged. For example, the transfer of shares or debt and the provision of many types of financial services are not subject to GST.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The GST is generally recoverable by all businesses. There are exceptional cases, however, particularly among the sectors where tax is not charged. For example, businesses engaged in the provision of financial services have limited recovery of the GST.

2.5 Are there any other transaction taxes?

Each province levies a variety of transaction taxes, the principal ones being imposed on alcohol, tobacco, and land transfers. In addition, some municipalities and cities levy a land transfer tax.

2.6 Are there any other indirect taxes of which we should be aware?

There are a number of other indirect taxes that are noteworthy. At the federal level, payroll taxes in the form of employment insurance premiums and pension plan contributions are paid by employers and employees. In addition, some provinces have additional payroll taxes (e.g., the Employer Health Tax in Ontario). The federal government also imposes indirect taxes on commodities such as fuel, alcohol and tobacco and certain forms of insurance.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Canada levies a 25% withholding tax on the gross amount of dividends paid by a Canadian-resident corporation to a non-resident shareholder. The 25% withholding tax may be reduced by treaty. Canada's treaties typically reduce the withholding tax rate on dividends to 15% where such dividends are paid to beneficial owners who are entitled to benefits under the relevant treaty and to 5% in the case of corporate shareholders that own more than 10% of the voting shares of the Canadian-resident corporation where such shareholder is the beneficial owner and is entitled to benefits under the relevant treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Canada levies at 25% withholding tax on royalties paid by Canadian residents to non-residents. There are a number of domestic exemptions, the most significant of which is for royalties or similar payments in respect to copyright or for the production and reproduction of dramatic, musical and artistic works. Additionally, Canada's treaties generally reduce the withholding tax on royalties to 10% where such royalties are paid to beneficial owners who are entitled to benefits under the relevant treaty, and in some cases eliminate withholding tax entirely for royalties paid for the use of computer software.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Canada levies a 25% withholding tax on interest paid or credited to a non-resident. However, interest payments made to by a Canadian resident to an arm's length non-resident are exempt from withholding tax unless the interest is computed by reference to commodity price, cash flow, etc. (i.e., the interest is "participating interest"). In addition, non-arm length interest payments (that are not participating interest) are exempt from withholding tax under the Canada-U.S. tax treaty.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Canada permits the deduction of interest if the amount borrowed is used for the purpose of producing income or constitutes the unpaid purchase price of property used for the purpose of producing income. There are a number of limitations on interest deductibility, including thin-capitalisation rules which may limit the deduction of interest paid to specified non-residents (in broad terms, non-residents that hold 25% or more of the voting stock, or 25% or more of the fair market value of all of the issued and outstanding stock, of the Canadian-resident corporate borrower).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The thin capitalisation rules limit interest deductibility on interest payments made to specified non-residents if the debt-to-equity ratio exceeds two to one. Any interest denied by the rule cannot be carried forward or otherwise applied.

The equity-side of the debt-equity formula is comprised of: (a) the company's retained earnings at the beginning of the year, determined on an unconsolidated basis; (b) the average of all amounts each of which is the company's contributed surplus in the beginning of a calendar month that ends in the year, counting only amounts that were contributed by specified non-residents; and (c) the average of the company's paid-up capital at the beginning of a calendar month that ends in the year, excluding the paid-up capital of shares that are not owned by specified non-resident shareholders.

The debt side of the formula is the average of all amounts, each of which is, in respect of a calendar month at that end of that year, the greatest total amount at any time in the month of the company's outstanding debts to specified non-residents.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The thin capitalisation rules do not apply to debt advanced by a third party that is guaranteed by a parent company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no additional rules that specifically apply to the deduction of interest payable by a Canadian-resident company to a non-resident. However, there are a number of other rules that are applicable to certain taxpayers that may apply to limit interest deductions. For example, interest expense relating to the construction of a building is not deductible and instead is required to be capitalised as part of the cost of the building.

3.8 Does Canada have transfer pricing rules?

Canada has transfer pricing rules which include documentation rules and penalties that apply if an adjustment exceeds a *de minimis* threshold. The transfer pricing rules adopt the arm's length standard, and the OECD transfer pricing guidelines are considered relevant in assessing arm's length price, terms and conditions.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The federal corporate tax rate for 2011 is 16.5%, which will be reduced to 15% on January 1, 2012. In addition to the federal corporate tax rate, each province levies a corporate tax at rates that range from 10% to 16%.

4.2 When is that tax generally payable?

A corporation's federal tax liability must be paid within two months (and in limited circumstances three months), following the end of the corporation's taxation year. In addition, corporations are subject to instalment rules that, if not complied with, result in penalties.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base upon which the corporate tax is levied is determined in accordance with specific statutory rules. The starting point for the calculation is the company's profit, as determined under general commercial principals. After profit is determined, specific adjustment rules in the *Income Tax Act* for both income inclusion and expense deduction apply to determine income.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

A corporation's tax profit will often differ significantly from its financial statement income. For example, no "reserve" amounts are permitted unless specifically authorised in the *Income Tax Act*, and there are very few reserves so provided. Additionally, depreciation and depletion rates for assets and mineral, timber and oil and gas properties differ significantly from financial statement income. These are but a few of the examples of the differences between commercial accounts and tax accounts.

4.5 Are there any tax grouping rules? Do these allow for relief in Canada for losses of overseas subsidiaries?

Under current law there is no consolidation or tax grouping regime. Instead, in-group tax relief is effected by way of "loss consolidation" transactions, using interest expense or undeducted depreciation expenses. These transactions are well understood and are not considered abusive by the tax authorities. Canada is actively considering introducing a loss transfer regime so that taxpayers do not have to rely on the *ad hoc* system currently in place.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

A corporation's tax rate is the same regardless of whether profits are distributed or retained. Note that certain corporations pay an additional tax on portfolio and investment income, which is refundable when dividends are paid. These rules are not relevant to most non-resident investors.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Some provinces have a capital tax, which is a tax on the net "wealth" of a corporation determined on a balance sheet basis. The federal capital tax has been repealed.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are many local business taxes and miscellaneous taxes (e.g., oil and gas royalties and mining taxes). Each province must be examined on a case-by-case basis to determine if the activities would attract the tax.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Canada provides a base preference for capital gains. That is, one-half of a capital gain is included in income and is taxed at ordinary rates. Capital losses may only be used to offset capital gains, and may be carried back three years and forward indefinitely.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

As noted above, Canada provides a base, not a rate, preference for capital gains. Therefore, one-half of realised capital gains are included in income and taxed ordinary rates.

5.3 Is there a participation exemption?

Canada does not have a participation exemption for capital gains.

5.4 Is there any special relief for reinvestment?

There is no special relief for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No stamp, capital or wealth duties are imposed on the formation of a subsidiary. As noted above, some provinces have retained a capital tax.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no such significant taxes.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch of a foreign company are determined in the same manner as a Canadian-resident company.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Canada levies a branch profit tax of 25% on branch profits that are considered withdrawn from Canada under a statutory formula. In this connection, amounts reinvested in Canada as determined by detailed statutory and regulatory rules may reduce the amount of branch profits that are considered withdrawn from Canada.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Under the Income Tax Act, the branch tax rate is generally reduced where the corporation is a resident of a country that has a tax treaty with Canada, which reduces withholding tax rates on dividends. The applicable rate is that which applies where a non-resident corporation owns all of the shares of a Canadian-resident company (this will often be 5%). In addition, some of Canada's tax treaties exempt the first $500,000 of a non-resident corporation's Canadian-source income from the branch tax base where such corporation qualifies for benefits under the relevant treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There is no other tax that would be imposed a consequence of remitting profits by the branch of the head office.

7 Overseas Profits

7.1 Does Canada tax profits earned in overseas branches?

Canadian residents are liable to Canadian tax on their worldwide income. Consequently, a Canadian-resident company will be subject to Canadian tax on profits earned from overseas branches. The *Income Tax Act* allows a foreign tax credit for foreign taxes paid. In computing the credit there are two income "baskets"; business income and non-business income. In addition, the credit is computed on a country-by-country basis, so that credits for foreign tax paid to one country cannot be used to reduce Canadian tax on foreign-source income from another country.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

In effect, the *Income Tax Act* exempts dividends received by a Canadian resident from "foreign affiliates" if the dividends are derived from active business profits earned by a foreign affiliate that is resident in a country with which Canada has a tax treaty or tax information and exchange agreement and the profits are earned by the affiliate through a permanent establishment in such a country. The foreign affiliate rules are complex, and are linked with Canada's controlled foreign corporation rules (discussed below).

7.3 Does Canada have "controlled foreign company" rules and if so when do these apply?

Canadian resident taxpayers that own shares of a "controlled foreign affiliate" at the end of a taxation year of the affiliate ending in a taxation year of the taxpayer are required to include certain types passive income and capital gains ("foreign accrual property income") in computing the taxpayer's income for the year. Where the taxpayer is a Canadian-resident taxpayer, the foreign accrual property income rules work in concert with the foreign affiliate rules mentioned above.

8 Anti-avoidance

8.1 Does Canada have a general anti-avoidance rule?

Canada has had a statutory general anti-avoidance rule since 1988. There is now a substantial amount of jurisprudence considering the application of the rule.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

The province of Quebec requires reporting of certain types of tax avoidance transactions if certain conditions are met. In addition, the federal government in its March 4, 2010 Federal Budget released draft proposals to require the reporting of certain tax avoidance transactions. Although draft legislation to implement the draft proposals has been released, it is our understanding that the consultation process is not complete.

Michael Colborne

Thorsteinssons LLP
33rd Floor, 181 Bay Street
Toronto, Ontario, M5J 2T3
Canada

Tel: +1 416 864 9783
Fax: +1 416 864 1106
Email: mwcolborne@thor.ca
URL: www.thor.ca

Michael's practice focuses on corporate and international tax planning, regularly advising Canadian and foreign-based multi-national groups on a variety of matters, including inbound and outbound investment and financing, mergers and acquisitions, divestitures, and natural resource taxation.

Michael also has considerable experience in handling tax controversy issues faced by multi-national groups in Canada and a number of other countries. Michael has appeared in the superior courts of British Columbia and Ontario, the Tax Court of Canada, the Federal Court of Appeal, the Supreme Court of Canada and before the Revenue Tribunal of the United Republic of Tanzania.

Michael has a particular expertise in the taxation issues faced by mining companies, and regularly advises a number of Canadian and foreign-based multinational mining companies. Michael has experience structuring mining investment in Canada (including oil sands), the United States, Australia, Mexico, Scandinavia, and numerous countries in South and Central America, Africa and Central Asia.

Michael McLaren

Thorsteinssons LLP
2700-595 Burrard Street
Vancouver, British Columbia
Canada

Tel: +1 604 689 1261
Fax: +1 604 688 4711
Email: mhm@thor.ca
URL: www.thor.ca

Michael's practice focuses on corporate and international tax planning, regularly advising Canadian and foreign-based multi-national groups on a variety of matters, including: inbound and outbound investment and financing; mergers and acquisitions; divestitures; restructurings; and natural resource taxation. Michael acts for a number of Canadian and foreign-based multi-national companies that operate in the following industries: natural resources; real estate; aerospace and defence; paper and household products; pharmaceuticals; financial services; and industrial engineering.

Michael speaks and writes frequently on international and mining tax matters. In addition, Michael is on the editorial board of the CCH *Income Tax Act* and is a member of the Canadian Tax Foundation, the International Fiscal Association, the International Bar Association and the CBA Tax Subsection.

Michael is listed in Law Business Research's International *Who's Who of Corporate Tax Lawyers 2010*, International *Who's Who of Business Lawyers 2011* and its Canada Special Report *Who's Who Legal: Canada 2010*.

THORSTEINSSONS LLP TAX LAWYERS

Thorsteinssons is Canada's largest law firm practicing exclusively in tax. Our lawyers are consistently recognized among Canada's leading tax practitioners.

Tax is an area of great complexity. By restricting our practice to tax we are better able to deliver the level of skill and attention demanded by our clients. Our practice encompasses all aspects of taxation including tax planning, compliance and representation at all levels.

We provide tax advice of the highest quality to clients around the world and are known for our skillful work in highly complex matters. Our close client relationships afford us the in-depth understanding of our clients' businesses that is necessary to deliver the quality of service and advice they demand. Our goal throughout is to provide our clients with valuable solutions in a timely and efficient manner.

Working together, we share an uncompromising commitment to excellence in everything we do.

Chapter 11

China

Dennis Xu

Eddie Wang

Hendersen Taxand

1 General: Treaties

1.1 How many income tax treaties are currently in force in China?

As of September 30, 2011, P.R. China has signed 96 tax treaties with 96 countries and 2 arrangements with 2 Special Administrative Regions.

1.2 Do they generally follow the OECD or another model?

They generally follow the UN model and OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

No, treaties do not have to be incorporated into domestic law before they take effect.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

No, they do not generally incorporate anti-treaty shopping rules.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

No, the treaties are not overridden by any rules of domestic law.

2 Transaction Taxes

2.1 Are there any documentary taxes in China?

Stamp Duty ("SD") is a documentary tax levied on specific categories of documents executed in China at different rates. SD is payable by all the contracting parties based on the contract value.

The categories of dutiable documents are outlined as below:

1) contracts or documents in the nature of a contract with regard to: purchases and sales (SD rate is 0.03%); the undertaking of processing (0.05%); engineering project reconnaissance and designing (0.05%); contracting for construction and instalation projects (0.03%); property leasing (0.1%); commodity transport (0.05%); warehousing or custody (0.1%); loans (0.005%); property insurance (0.1%); and technology contracts (0.03%);
2) documents of transferring the title of property (0.05%);
3) accounting books (0.05% for capital book and RMB5 per book for others);
4) certificates or licences (RMB5 per certificate/licence); and
5) other documents which the Ministry of Finance determines to be dutiable.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

China has enacted Value Added Tax ("VAT") rules since the early 1980s and in 2008 China revised the VAT rule. The new VAT rule has been effective since January 1, 2009. In China, VAT is a turnover tax levied on all businesses engaged in the sale of goods, provision of processing, repair or replacement services within China, or importation of goods.

The applicable VAT rate varies according to different type of taxpayers and different goods.

- The basic VAT rate is 17%.
- A reduced VAT rate of 13% is applicable for the sales and importation of some specific goods (e.g. crops, water, gas, books, newspapers, magazines, etc.).
- The 3% collection rates are applicable for all goods sold by small scale VAT taxpayers engaged in manufacturing and trading. The 6%, 4% or 3% rate are applicable to some specific goods sold by general VAT taxpayers. Under such mechanism, VAT is calculated on sales income while no input credit is available.
- Export is generally zero-rated, but there is not a full zero-rated system. China adopts different VAT refund rates for different types of products.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In China, Business Tax ("BT") is another type of turnover tax. BT and VAT are mutually exclusive. BT applies to the provision of services (excluding the VATable services, i.e. processing services, repair and maintenance services), the transfer of intangible assets and the sale of real estate properties in China.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input VAT is only recoverable by a general VAT taxpayer.

Furthermore, under the following circumstances, input VAT is not recoverable even for general VAT taxpayers and should be transferred out as a cost or expense of the enterprise:

- Purchase of goods or taxable services which are used for non-taxable items.
- Purchase of goods or taxable services which are used for tax-exempt items.
- Purchase of goods or taxable services which are used for collective welfare or personal consumption.
- Purchase of goods which suffer abnormal losses.
- Purchase of goods or taxable services consumed in the production of work-in-progress or finished products which suffer abnormal losses.
- Purchase of motorcycles, cars and yacht for self-use.
- Purchase of goods or taxable services without receiving valid VAT invoices.

In case of exportation, input VAT may be totally or partially non-recoverable, provided that the exported goods are not entitled to a VAT refund or the VAT refund rate of the goods is lower than its applicable VAT rate.

In addition, in order to credit the input VAT against output VAT, the input VAT invoices should be valid and be verified within a determined period (normally 180 days, effective January 1, 2009); otherwise the relevant input VAT will be non-recoverable.

2.5 Are there any other transaction taxes?

Consumption Tax ("CT") is levied on 14 categories of goods, including tobacco, alcoholic drinks, cosmetics, jewellery, fireworks, gasoline, tires, motorcycles, automobiles, golf balls and instruments, luxury watches, yachts, disposable wooden chopsticks and solid wood floor boards. CT is normally levied at the manufacturing stage and import stage but for some goods it is levied at the sales stage.

2.6 Are there any other indirect taxes of which we should be aware?

All goods permitted to be imported into or exported out of China shall be subject to Customs import or export duties, according to the PRC Customs Import and Export Tariff.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Yes. Under the new corporate tax law of China and its implementation rules, the withholding tax ("WHT") rate on dividends paid by a locally resident company to a non-resident is 10%. Some treaties allow lower rates at 5% or 7%, etc.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Yes. Under the new Corporate Income Tax Law of China and its implementation rules, effective as of January 1, 2008, China-sourced royalties obtained by a foreign enterprise shall be subject to 5% BT and 10% WHT, based on the royalty payments. BT may be exempt for licensing of technologies. The BT and WHT should be withheld from the amount of each payment by the Chinese payer (as the withholding agent). Some tax treaties allow lower WHT rates at 6% or 7% on the royalties paid by a local company to the beneficiaries located in the treaty contracting countries.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Yes. Under the new Corporate Income Tax Law of China and its implementation rules, effective as of January 1, 2008, China-sourced interest income obtained by a foreign enterprise shall be subject to 10% WHT, with the Chinese payer as the withholding agent.

According to the new BT rules, effective from January 1, 2009, the interest shall be subject to 5% BT.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Yes. The new Enterprise Income Tax ("EIT") Law introduced the "thin capitalisation" rule into the China income tax regime. The new law stipulates that if the debt investment from affiliated parties exceeds the statutory requirement, the interest expense for the exceeded debt investment will be non-deductible for corporate income tax purpose.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

No. There is no such "safe harbour" available under current China tax rules and regulations.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, the "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

The interest payment made by a local company to non-resident related parties shall comply with the arms-length principle. The interest rate on loans prescribed by the China central bank with the same or similar terms and conditions shall act as a reference to the judge as to whether the interest rate is appropriate.

3.8 Does China have transfer pricing rules?

Yes. China established detailed transfer pricing rules in 1998. And in 2009, China released new transfer pricing rules. According to the transfer pricing rules, related party transactions should be carried out at arm's length; otherwise the tax authorities are empowered to make adjustments on the taxable income by a reasonable method and to impose relevant taxes accordingly.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax on corporate profits is 25%.

4.2 When is that tax generally payable?

Enterprises shall file quarterly tax returns for the corporate income tax and make quarterly estimation payments. The quarterly returns and estimation payments are due within 15 days after the end of each quarter, i.e., 15 January, 15 April, 15 July, and 15 October. An annual tax return, together with financial statements of the enterprise audited by a local accounting firm, must be filed within five months after the end of the tax year. The tax already paid in advance by quarterly instalments could be set off against the annual tax payment. Meanwhile, any overpayment should be refunded.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base follows the accounting profit subject to book-to-tax adjustments.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The differences between book profit and tax profit can be classified into two types: permanent differences; and timing differences. The main permanent differences include over-deducted expenses and non-deductible expenses for tax purposes, interest income from treasury bonds, deemed income for tax purposes, etc. The main timing differences include provisions, accrual expenses, pre-operation expenses, depreciation expenses and amortisation expenses, etc.

4.5 Are there any tax grouping rules? Do these allow for relief in China for losses of overseas subsidiaries?

There is no tax grouping rules in China for Foreign Investment Companies. Operating loss of overseas subsidiaries is not tax deductible for the China parent company. However, the China parent company is allowed to recognise loss for tax purposes on actual asset losses, such as loss on the disposal of overseas subsidiaries, upon the approval of the in-charge tax authorities.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Under the new EIT law, profit distributed to a foreign enterprise is subject to 10% withholding tax. Profit distributed between resident enterprises shall be exempt from income tax.

Retained profit is not subject to PRC tax.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The other major national taxes include Real Estate Tax, Land Appreciation Tax, Deed Tax, Resource Tax and Motor Vehicle Acquisition Tax.

Real Estate Tax ("RET")

RET is payable by Foreign Investment Enterprises that own properties in the designated cities or areas. RET is levied annually at the rate of 1.2% on the original value of the property. Generally, local authorities will grant a 10% to 30% discount of the taxable amount. For leased property, RET is levied annually at the rate of 12% on rental income.

Land Appreciation Tax ("LAT")

LAT is levied on gains realised from real property transactions at progressive rates from 30% to 60%, "based on the land value appreciation amount", which is the excess of the consideration received from the transfer of real property over the total deductible amount.

Deed Tax ("DT")

DT is levied on the purchase or sale, gift or exchange of ownership of land-use rights or real properties. The transferee/assignee is the taxpayer. Tax rates range from 3% to 5%.

Resource Tax ("RT")

RT may be levied on natural resources, generally on a tonnage or volume basis, at rates specified by the Ministry of Finance in consultation with relevant ministries of the State Council. The resources taxed include crude oil, natural gas, coal, other raw non-metallic minerals, raw ferrous metals, non-ferrous metallic minerals, and salt (including solid and liquid salt).

Motor Vehicle Acquisition Tax ("MVAT")

MVAT is imposed on the purchasing and importing of the following types of transport vehicles:

- Cars.
- Motorcycles.
- Trams.
- Electric buses.
- Carts.
- Certain types of trucks.

The Manufacture of the above vehicles for own use or receipt of the above in the form of a gift or lottery, etc., would also be subject to MVAT. The MVAT rate is fixed at 10% of the taxable consideration.

Urban Construction and Maintenance Tax ("UCMT") and Education Surcharges ("ES")

UCMT and ES are calculated on the payment of turnover taxes, including VAT, BT, and Consumption tax. The rate of ES is 3%. The rate of UCMT varies with the different locations from 1% to 7%.

4.8 Are there any local taxes not dealt with in answers to other questions?

Vehicle and Vessel Tax ("VVT")

VVT is levied on Vehicle and Vessel. Certain categories of vehicles and vessels (e.g. non-powered vehicles and vessels) are exempt from VVT, as listed in the governing regulations. The tax on vessels is based primarily on tonnage. The provincial authorities are required to draw up a schedule based on the tax amounts applicable to different types of vehicles and on their tonnage capacity and usage.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

For Foreign Investment Enterprise (FIEs), capital gains and losses are taxed the same as business profits. There is no special set of rules for taxation on capital gains and losses.

Foreign shareholders (corporate and individual) are taxed on capital gains from the disposal of their investment in China FIEs at a 10% withholding tax rate, with further tax treaty relief available.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

This is not applicable in China.

5.3 Is there a participation exemption?

No, there is not.

5.4 Is there any special relief for reinvestment?

No, there is not.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There is no tax imposed upon the formation of a subsidiary. The capital contribution is subject to stamp duty, at the rate of 0.05%.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No. There are no other significant taxes or fees incurred by a local subsidiary.

In practice, it is currently not possible for foreign enterprises to establish branches. Approvals to establish branches have only been granted to several specific industries, e.g. financial institutions, shipping and oil and gas companies. Most of the foreign direct investment takes the form of subsidiaries.

However, it is common for foreign enterprises to establish representative offices in China. A rep office is an extension to its head-office and its business scope is limited to liaison activities which are of a non-profit making nature.

6.3 How would the taxable profits of a local branch be determined?

The taxable profit of a local branch of a foreign enterprise is determined by the same method as that of a foreign invested enterprise, i.e. actual basis method. However, as mentioned above, a branch is not a common investment vehicle by Foreign Investors.

Effective as of January 1, 2010, the taxable profit of a representative office may be determined by one of the following methods:

- Actual basis method.
- Deemed income/profit method.
- Cost-plus method.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

No. There is no branch profit tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

No. A branch would not benefit from tax treaty provisions.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, it would not.

7 Overseas Profits

7.1 Does China tax profits earned in overseas branches?

Yes, profits obtained by a PRC resident company from overseas branches are taxed the same as business profits of the company.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Yes, dividends obtained by a PRC resident company from a non-resident company are taxed the same as business profits. The foreign tax related to the dividends which has been paid is creditable in China subject to the tax treaty between China and the foreign country.

7.3 Does China have "controlled foreign company" rules and if so when do these apply?

Yes, the controlled foreign company ("CFC") rules are included in the EIT Law and the transfer pricing regulations, both effective on January 1, 2008. CFC refers to any foreign enterprise, which is controlled by Chinese resident shareholders and established in a country (region) where the effective tax burden is distinctly lower (i.e., 50%) than the tax rate specified set forth in the EIT Law, which does not distribute its profits or reduces the distribution of the profits not on account of any reasonable operations needs. Under such circumstances, the portion of the aforesaid profits attributable to the resident enterprise shall be included in the revenue of the resident enterprise in the current period.

8 Anti-avoidance

8.1 Does China have a general anti-avoidance rule?

The EIT Law of China devotes an entire chapter, entitled "Special Tax Adjustment", to anti-avoidance. In the chapter, a general Anti-Avoidance Rule is defined as: "competent tax authorities may adjust taxable income where business transactions are arranged without reasonable business purpose".

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no disclosure requirement to disclose avoidance schemes in advance of the company's tax return being submitted. But the company is required to enclose a statement of the annual business transactions between the company and its affiliates when the annual EIT return is submitted.

When the tax authority conducts an affiliated business investigation, the company and its affiliates shall provide the relevant information of the affiliated transaction like pricing, expense pricing method, and profit margin, etc.

The new transfer pricing documentation rule has been effective since January 1, 2008.

Dennis Xu

Hendersen Taxand
12th Floor, Central Modern Building
468 Xin Hui Road, Pu Tuo District
Shanghai 200060
China

Tel: +86 21 6447 7878 - 506
Fax: +86 21 6076 1736
Email: dennis.xu@hendersen.com
URL: www.hendersen.com

Dennis Xu obtained bachelor of business management in Shanghai International Studies University, a member of China Institute of Certified Public Accountants (“CICPA”) and a qualified Certified Tax Agent (“CTA”); started his professional career in Tax, Legal & Business Advisory division of Andersen Shanghai; joined General Electric (China) Co., Ltd. as China tax manager in 2002; established Hendersen Consulting in 2004 as partner; experienced in transfer pricing, due diligence, M&A and corporate restructuring, international employment services, etc.; specialised in electric, financing market, automobile, energy, medical, tobacco, water treatments, etc.

Eddie Wang

Hendersen Taxand
12th Floor, Central Modern Building
468 Xin Hui Road, Pu Tuo District
Shanghai 200060
China

Tel: +86 21 6447 7878 - 518
Fax: +86 21 6076 1736
Email: eddie.wang@hendersen.com
URL: www.hendersen.com

Eddie Wang obtained bachelor of laws degree in Shanghai Jiaotong University, a member of CICPA and CTA, PRC Attorney at Law and PRC National Economist; started his professional career in Tax, Legal & Business Advisory division of Andersen Shanghai and PwC Shanghai; established Hendersen Consulting in 2004 as partner; experienced in M&A, set up in China, corporate tax consulting, transfer pricing, contract review, etc.; specialised in real estate, financing, software, semi-conductor, trading, telecommunication, automobile, media, etc.

Hendersen
Taxand

Hendersen Consulting was mainly founded by former Arthur Andersen professionals in August 2004. Starting with 3 people, the firm currently has more than 80 professionals in Shanghai and Beijing. We are mainly serving multinational companies on M&A, finance, tax and customs related areas in China. Over the past 7 years, our firm has achieved fast growth through acquisition of new clients as well as provision of new service offering with high value-added to their investment in China. Currently, most of our clients are fortune 500 multinational companies, investment banks and funds, such as GE, GM, Boeing, BP, Virgin, Agilent, Bayer, BMW, Danaher, Ferrari, SNDA, Starwood, ThyssenKrupp, Tyco, JP Morgan, etc.

Cyprus

Dr. Kypros Chrysostomides

George Ioannou

Dr. K. Chrysostomides & Co LLC

1 General: Treaties

1.1 How many income tax treaties are currently in force in Cyprus?

Cyprus has 47 bilateral treaties in force.

1.2 Do they generally follow the OECD or another model?

The treaties generally follow the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

The treaty is signed by a representative of the Cyprus government (usually the Minister of Finance), it is approved by the council of Ministers and it is published in the Government Newspaper before its takes effect.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Treaties follow the OECD model. There are no specific provisions for "limitation of benefits".

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Treaties are not overridden by domestic law, but in some cases domestic law provides greater relief and benefits to Cyprus tax residents. For example, domestic legislation provides for credit in relation to payment of taxes abroad and no withholding tax on payments from Cyprus to a third country regardless of the text of a treaty.

2 Transaction Taxes

2.1 Are there any documentary taxes in Cyprus?

Stamp duty is imposed on any document which concerns any property situated in the Republic of Cyprus or matters or things to be executed or done in the Republic of Cyprus, irrespective of the place of execution of the document, at the following rates:

- 1.5% for any amounts up to EURO 170,860.14; and
- EURO 256.29 plus 2% for any amounts over EURO 170,860.14, with a maximum stamp duty of EURO 17,086.01.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Cyprus has VAT tax which is 15% (standard rate), or a reduced rate of 8%, 5% or 0% for certain items.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

VAT is charged only for the provision of goods and services.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

VAT is recoverable by those businesses which are registered with the Cyprus VAT authority.

2.5 Are there any other transaction taxes?

None, other than stamp duty.

2.6 Are there any other indirect taxes of which we should be aware?

Other than VAT, there are no other indirect taxes.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

No withholding tax is imposed on dividends paid by a local resident company to a non-resident.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

No withholding tax is imposed on royalties paid by a local resident company to a non-resident.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

No withholding tax is imposed on interest paid by a local resident company to a non-resident.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

This is not applicable in Cyprus. There are no "thin capitalisation rules" in Cyprus.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not applicable in Cyprus.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not applicable in Cyprus. There are no "thin capitalisation rules" in Cyprus.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

This is not applicable for Cyprus as there are no restrictions.

3.8 Does Cyprus have transfer pricing rules?

Cyprus does not have transfer pricing rules.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Cyprus has a flat rate of 10% tax on corporate profits.

4.2 When is that tax generally payable?

Tax is payable in three instalments according to the year of assessment (1st August, 30th September, 31st December). Any balance not paid within the year is paid when the tax return is filed.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Financial statements prepared under IFRS are subject to tax adjustments.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

This is not applicable in Cyprus.

4.5 Are there any tax grouping rules? Do these allow for relief in Cyprus for losses of overseas subsidiaries?

There is group tax relief in Cyprus between companies where one is a shareholder of the other by 75%, or both are 75% subsidiaries of a third company. Losses from overseas subsidiaries are included in the group.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

There is no difference in these rates in Cyprus.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Cyprus tax resident companies are subject to special defence contribution tax on rents (3%), interest income (10%) and dividends (15%), if the subsidiary payment of the dividend is established in a jurisdiction which has less than 5% corporate tax, and more than 50% of the subsidiary's income results from investment activities.

4.8 Are there any local taxes not dealt with in answers to other questions?

No other local taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains tax of 20% is imposed on profit from the sale of immovable property situated in Cyprus. Proceeds from the sale of shares are exempt from capital gains tax.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The rate is 20% on the profit.

5.3 Is there a participation exemption?

There is no such exemption in Cyprus.

5.4 Is there any special relief for reinvestment?

There is no relief for reinvestment in Cyprus.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There is no tax for the formation of a subsidiary in Cyprus or abroad.

There is capital duty of 0.6% on the value of share capital issued, but not on the value of the share premium.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

The tax treatment between a Cypriot company and a branch of a non-resident company is the same.

6.3 How would the taxable profits of a local branch be determined?

The branch, being a permanent establishment in Cyprus, should account for its taxable profits in Cyprus. The branch should prepare audited financial statements under IFRS.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Please see above.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch which is a permanent establishment in Cyprus would benefit from the tax treaty network.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax will be imposed.

7 Overseas Profits

7.1 Does Cyprus tax profits earned in overseas branches?

This will depend on the wording of the double tax treaty between Cyprus and the other country.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received from a non-resident subsidiary will be exempt from corporation tax, but might be subject to a special defence contribution tax (please see question 4.7 above).

7.3 Does Cyprus have "controlled foreign company" rules and if so when do these apply?

No CFC rules are in place in Cyprus.

8 Anti-avoidance

8.1 Does Cyprus have a general anti-avoidance rule?

No anti-avoidance rules are in place.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No such requirement is in place.

Dr. Kypros Chrysostomides

Dr. K. Chrysostomides & Co LLC
1 Lampousas Street
1095 Nicosia
Cyprus

Tel: *+357 2277 7000*
Fax: *+357 2277 9939*
Email: *k.chrysostomides@chrysostomides.com.cy*
URL: *www.chrysostomides.com*

Dr. Kypros Chrysostomides, founder and managing partner of Dr. K. Chrysostomides & Co LLC, is one of Cyprus' leading corporate and tax lawyers. He specialises in business law, human rights law, international and constitutional law, and has published extensively on all these subjects. Dr. Chrysostomides studied Law at Athens University and Comparative Law at the Luxemburg Law School, followed by postgraduate studies at the University of Bonn, where he gained his Ph.D., specialising in Company Law. Dr. Chrysostomides is a member of the Cyprus Bar Association, the Greek Institute of International Law, the ILA, the IBA, the IFA and the ITPA. He served as a Government Spokesman (Minister for Press & Information) of the Republic of Cyprus between 2003-2006, and in May 2006 he was elected a member of the House of Representatives. He was appointed Minister of Justice and Public Order in February 2008.

George Ioannou

Dr. K. Chrysostomides & Co LLC
1 Lampousas Street
1095 Nicosia
Cyprus

Tel: *+357 2277 7000*
Fax: *+357 2277 9939*
Email: *g.ioannou@chrysostomides.com.cy*
URL: *www.chrysostomides.com*

Senior associate George Ioannou joined the Corporate & Commercial department at Dr. K. Chrysostomides & Co LLC in 2008. He has significant experience in transactions support, and is highly specialised in the provision of tax advice and international tax planning, cross border mergers, transfers of corporate seat, preparation of legal capacity opinions and due diligence reports. Prior to joining the firm, Mr. Ioannou held the position of Assistant Manager at PricewaterhouseCoopers Cyprus, where he also qualified as a Chartered Accountant. He advised on tax planning and tax compliance, and was involved with the provision of internal audit services, feasibility studies and due diligence assignments in a number of areas, including retail, manufacturing, trading and service industries.

DR. K. CHRYSOSTOMIDES & CO LLC
ADVOCATES AND LEGAL CONSULTANTS

Dr. K. Chrysostomides & Co LLC is one of the largest law firms in Cyprus. Established in 1981, it is recognised as one of the country's leading firms by the major international legal directories. The strength of the firm's legal practice lies in the capabilities and diversified qualities of more than 55 legal and paralegal professionals, covering a wide range of legal and related services.

The firm operates via its head office in Cyprus' capital city Nicosia, along with branches in Larnaca and Limassol (Cyprus), and its Brussels office, providing legal services to a worldwide clientele, comprising of both multinational and private clients. Through the firm's long interaction with international clients, its participation in international professional bodies, and its servicing of the Cyprus-based client network, Dr. K. Chrysostomides & Co LLC has built a highly regarded practice which combines a detailed, multi-faceted knowledge of the domestic legal system with an international orientation.

Main practice areas include (in alphabetical order): Acquisitions & Restructures Arbitration, General Practice, Banking & Secured Financing, Competition Law, Corporate & Commercial Law, Cross-border Transactions & Structures, Employment & Migration Law, Family Law, Human Rights Law, Intellectual Property Law (trade marks, patents, designs, copyright and other related rights), Litigation, Mergers, Public & Private International Law, Real Estate Law, Securities, Taxation Law, Trusts, and Wills & Succession.

Dr. K. Chrysostomides & Co LLC is the exclusive Cyprus member to Lex Mundi, the world's leading association of independent law firms. The firm is, in fact, one of the founding members of Lex Mundi. It is also the exclusive Cyprus legal firm to WSG (World Services Group) and TELFA (Trans European Law Firms Alliance). The firm's partners are active members of professional legal organisations, such as the International Bar Association, the International Law Association, the International Association of Young Lawyers and the International Trademark Association. In February 2011, Dr. K. Chrysostomides & Co LLC received the "Cyprus Export Award for Services 2009" from the Cyprus Ministry of Commerce, Industry and Tourism, as well as the Cyprus Chamber of Commerce and Industry, in recognition of exceptional legal services.

Czech Republic

Salans

Petr Kotáb

1 General: Treaties

1.1 How many income tax treaties are currently in force in the Czech Republic?

At present, there are 77 tax treaties to which the Czech Republic is a party covering all regions worldwide.

1.2 Do they generally follow the OECD or another model?

The tax treaties between the Czech Republic and other countries are generally based on the OECD Model Tax Convention in cases where the other party of the treaty is an industrially-developed country (European countries are typical). In cases of tax treaties with some of the less-developed countries, the UN Model Tax Convention is followed. The tax treaty with the USA stands apart and forms a model of its own.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

International tax treaties need to be agreed to by the Parliament and ratified by the President of the Czech Republic (subsequent to possible examination as to the constitutionality thereof by the Constitutional Court which is done only upon qualified request and which in practice has never been initiated). The treaties are then published in the Collection of International Treaties and become part of the domestic law. No further incorporation into domestic law is needed.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The general anti-treaty shopping principles contained in the model tax treaties are usually incorporated in the Czech tax treaties; however, the treaties usually do not contain more comprehensive anti-treaty shopping provisions in comparison with those presented in a model treaty. For example, the criterion of place of effective management is commonly applied, in addition to mere registered address, to limit the benefits of a tax treaty available to a foreign corporate taxpayer. On the other hand a "limitation of benefits" clause is not commonly used.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

A tax treaty published in the Collection of International Treaties prevails over any Czech law, irrespective of whether it previously existed or was issued subsequently. In the event that a tax treaty sets forth provisions different than those set forth in the domestic law, the provision of such treaty will be applied. The Ministry of Finance however tends to issue tax instructions for the application of tax treaties which sometimes twist the interpretation of a tax treaty contrary to the common interpretation of the same (e.g., interpretation in respect of a service-based permanent establishment under the OECD Model Treaty).

2 Transaction Taxes

2.1 Are there any documentary taxes in the Czech Republic?

There are no documentary taxes in the Czech Republic. Based on the nature of a transaction (real estate transfer, share transfer, etc.), standard court or administrative fees or notary compensation may be charged that are supposed to cover or contribute to the expenses of the registration made by the pertinent authority and have no taxation nature.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

There is value added tax (VAT) in the Czech Republic and it applies to taxable supplies described in more detail in question 2.3. The Czech VAT system is based on, and generally complies with, the EU VAT rules, particularly the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax.

Two VAT rates are applied in the Czech Republic:

- the standard VAT rate of 20% is applied to most taxable transactions involving supply of goods and services unless a reduced VAT is set forth; and
- the reduced VAT rate of 10% is applicable to certain supplies of goods and services permitted by the Directive 2006/112/EC (e.g., foodstuffs, medical equipment, pharmaceutical products, books, and broadly defined social housing, among others), and to certain supplies related to construction works for residential housing.

As part of the governmental measures addressing the public finance deficit, an increase of the reduced rate from 10% to 14% as from 1 January 2012, and the introduction of a uniform rate of 17.5% as from 1 January 2013 are proposed.

In addition, some taxable supplies that are VAT-exempt still grant the supplier the right of VAT deduction on the input, which renders such supplies effectively a 0% rate.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

As a universal indirect tax, VAT applies to a broad array of transactions including delivery of goods, transfer of real estate or provision of service by a person liable to VAT for consideration, acquisition of goods by a person liable to VAT from other EU Member States for consideration, other imports of goods with a place of taxable supply in the Czech Republic, etc.

From among a number of VAT exclusions and exemptions, the following examples of supply of goods and services excluded from VAT can be highlighted:

- supply of goods and provision of services effectuated by an exempt person, i.e., a person liable to VAT whose turnover for a period not longer than 12 months does not exceed CZK1 million or €40,000 (proposed to go down to CZK750,000 or €30,000 as from 1 January 2013), who is not registered as a VAT payer;
- the provision of certain services in the public interest (postal services, social assistance, medical goods and services, radio and TV broadcasting, financial activities, insurance activities, etc.) and other listed activities, if the conditions set out by law are complied with (e.g., transfer and lease of land, structures, apartments and non-residential space); and
- exemptions connected to exports of goods and linked transactions and to international transport.

Depending on the type of VAT-exempt supply provided by a taxpayer on its output, such taxpayer may or may not be allowed to deduct VAT charged to it on its input.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

As a general rule, a taxpayer registered for VAT who uses the received taxable supply for the exercise of its economic activity is entitled to a deduction of VAT paid in connection with the received taxable supply.

The deduction is not available when the taxpayer uses the received taxable supply for making supplies that are exempt from VAT without the right of VAT deduction (such as postal services, social assistance, medical goods and services, radio and TV broadcasting, financial and insurance activities unless the place of taxable supply is outside of the EU, lotteries, transfer and lease of some land and structures, apartments and non-residential space, etc.) or for purposes other than its economic activity (e.g. personal consumption).

2.5 Are there any other transaction taxes?

The following can be considered other transaction taxes in the Czech Republic applicable to transactions involving a legal entity:

- real estate transfer tax, for which the tax rate is set at 3%;
- inheritance tax, for which the tax rate is set progressively and ranges effectively from 3.5% up to 20%; and
- gift tax, for which the tax rate is set progressively and ranges from 7% to 40%.

2.6 Are there any other indirect taxes of which we should be aware?

In addition to VAT, excise taxes and energetic (environmental) taxes represent other types of indirect taxes.

Excise taxes are levied on the following products distributed in the Czech Republic:

- mineral oils;
- spirit (alcohol);
- beer;
- wine and intermediate products; and
- tobacco products.

Energetic (environmental) taxes are levied on supply of the following energetic media to end consumers in the Czech Republic:

- electricity;
- natural gas and certain other gases; and
- solid fuels.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

In general, a local company paying out dividends (profit distributions) to a Czech non-resident must withhold income tax equal to 15% of the payable dividend.

The above withholding tax rate may be reduced in cases where the dividends are paid out to and beneficially received by a non-resident entitled to a protection under a relevant tax treaty. The treaty-reduced tax rate is usually as low as 10% or 5% or even nil (e.g., under the Czech-Netherlands tax treaty and subject to the terms and conditions as set forth in the treaty).

The income from dividends (profit distributions) paid by a Czech resident to a parent company resident in an EU Member State (including the Czech Republic) or Switzerland, Norway and Iceland, is exempt from income tax if the ownership interest of the parent company in the share capital of the Czech company (payer of the dividend) is (or will be) at least 10% for an uninterrupted period of 12 months and certain other conditions based on the relevant EU Parent-Subsidiary Directive (90/435/EEC) are met. In respect of Czech subsidiary companies, the aforesaid rule applies to joint stock companies and limited liability companies.

The Czech government has proposed to eliminate the taxation of dividends paid by Czech resident companies to its EU, EEA and some third-country resident shareholders on profits generated after 2012.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In general, a local company paying out royalties to a Czech non-resident must withhold income tax of 15% of the payable royalties. The withholding tax rate applicable to financial leases is 5%.

The above-mentioned withholding tax rate may be reduced in cases where the royalties are paid out to and beneficially received by a non-resident entitled to a protection under a relevant tax treaty.

As from 1 January 2011, subject to the conditions set forth by Czech tax law (generally following the rules set forth by the relevant EU Interest and Royalty Directive 2003/49/EC), royalties received by a company which is a tax resident of another EU

Member State or Switzerland, Norway and Iceland from a company which is a Czech resident are exempt from Czech income tax and thus also from any withholdings. Similar exemption applies to payment of royalties to a company which is a tax resident of another EU Member State by a Czech permanent establishment of a company resident in another EU Member State.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In general, a local company paying out interest to a Czech non-resident must withhold income tax of 15% of the payable interest.

The obligation to withhold the tax does not apply to cases where the interest is paid out to and beneficially received by a non-resident entitled to a protection under a relevant tax treaty. The obligation to withhold further does not apply to cases where the interest is paid out to a non-resident's permanent establishment in the Czech Republic.

Subject to the conditions set forth by Czech tax law (generally following the rules set forth by the relevant EU Interest and Royalty Directive 2003/49/EC), interest paid to a company which is a tax resident of another EU Member State, or Switzerland, Norway and Iceland, by a company which is a Czech resident, is exempt from Czech income tax and thus also from any withholdings. Similar exemption applies to payment of interest to a company which is a tax resident of another EU Member State by a Czech permanent establishment of a company resident in another EU Member State. The aforesaid exemption does not apply to interest from certain loans and credits of hybrid nature (such as those where the creditor is entitled to participate in profits of the debtor as a result of the loan or credit provided to the debtor).

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Although interest paid in excess of the "thin capitalisation" rules may generally be subject to reclassification to profit distribution (dividend) and thus ineligible for certain tax reliefs rendered to interest on loans and credits, such reclassification is disallowed when the recipient of the interest is a corporate resident of the EU or the EEA. Consequently, the tax exemption of interest on loans and credits mentioned in question 3.3 will still apply to EU and EEA residents irrespective of the breach of the "thin capitalisation" rules on the side of the borrower.

In other cases, "thin capitalisation" rules apply to debt financings (provision of loans and credits) between related parties (or refinanced by related parties on a back-to-back basis) where the corresponding financial expenses (i.e., in addition to interest also other financial expenses, such as loan arrangement or processing fees, etc.) exceeding the specific debt-to-equity ratio are not tax deductible and, as a result, the interest and other financial expenses are reclassified to dividend (profit distribution). The above debt-to-equity ratio generally equals to 4:1 and in case of banks and insurance companies, 6:1.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

A "safe harbour" is usually sought in some bilateral tax treaties binding on the Czech Republic that either do not allow reclassification of interest to dividend, or grant favourable tax treatment to dividends even after reclassification from interest.

As mentioned above, the EU resident or EEA resident status of a corporate lender would suffice to protect the lender from the taxation of interest paid to it in excess of the "thin capitalisation" rules. The adverse impact of such rules on the Czech borrower (the non-deductibility of interest and other financial expenses on loans and credits in excess of the "thin capitalisation" rules), however, would still remain.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Generally, no. A debt advanced by a third party, however, that is conditioned upon the provision to such third party of a directly connected loan or credit by a party related to the borrower (including the borrower's parent), is viewed as debt advanced by a related party and therefore is subject to the "thin capitalisation" rules, as mentioned above in question 3.4.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

As mentioned in question 3.3, tax relief for interest payments by a local company to a non-resident that is a tax resident of another EU Member State or Switzerland, Norway or Iceland is not available in cases of interest from loans and credits that are agreed upon between affiliated persons at non-arm's-length terms or where the creditor is entitled to participate in profits of the debtor as a result of a loan or credit provided to the debtor or to change the right to interest from a loan or credit to the right to participate in profits of the debtor.

Furthermore, interest and other financial expenses on loans and credits where such interest or other yield or the maturity of the financial expenses are partly or wholly dependent on the borrower's profits may be reclassified (to recipients other than EU-residents and EEA-residents) to dividend and thus ineligible for tax relief on interest payments.

3.8 Does the Czech Republic have transfer pricing rules?

Yes, under the law in the case where the prices agreed upon between connected persons differ from prices that would be agreed upon between independent persons in ordinary business relations under the same or similar conditions, and unless such variance is justified in a satisfactory manner, the tax authority may adjust the income tax base of the involved taxpayer by the variance so ascertained. Connected persons are deemed to include (i) affiliated persons by reason of capital relation or voting rights through ownership of at least 25% of capital or voting shares, (ii) persons otherwise related, e.g. by kinship, and (iii) persons who have created a legal relation mainly for the purpose of reducing a tax base or increasing a tax loss.

Czech law does not provide more detailed guidelines as to how an arm's-length price is to be established. The Czech Ministry of Finance, however, has instructed the local tax authorities to take into account the OECD Transfer Pricing Guidelines for intra-group transactions. To eliminate uncertainty relating to establishing arm's-length prices, taxpayers may request the relevant local Financial Office to issue an appraisal of the methods employed by a taxpayer when calculating prices to be charged/paid to connected persons. Such appraisal is binding on all Czech tax authorities and has thus the quality of an advance tax ruling.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax on corporate profits in the Czech Republic is 19%. A reduced tax rate of 5% (Czech government proposes to reduce this rate to 0% as from 1 January 2011) applies to pension funds, investment funds and unit trusts. A reduced rate of 15% applies to certain specified types of income (dividends, profit distributions, liquidation surplus payments, etc.).

4.2 When is that tax generally payable?

In general, the income tax must be paid not later than within 3 months from the end of the preceding tax period (usually, but not always, a calendar year). In certain cases including tax payable by larger companies (the financial statements of which are subject to mandatory audit) and by taxpayers whose tax return is being submitted by a qualified tax advisor and who have notified the tax authority of this in advance, the income tax is payable not later than within 6 months following the end of the tax period.

In addition to the final settlement of tax due, taxpayers are also liable to pay semi-annual tax advances on account of corporate income tax if their most recent known tax has exceeded CZK30,000 (approximately €1,200), or quarterly tax advances if their most recent known tax has exceeded CZK150,000 (approximately €6,000).

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for income from general business operations is determined on the basis of profits pursuant to commercial accounts (set up in accordance with the national accounting standards and always free of any impact of the IFRS), subject to certain adjustments (see question 4.4).

The tax base is determined differently in certain cases including income subject to withholding tax, profit distributions and other similar income sourced abroad, and taxation of some permanent establishments of non-residents.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The profits or losses ascertained on the basis of the commercial accounts have to be adjusted (increased or reduced by certain items) for the purpose of setting the tax base. The most notable difference stems from the fact that the tax depreciation of fixed assets usually differs from the accounting depreciation of the same.

The items increasing the tax base include for example, the following:

- amounts shown in the accounting which, according to the Income Taxes Act, cannot be included in expenses or can be included therein only in a limited manner (e.g., disallowed expenses such as business entertainment, remuneration of corporate directors, costs relating to revenues excluded from the tax base, certain travel expense reimbursements, certain types of damages, interest that cannot be claimed due to the thin capitalisation rules);
- amounts not included in the accounting for which the tax base is raised (e.g., non-cash income as a result of transfer pricing policy); and
- in certain events the profits must be increased by amounts accounted for as an expense if not actually paid (contractual penalties, social security and medical insurance).

The items reducing the tax base include, for example, the following:

- amounts not included in the accounting for which the tax base may be reduced (e.g., claim of a tax loss from previous years, research and development project expenses);
- revenues exempt from tax (e.g., some intra-group interest and royalties) or revenues that are a part of a separate, and not the general, tax base;
- revenues taxed by withholding at a special tax rate; and
- in certain cases, it is possible to lower the profits by amounts accounted for as an expense in a preceding accounting period, provided that the payment thereof is made by the company in the current period (e.g., contractual penalties, social security and medical insurance).

4.5 Are there any tax grouping rules? Do these allow for relief in the Czech Republic for losses of overseas subsidiaries?

No, Czech law does not recognise any income tax grouping rules and taxation on a consolidated basis is not applied.

Tax grouping rules have been introduced for the purposes of VAT; the application of the VAT tax grouping is, however, optional.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, taxation at the corporate level does not differentiate between distributed and retained profits and the rate of corporate income tax is not dependent on the fact whether the company allocates the profit from its business activity or not.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Other direct taxes applicable to companies are:

- real estate tax; and
- road tax.

4.8 Are there any local taxes not dealt with in answers to other questions?

In addition to the aforesaid taxes, there are no taxes imposed at the local level. Local governments can, however, assess quasi-tax payments known as "local fees". From among a wide array of local fees, the following may be particularly relevant to companies as fee-payers:

- fees on admission;
- fees on accommodation capacity;
- fees on operation of winning game slot machines or other gaming devices;
- fees on using a public area; and
- fees on an improvement of a construction land parcel by a possibility of connection thereof to a water main or sewage.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Generally, there are no substantial special rules for taxing capital gains and losses.

Subject to the conditions set forth by Czech tax law, capital gains made on the transfer of a qualifying subsidiary are exempt from corporate tax. (See question 5.3.)

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

There is no different rate and the standard corporate income tax rate applies unless the relevant capital gain is exempt (see question 5.1).

5.3 Is there a participation exemption?

Yes, similarly as in the case of exemption connected with the dividend payments (see question 3.1), a participation exemption will generally apply in the Czech Republic to income derived by the Czech resident corporate shareholder or a company resident in another EU Member State, or Norway or Iceland from the sale of shares (ownership interests) in a Czech subsidiary or other subsidiary resident in the EU, or Norway or Iceland, or a country with which the Czech Republic has concluded a double taxation treaty (irrespective of the actual text of such treaty).

The above exemption relating to the sale of shares (ownership interests) requires the participation of the selling shareholder on the subsidiary of at least 10% for an uninterrupted period of 12 months. As for the sale of shares in a foreign non-EU/Norway/Iceland subsidiary, in addition to the foregoing participation requirement, the following pre-requisites must be met: (i) the subsidiary is a resident of a country with which the Czech Republic has concluded a double taxation treaty; (ii) the subsidiary has a legal form similar to a Czech joint stock company, limited liability company or cooperative; and (iii) the subsidiary is subject to corporate tax comparable to the Czech Republic taxation (generally, at a rate of at least 12% and on a similar basis).

5.4 Is there any special relief for reinvestment?

In principle, Czech tax regulations do not link the capital gains exemptions or similar tax relief to reinvesting company's profit, e.g., into the acquisition of the same category of capital asset.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Formation of a company in the Czech Republic is not subject to any capital or other tax.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

In principle, the taxation of a Czech subsidiary and a Czech branch of a non-resident is subject to identical rules. The only material difference is that in some cases the tax base of a branch (but not a subsidiary) may be determined on the basis of other criteria than profits based on commercial accounts. Such determination is made by the tax authorities only after the formation of the branch and is therefore not of much use for advance tax planning.

In case of a Czech branch of a non-EU/EEA resident, a deduction from the income paid to it has to be made by the payer; such deduction serves as a tax security and is offset against the final Czech tax liability of the branch. Such deduction is not required in case of payments to a Czech subsidiary of a non-EU/EEA resident.

6.3 How would the taxable profits of a local branch be determined?

In case of a branch, generally only the income gained from its Czech-related activity is subject to income tax. This means that generally the same rules and regulations apply (e.g., the admissibility of tax expenses of the branch, the rate of tax, the list of items increasing and reducing the tax base, admissibility of a tax loss, etc.), unless Czech tax law provides otherwise. An important difference resides in the fact that the tax base on a branch can in some infrequent cases be determined on the basis of other criteria than just profits shown in the branch's corporate accounts (e.g., a commission on sales by the branch, the gross amount of the branch's expenses, the number of the branch's employees, etc.). The level of such-determined tax base, however, cannot be lower than that of a Czech resident company involved in the same business activity.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is neither a special tax set in the Czech Republic for branches nor any special rate under the existing income tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

While many of the benefits under tax treaties apply only to income not generated through a branch (e.g., dividends, interest, royalties or capital gains), there are still considerable advantages provided by tax treaties to branches such as the application of the non-discrimination principle. On the basis of tax treaties, for example, a branch in the Czech Republic may not be imposed a larger tax liability than a Czech company involved in the same type and extent of business; it may also deduct from its tax base, in addition to its own expenses, relevant expenses (or part thereof) incurred by the head office outside of the Czech Republic.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Remittance of net profits by the branch of a non-resident company to (the head office of) such non-resident company is treated as intra-company financial transfer and as such is not subject to any withholding tax or other tax. As described under question 6.3, Czech tax law sets forth rules regarding calculation of the tax base of the Czech branch, preventing such branch from transferring its profits to its head office without such profits being first duly taxed at the branch.

7 Overseas Profits

7.1 Does the Czech Republic tax profits earned in overseas branches?

Yes. Such profits of overseas branches of Czech resident entities are usually integrated into, and taxed along with, other profits of the resident entity establishing the branch.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

In general, yes. Such taxation of dividends is, however, eliminated for most major local corporate shareholders of EU and EEA resident companies (subject to meeting certain qualifying criteria) on the basis of the EU Parent-Subsidiary Directive and its Czech implementation. In addition, it is proposed to eliminate the taxation of dividends paid by the EU, EEA and some third-country resident companies on profits generated after 2012.

7.3 Does the Czech Republic have "controlled foreign company" rules and if so when do these apply?

There are no "controlled foreign company" tax rules in the Czech Republic.

8 Anti-avoidance

8.1 Does the Czech Republic have a general anti-avoidance rule?

There is no general anti-avoidance rule in the written tax law of the Czech Republic. Tax authorities and courts, however, tend to establish such rule by application practice and consistent judgments. Some specific provisions of tax laws can be used to prevent tax avoidance, such as anti-avoidance rules for the utilisation of losses carried forward, for tax-neutral mergers, de-mergers and corporate reorganisation, etc., as well as the substance-over-form principle. Also, sound economic and business reasons other than just tax-saving are expressly required in certain kinds of transactions by law and generally in most if not all transactions by tax practice, in order to give rise to beneficial tax consequences of the same.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

With the exception of an advance notification of a tax-neutral merger, de-merger or corporate reorganisation, there are no anti-avoidance advance disclosure rules.

Petr Kotáb

Salans
Platnéřská 4/191
110 00 Prague 1
Czech Republic

Tel: +420 236 082 111
Fax: +420 236 082 999
Email: pkotab@salans.com
URL: www.salans.com

Petr Kotáb is an honorary partner in Salans' Prague office. He is also a member of the Department of Financial Law of Charles University School of Law in Prague, teaching taxation, financial markets and banking, and has published extensively on these subjects, including being the co-author of several university textbooks. He also lectures at other universities and was a Visiting Professor at the University of Connecticut School of Law. He was a member of boards of several large Czech financial institutions and currently serves as chairman of an Appellate Senate of the Czech National Bank. Mr. Kotáb received both Master of Laws and Doctor of Laws degrees from Charles University School of Law where he also attended postgraduate studies in financial law. He speaks Czech, English and Russian. He is a member of the Czech Chamber of Advocates, Slovak Chamber of Advocates, International Bar Association and International Fiscal Association.

SALANS

www.salans.com

Salans is a full service international law firm with more than 20 offices worldwide. Reflecting the globalisation of business, the firm represents clients from all over the world in a broad range of cross-border transactions and disputes. At the same time, each Salans office provides a full spectrum of in-depth legal services for local law matters. The combination of international capability and domestic expertise enables Salans to provide comprehensive services matching the needs of global and local clients alike. The firm has around 800 lawyers of more than 20 nationalities, qualified to practice law in each of the jurisdictions in which Salans is present. Each Salans office provides wide-ranging expertise in such fields as arbitration, banking and finance, bankruptcy, commercial transactions, competition law, employment law, intellectual property, litigation, M&A, property, securities, taxation, technology and telecommunications.

Chapter 14

Denmark

Lars Fogh

Gorrissen Federspiel

Jakob Skaadstrup Andersen

1 General: Treaties

1.1 How many income tax treaties are currently in force in Denmark?

Denmark has concluded more than 80 international tax treaties, most of which are based on the OECD Model Tax Convention.

Denmark has income tax treaties with almost all European countries, with the exception of Spain and France. Also many countries in North and South America, the former Soviet Republics, Asia and Africa have entered into tax treaties with Denmark.

In addition, Denmark has entered into treaties regarding the exchange of information with several countries.

1.2 Do they generally follow the OECD or another model?

The tax treaties generally follow the OECD Model Tax Convention.

Denmark seeks to achieve a certain degree of uniformity in the Danish tax treaties by basing them on the principles of the OECD Model Tax Convention. Accordingly, the explanatory notes to the OECD Model Tax Convention have become widely recognised guidelines for the interpretation and application of the provisions of the existing bilateral tax treaties.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

A tax treaty must be incorporated into Danish law. When the two countries' representatives have reached an agreement, the negotiating Danish party must introduce a bill to the Danish Parliament. If such a bill is passed, the new double tax treaty must subsequently be ratified. Typically, the new treaty will not be implemented until 1 January of the year after ratification.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Denmark follows the principles of the OECD Model Treaty.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In general, a tax treaty becomes enforceable when incorporated into Danish law. However, under Danish constitutional law the Danish Parliament may, in principle, pass acts whose contents conflict with both previous and future tax treaties. Danish law generally provides, however, that the interpretation of domestic Danish law must seek to reach a result that does not conflict with Danish obligations under public international law.

2 Transaction Taxes

2.1 Are there any documentary taxes in Denmark?

Denmark has no capital duty on the buying and selling of shares.

As regards real estate, Denmark has a mortgage registration fee of DKK 1,400 plus 1.5% of the principal of the loan.

Denmark also has a registration fee of DKK 1,400 plus 0.6% of the higher of the purchase price and the tax value of the property.

There is no stamp duty on other forms of loans.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Denmark has a Value Added Tax (VAT). The standard VAT rate is 25%. However, some supplies are zero-rated, for example, newspapers.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The exclusions from VAT are as permitted or required by the Directive on the Common System of VAT (2006/112/EC).

The Danish VAT rate constitutes 25% of the VAT basis for all taxable goods and services. Accordingly, all amounts paid as part of a taxable transaction are, in general, subject to VAT.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Businesses providing exempt supplies cannot recover VAT. If a part of the supplies are exempt, partial recovery is granted according to a *pro rata* scheme.

2.5 Are there any other transaction taxes?

Denmark has no transaction taxes other than the taxes mentioned in the answer to question 2.1.

2.6 Are there any other indirect taxes of which we should be aware?

Denmark has other indirect taxes. The most common indirect tax is customs duties that are generally payable on goods imported from outside the EU. Moreover, Denmark has some environmental and health-related taxes/duties.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Denmark has no withholding tax on dividends paid to a foreign parent company resident in another EU country or in a country with which Denmark has entered into a tax treaty if the parent company holds at least 10% of the share capital. The same principle applies to the distribution of dividends by a subsidiary located in Denmark to a Danish parent company.

Distribution of dividends to a foreign company which holds less than 10% of the share capital is only subject to a 15% withholding tax provided that Denmark has entered into an agreement with that country to exchange information. Often the normal withholding tax of 28% (27% in 2012) will however have to be withheld subject to a subsequent tax refund application, resulting in an effective withholding tax of 15%.

If none of the above-mentioned conditions for distribution of dividends are met, dividends from a Danish company to a foreign shareholder are subject to a 28% (27% in 2012) withholding tax.

A further requirement for reducing tax at source is that the company receiving the dividend must be the beneficial owner of such dividends. The requirement means that mere conduit companies will be disregarded as beneficial owner.

Many elements are of importance in the determination of whether an intermediate holding company is beneficial owner of dividends paid from Denmark. It has been ascertained that a holding company which main function is to hold assets or rights is not in itself sufficient to categorise the company as a mere conduit company. The most important factor in the determination is whether the cash flow of the received dividends has stayed in the intermediate holding company or has been passed on to the owners of the intermediate holding company. The fact that an intermediate holding company is owned by a company resident in a non-EU country or in a state which has not entered a tax treaty with Denmark is not sufficient to deny that the intermediate holding company is not beneficial owner of the reviewed dividends.

If the cash flow has stayed in the intermediate holding company, then Danish case law has shown that the company is beneficial owner. However, even if the cash flow has been passed on to the owners of the intermediate holding company, this does not mean that the holding company cannot be seen as being beneficial owner, although this may indicate that further examination is necessary.

The movement of the cash flow is only one factor in the evaluation; however one of many. Other factors, such as whether the intermediate holding company has autonomous discretion, or if the company, though the formal ownership only has narrow powers in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties are also of interest. Also of importance in the determination of whether the company is beneficial owner, for example when there is a business justification for the transaction or whether the construction is artificial, etc.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Denmark has a 25% withholding tax on royalties. Tax is withheld from royalty payments deriving from sources in Denmark. The tax may, however, be reduced under a tax treaty.

No withholding tax applies if the royalty is attributable to the receiver's permanent establishment in Denmark, or if the receiver is subject to the protection of the EU Interest/Royalty Directive (2003/49/EEA) prohibiting EU Member States from retaining withholding tax on royalty and interest payments between affiliated companies within the EU.

The above-mentioned requirement regarding beneficial ownership does also apply for royalties.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

As a general rule, a Danish resident company is not required to withhold Danish tax in respect of interest payments on loans granted by a third party. Interest payments on loans granted by a group company may give rise to a 25% withholding tax, but generally only if the recipient of the interest is a resident of a tax heaven country (a recipient is taxed at a rate considerably lower than the Danish tax rate; three fourths of the Danish corporate tax (i.e. at least 18.75%)).

Payments to group companies in the EU or a country with which Denmark has concluded a tax treaty are not liable to withholding tax.

The specific rules are that a 25% withholding tax on interest payments will be paid if the following conditions are not met:

- the interest payment is related to a permanent establishment in Denmark;
- the taxation of interest is comprised by the EU interest/royalty directive, and the paying company and the receiving company have been affiliated for a continuous period of not less than 1 year, and the payment takes place in this period;
- the taxation of interest is reduced under a tax treaty; or
- the Danish company owns directly or indirectly at least 25% of the share capital or has more than 50% of the votes in the receiving company.

Moreover, Danish companies are not subject to withholding tax: (i) if a parent company resident in a state which has a double tax treaty with Denmark has a controlling interest in the receiving company; and (ii) if, under the rules of that state, the receiving company is subject to CFC taxation on interest payments, provided that the conditions are met under these rules.

Moreover, Danish companies are not subject to withholding tax if the receiving company etc. substantiates that the foreign corporate tax on interest payments constitutes at least three fourths of the Danish corporate tax (i.e. at least 18.75%), and that such interest payments are not transferred to another foreign company, etc. and are therefore subject to a corporate tax rate on such interest payments which is lower than three fourths of the Danish corporate tax (i.e. 18.75%).

The above-mentioned requirement regarding beneficial ownership does also apply for interest.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Interest payments made by a Danish company are generally deductible for Danish corporate income tax purposes unless they relate to foreign property (due to the territoriality principle, according to which foreign property owned by a Danish company is not taxed in Denmark).

The thin capitalisation rules apply to related-party debt whereby a 4:1 debt-to-equity ratio has to be met for interest on such related party debt to remain deductible. In that respect, third party bank debt will be deemed as related-party debt if such debt is guaranteed by a party related to the Danish borrowing company.

The limitation only applies to the part of the debt that should have been equity in order to avoid limitation, and if the controlled debt exceeds DKK 10 million at year-end.

To determine the 4:1 ratio, "debt" is defined as the aggregate of related-party debt and debt to third parties, and "equity" is defined as the market value of assets less the market value of debt provided, however, that the equity injected by shareholders is only taken into account if such equity remains in the company for at least 2 years.

In the case of two affiliated Danish companies, the calculation of the debt-to-equity ratio must be made on a consolidated basis. The calculation of the debt-to-equity ratio must be made at the end of each income year.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The 4:1 ratio in connection with thin capitalisation is a safe harbour, i.e. interest above the 4:1 ratio can be deducted if it can be substantiated that a similar loan could have been obtained (on market terms) from an independent third party without any security from a related party. Furthermore, the thin capitalisation rules only apply if the controlled debt exceeds DKK 10 million at year-end.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes. Third party debt will be deemed to be related-party debt if such debt is guaranteed by a party related to the Danish borrowing company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

In addition to the thin capitalisation rules, the following two tests have to be made to determine the actual level of deductibility of interest payments:

1. "interest ceiling" test; and
2. the "EBIT model" test.

These tests only apply if net financing costs exceed DKK 21.3 million in 2010 (adjusted annually, i.e. currently approximately EUR 3 million) per fiscal year. In the case of two (or more) affiliated Danish companies, the amount of DKK 21.3 million applies to the aggregate net financing costs of the affiliated companies (i.e. the tests apply if the companies' aggregate net financing costs exceed DKK 21.3 million).

If the net financing costs exceed DKK 21.3 million per year, there will be an interest cap limiting the tax deductibility of any net financing cost exceeding the taxable value of the qualifying company's (or jointly taxed companies') assets at year-end, multiplied by a standard interest rate (in 2011, 4.5%). The part of the net financing costs that are in excess of the interest cap are lost and cannot be carried forward.

The EBIT rule applies alongside the above interest cap rule. Even if the interest ceiling test (4.5% test) is met, net financing costs can only reduce taxable income with 80% of taxable EBIT (earnings before interest and taxes). Any excess net financing cost can be carried forward to reduce taxable EBIT in subsequent years.

Please note that only net financing costs exceeding DKK 21.3 million (2010) will be capped.

3.8 Does Denmark have transfer pricing rules?

Yes. Danish transfer pricing legislation follows the OECD transfer pricing guidelines, and the rules apply to Danish companies with both cross-border related party transactions and national transactions.

In summary, the transfer pricing legislation implies that Danish tax payers subject to the rules must:

(1) apply the arm's length principle when determining intergroup prices;

(2) provide information on the nature and the extent of intergroup transactions in their tax return; and

(3) prepare and keep on file written documentation to justify whether the prices in terms of their intergroup transactions are on an arm's length basis.

Danish transfer pricing legislation does not specify any methods for determination of arm's length prices. This means that the method described in the OECD transfer pricing guidelines should be followed. OECD has given priority to the traditional transaction-based methods. Accordingly, the Danish guidelines also recognise the following transfer pricing methods listed in order of priority:

- comparable uncontrolled price methods;
- resale price method;
- cost plus method;
- profit split method; and
- transactional net margin methods.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The corporate tax rate is 25%.

4.2 When is that tax generally payable?

The tax is payable on account in two equal instalments no later than 20 March and 20 November in the income year.

A Danish company must file an income tax return annually. A tax assessment is issued after the tax return has been filed. The tax assessment shows the assessed taxable income and the tax payable.

If the final tax liability exceeds the tax payments made, a surcharge of 4.8% (2011) of the outstanding tax liability will be payable.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In Denmark, the tax base follows the commercial account, subject to adjustments.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Normally, depreciation for tax purposes differs from depreciation for accounting purposes. In general, the depreciation for tax purposes exceeds the depreciation permitted in connection with commercial accounts. Depreciation for accounting purposes must use the real value of the assets which does not apply to depreciation for tax purposes.

4.5 Are there any tax grouping rules? Do these allow for relief in Denmark for losses of overseas subsidiaries?

Mandatory Danish joint taxation

Denmark has mandatory joint taxation for affiliated companies (controlling interest) which are domiciled in Denmark.

Under Danish law, any permanent place of operation or real estate located in Denmark, which is owned by a company not taxable in Denmark, is jointly taxed with all its affiliated companies in Denmark.

Optional international joint taxation

International joint taxation is not mandatory but can be elected. If international joint taxation is chosen, it will comprise all the foreign affiliated companies of the group. This means that Denmark has an all-or-nothing principle, a so-called global pooling principle.

Pursuant to this, affiliated foreign companies need to decide whether they wish to be jointly taxed with the companies in Denmark, which rules out any possibility of joining only with one or a few of the group's foreign companies for tax purposes. The principle also applies to any permanent establishment and real estate located abroad which is owned by jointly taxed Danish and foreign companies.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

The corporation tax rate of 25% applies in general.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Companies are subject to the payment of property tax to the municipal authorities. Normally, property tax is calculated as a fixed per thousand rate of the site value of the property in question.

4.8 Are there any local taxes not dealt with in answers to other questions?

The Danish tonnage tax regime is generally perceived as one of the worlds most competitive and attractive shipping tax systems. Under this regime, the companies pay tax on the basis of the ships tonnage and not on the basis of result.

Denmark has also passed new rules for taxation of carried interest tax for equity funds in 2010. These rules have lead to a change in taxation of the total return. Before this time, the carried interest was taxed as share income, but it is now taxed both as share income and personal income. A fixed return is taxed as share income, while the remaining part is taxed as personal income. Overall the taxation of carried interest tax for equity funds has increased.

Furthermore, Denmark has check-the-box rules for transparent entities. According to these rules, if a company is construed as transparent under foreign tax law, the Danish tax authorities will also construe the company as transparent under Danish tax law. If a transparent company under foreign tax law is construed as a taxable company, the company will also under Danish tax law be regarded as a taxable company.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains are normally added to a company's taxable income and taxed at the standard corporate tax rate of 25%. No special capital gain tax rate applies.

Special rules for the taxation of capital gains on shares apply. Capital gains on shares are tax free if the company owns at least 10% of the share capital. Losses are not deductible.

Companies selling and purchasing shares as a business activity are taxable on all income arising from such business and may deduct losses.

Capital gains on shares are taxable if the company owns less than 10% of the share capital. Losses are deductible.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The 25% rate imposed on companies is also imposed on capital gains.

Taxation of share income for private individuals

Share income up to DKK 48,300 (for married couples, DKK 96,600 - 2010) is taxed at a rate of 28%. Share income exceeding this amount is taxed at a rate of 42%.

5.3 Is there a participation exemption?

Denmark has a participation exemption in connection with capital gains on shares; *cf.* the answer to question 5.1. The minimum holding requirement is 10%.

5.4 Is there any special relief for reinvestment?

If a company sells a property used for business purposes or a farm, the company may reinvest the proceeds in another business property or farm property in Denmark or abroad. If the company chooses to reinvest the proceeds, it may reduce the acquisition cost of the acquired property by the proceeds earned instead of including the proceeds in its taxable income.

To reinvest as described above, the company must acquire the property in the same income year, or in the income year proceeding or following the year of sale. The company may also reinvest the proceeds in the expenses incurred in connection with the conversion or extension of the property or with a new building on the property. The reinvestment rules do not apply to rental properties. The rules only apply if the owner has its residence for tax purposes in Denmark.

When selling their own business or part thereof, natural persons may - under certain circumstances (including age and ownership period) - pay the proceeds earned into a pension scheme. The same applies to a person selling shares in a company carrying on business activities in which he is the principal shareholder. The total amount paid in must not exceed the taxable proceeds earned by the owner/principal shareholder from the sale of the company/shares or part thereof. The amount paid into the pension scheme must not exceed DKK 2,507,900 (2010).

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No taxes or capital duties are imposed upon the formation of a subsidiary.

A Danish subsidiary can be set up as a limited liability company either as an "*Anpartsselskab*" (ApS) (similar to a private limited company) or as an "*Aktieselskab*" (A/S) (similar to a public limited company).

An A/S must have a share capital of at least DKK 500,000 (or the equivalent EUR amount) and an ApS must have a share capital of at least DKK 80,000 (or the equivalent EUR amount). The share capital can be paid up in cash or by contribution of assets in kind.

Under Danish law, the formation of a Danish limited company is quite simple and can be completed within a day.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Subsidiary and branches are taxed at the same rate and subject to generally the same taxable principles.

6.3 How would the taxable profits of a local branch be determined?

The taxable income of a branch in Denmark will basically be the same as that of a Danish limited liability company. Generally, a branch - just like a company - must base its inter-company transactions on the arm's length principle, and it will be considered as an independent operation for tax purposes. However, a territorial principle applies to Danish companies to the effect that income from a foreign branch is not included in the Danish income.

The Danish branch is taxed on the income deriving from the Danish business. Expenses relating to the business of the branch can be deducted provided that they are incurred when generating or maintaining taxable income. Foreign exchange, gains and losses realised in trade with third parties can also be included in the taxable income. Tax losses can be carried forward on the Danish tax return for an unlimited period of time.

Payments by a Danish branch to its foreign head office for items such as royalties, interests and other expenses are, however, not deductible for tax purposes as the branch constitutes an integral part of the foreign head office.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no special branch profit tax. A branch will be subject to the 25% standard corporate tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Yes, a branch can benefit from tax treaty provisions.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Profits of a branch may be remitted to the head office free of withholding tax. In principle, there are no restrictions on the remittance of the profits of branch to its head office.

7 Overseas Profits

7.1 Does Denmark tax profits earned in overseas branches?

Denmark has adopted a territoriality principle. Due to the territoriality principle, income or capital gains from a property or a permanent establishment outside of Denmark owned by a Danish company are not taxed in Denmar, unless the group of companies in question elects international joint taxation.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

The receipt of dividend by a local company from a non-resident company is not liable to tax, if the dividends are subsidiary shares or group shares.

Subsidiary shares are shares where the shareholder owns at least 10% of the share capital. Group shares are shares where the shareholder controls more than 50% of the voting rights or owns more than 50% of the share capital.

When a shareholder owns less than 10% of the share capital, the share is a portfolio share and taxable.

7.3 Does Denmark have "controlled foreign company" rules and if so when do these apply?

Denmark has CFC (controlled foreign companies) rules. The CFC rules apply if all the three following tests are met:

- The control test: a test primarily focused on whether the parent company controls more than 50% of the voting rights.
- The financial income test is met if more than 50% of total taxable income of a subsidiary consists of financial income.
- Finally, a financial assets test: Only if more than 10% of the company's assets are financial, can the company become a CFC.

If CFC taxation is applicable, the total income of the subsidiary must be added to the income of the Danish parent company.

The CFC rules do not apply if the group has chosen international joint taxation.

Exemption from the CFC rules may be granted to banks, insurance companies, mortgage institutions and other financial institutions.

8 Anti-avoidance

8.1 Does Denmark have a general anti-avoidance rule?

Denmark has no general anti-avoidance rule. However, according to the case law established by the Danish courts, the real economic aspect and the real contents of transactions are taken into account rather than their formal appearance. As a result, the courts sometimes refuse to recognise lawful and valid transactions without contents in connection with tax avoidance if the real contents of such transactions conflict with the real economic situation. Most recently, however, the courts have recognised decisions on the basis of their formal appearance where such decisions have been made in compliance with Danish company law and satisfy the formal requirements under Danish law.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Fiscally there is no requirement to make special disclosure of avoidance schemes.

However the Danish Act on Financial Statement contains requirements for the statement of the accounts. For instance, it is a requirement that the financial statement is clear and manageable and shows a true and fair view of the of the companies' assets and liabilities. Essential is therefore substance over formality without any real content.

The companies are therefore liable to disclose any nearby risk of non-self-declared tax in the financial statements.

Lars Fogh

Gorrissen Federspiel
H. C. Andersens Boulevard 12
DK-1553 Copenhagen
Denmark

Tel: +45 3341 4170
Fax: +45 3341 4133
Email: lfo@gorrissenfederspiel.com
URL: www.gorrissenfederspiel.com

Lars Fogh is co-head of tax in Gorrissen Federspiels's department of tax. He is well-known for his expertise on transactional tax issues and complex structuring advice.
He serves a number of Danish and international corporate clients on general legal tax issues relating to Denmark and other countries, in particular in relation to restructurings, reorganisations, succession of ownership, the setting up of holding companies, mergers and acquisitions and real estate transactions. Also, he conducts litigation in direct and indirect tax cases before the National Tax Tribunal and the ordinary courts.
Lars holds rankings from Chambers, Legal 500, PLC Which Lawyer and others.

Jakob Skaadstrup Andersen

Gorrissen Federspiel
H. C. Andersens Boulevard 12
DK-1553 Copenhagen
Denmark

Tel: +45 3341 4177
Fax: +45 3341 4133
Email: jsa@gorrissenfederspiel.com
URL: www.gorrissenfederspiel.com

Jakob Skaadstrup Andersen heads the tax practice at Gorrissen Federspiel.
Jakob is an expert in international tax matters and advises on structuring of Mergers & Acquisition, on corporate reorganisations and on transfer pricing issues, VAT and duties. He successfully represents clients in controversies with the tax authorities.
Over the years, Jakob has assisted a number of international clients establishing themselves in Denmark as well as assisting foreign and Danish clients with acquisition of Danish and foreign entities by providing structural and due diligence advice.
Jakob focuses on understanding the commerciel drivers in the client's industry and always aims to provide swift advice that supports the client's individual objectives and strategy.
Jakob holds rankings from Chambers, Legal 500, PLC Which Lawyer and others.

Gorrissen Federspiel

Gorrissen Federspiel has for many years been positioned as one of the leading corporate law firms in Denmark with strong and long standing international relations.

The Tax Group advises on all areas of tax advising, including mergers & acquisitions, private equity investments, taxation of financial products and financial institutions, corporate restructuring resulting from mergers, demergers, share exchange and contribution of assets, Danish and international incentive programmes, transfer pricing, VAT, customs and duties. The Tax Group represents clients in tax controversies before the courts and in the administrative dispute resolution system.

We combine a solid legal background with innovation, which result in legal advice at the highest professional and ethical level, tailored to the client's individual situation and requirements.

Estonia

Jaak Siim

Aivar Pilv Law Office

Ilmar-Erik Aavakivi

1 General: Treaties

1.1 How many income tax treaties are currently in force in Estonia?

Estonia has currently 47 income tax treaties in force (see Appendix 1).

1.2 Do they generally follow the OECD or another model?

Yes, they do generally follow the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes, treaties have to be incorporated into domestic law before they take effect.

The Government of the Republic of Estonia signs international agreements and presents to the Parliament of Republic of Estonia, the Riigikogu, those treaties that need ratification. The parliament ratifies agreements via approving a law. The President of the Republic of Estonia shall proclaim the law passed in the parliament and after that the ratification law is published in the State Gazette.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

No, they do not incorporate anti-treaty shopping rules.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

According to the Constitution of the Republic of Estonia, Estonia shall not enter into international treaties which are in conflict with the Constitution. If laws or other legislation of Estonia are in conflict with international treaties ratified by the Parliament of Republic of Estonia, the provisions of the international treaty shall apply.

2 Transaction Taxes

2.1 Are there any documentary taxes in Estonia?

Yes, for example, state fees and notary fees.

A state fee is a sum payable in the cases provided by law in an amount established by the State Fees Act for the performance of an act for which a state fee is charged.

A notary fee means the fee paid to a notary for the performance of a notarial act and related legal or technical services.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes, there is Value Added Tax (hereinafter VAT) in Estonia. The standard rate of VAT is 20 per cent of the taxable value, the reduced rate is 9 per cent and 0 per cent in some cases.

The rate of VAT on the following goods and services shall be 9 per cent of the taxable value on:

- books and work exercise-books used as learning materials;
- medicinal products, contraceptive preparations, sanitary and toiletry products, and medical equipment or medical devices intended for the personal use of disabled persons within the meaning of the Social Welfare Act and specified in the list established by a regulation of the Minister of Social Affairs;
- medicinal products, contraceptive preparations, sanitary and toiletry products, and medical equipment or medical devices intended for the personal use of disabled persons within the meaning of the Social Welfare Act and specified in the list established by a regulation of the Minister of Social Affairs, and the grant of the use of such medical devices to disabled persons; medicinal products, contraceptive preparations, sanitary and toiletry products, and medical equipment or medical devices intended for the personal use of disabled persons within the meaning of the Social Welfare Act and specified in the list established by a regulation of the Minister of Social Affairs, and the grant of the use of such medical devices to disabled persons;
- periodic publications, excluding publications mainly containing advertisements or personal announcements, or publications the content of which is mainly erotic or pornographic; and
- accommodation services only or accommodation services with breakfast, excluding any goods or services accompanying such services.

The rate of VAT on the following goods and services shall be 0 per cent of the taxable value on:

- exported goods, excluding cases where the supply of such goods is exempt from tax pursuant; and
- goods where their transfer and transport to another Member State of the European Community (hereinafter Member State) or the transport to another Member State without transfer is deemed to be intra-Community supply of goods.

This provision does not apply in cases where the supply of goods is exempt from tax pursuant or the acquirer of the goods, except for new means of transport or excise goods, or the transferor of own goods to another Member State has no valid number of registration as a taxable person or taxable person with limited liability issued in the other Member State;

- sea-going vessels navigating in international waters, except pleasure crafts used for purposes other than those of business interests, and equipment, spare parts, fuel and other supplies used on such sea-going vessels and goods to be transferred to passengers for consumption on board, except goods sold on board sea-going vessels during intra-Community passenger transport to be taken away;
- aircrafts used by an air carrier operating mostly on international routes and equipment, spare parts, fuel and other supplies used on such aircraft and goods to be transferred to passengers for consumption on board, except goods sold on board of such aircraft during intra-Community passenger transport to be taken away;
- goods transferred and transported to another Member State to a diplomatic representative, a consular agent (except an honorary consul), a representative or representation of a special mission or an international organisation recognised by the Ministry of Foreign Affairs, a diplomatic representation or consular post, a special mission or a Community institution;
- goods transferred and transported to another Member State which is a Member State of the North Atlantic Treaty Organisation (hereinafter NATO) and intended either for the use of the armed forces of any other NATO Member State or the civilian staff accompanying them, or for supplying their messes or canteens when such forces take part in the common defence effort;
- non-Community goods (as defined in the Community Customs Code) placed in a free zone or free warehouse, where such goods have not been placed under any customs procedure and have not been consumed or used under conditions other than those prescribed by the customs rules;
- non-Community goods placed in a free zone or free warehouse or other non-Community goods, placed under the customs warehousing procedure, the inward processing procedure applying the suspension system, the transit procedure or the temporary importation procedure with total relief from import duties, and non-Community goods in temporary storage on the condition that the goods have not been unlawfully removed from under customs supervision or consumed or used under conditions other than those prescribed in the customs rules;
- Community goods transferred and transported to a free zone or free warehouse for export purposes and Community goods placed in a free zone or free warehouse which are exported within two months as of transportation to the free zone or free warehouse;
- gold transferred to Bank of Estonia;
- the goods specified in Annex V to Council of the European Union Directive 2006/112/EC if the goods are immediately placed in a tax warehouse or have been placed in a tax warehouse and the transaction does not involve termination of tax warehousing; and
- excise goods placed in an excise warehouse if the transaction does not involve taking the goods out of the excise warehouse, except transporting the excise goods from one excise warehouse to another.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

No, VAT is not charged on all transactions.

VAT shall not be imposed on the supply of the certain goods and services of a social nature (e.g. universal postal services, health services, services relating to shelters for the protection of children and young persons, etc.) or other specified nature (e.g. insurance services, the leasing or letting of immovables or parts thereof, investment gold and services relating to the transfer of investment gold or entry into a corresponding transfer agreement, etc.) or financial services (e.g. deposit transactions for the receipt of deposits and other repayable funds from the public, leasing transactions, money broking, etc.) specified in the VAT Act.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input VAT is recoverable to Estonian VAT registered entities and in certain cases also to foreign legal entities that do not have a permanent establishment in Estonia.

When goods and services are supplied for a business subject to VAT, the VAT paid is fully recoverable. If only a part of the business is subject to VAT, only the VAT related to this business is recoverable. Input VAT on goods or services relating to the reception of guests or the provision of meals or accommodation for employees shall not be deducted from calculated VAT.

2.5 Are there any other transaction taxes?

Other transaction taxes in Estonia are gambling tax, excise duties and heavy goods vehicle tax. Customs duties are charged in certain cases of export and import.

2.6 Are there any other indirect taxes of which we should be aware?

No, transaction taxes are directly related to relevant transactions.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

The resident legal person has to pay 21/79 of the amount of profits distributed (unless any tax exemption does apply). If dividends are paid to a non-resident legal person, then no additional income tax (21 per cent) is withheld on the amount of dividend.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

According to the income tax act, 10 per cent withholding tax applies to royalties paid to non-resident persons. Royalty payments to qualifying companies of the Member States may be exempt if they meet the conditions for the Council of the European Union Directive 2003/49/EC of 3 June 2003. The withholding tax exemption will not apply to any part of the royalty that exceeds the value of similar transactions carried out between unrelated persons.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Income tax is withheld from interest payments subject to income tax paid to a non-resident or to a resident natural person.

Income tax is charged on interest received by a non-resident from the Republic of Estonia, a local government or a resident, or from a non-resident through or on account of its permanent establishment in Estonia, if it significantly exceeds the amount of interest payable on the similar debt obligation under the market conditions during the period when the debt obligation and payment of the interest occurred. In that case, income tax is charged on the difference between the interest received and the interest payable according to market conditions on the similar debt obligations.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

There are no traditional "thin capitalisation" rules in Estonia.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There is no "safe harbour" principle in the laws.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

See the answer above (question 3.4).

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are not any other restrictions on tax relief for interest payments by a local company to a non-resident.

A local company who has during a calendar year paid interest to a natural person residing in another Member State of the European Union, is required to submit a declaration concerning the payment of interests to the tax authority.

3.8 Does Estonia have transfer pricing rules?

Estonia does have transfer pricing rules from 2007. The Estonian transfer pricing regulation should generally be in line with the principles laid down in the OECD Guidelines. The current regulation is based on the arm's-length principle, which requires that the prices charged between related parties are equivalent to those that would have been charged between non-associated independent persons in the same circumstances.

According to the amendment which entered into force on 1 January 2011, persons are deemed to be associated if they share a common economic interest or if one person has a dominant influence over the other. This amendment means tighter regulations for minimising the use of transfer pricing schemes between related parties.

If the value of a transaction conducted between a related parties differs from the value of similar transactions conducted between non-associated persons, income tax is charged either on the income which the taxpayer would have derived or the expense which the taxpayer would not have incurred if the value of the transaction conducted with the associated person had been such as applied by non-associated independent persons under similar conditions.

A resident company is required to submit additional information on the transactions with associated persons; the activity of companies belonging to the same group and structure of the group at the demand of a tax authority. The transfer pricing rules also apply to transactions concluded through or on account of the permanent establishment of a non-resident person.

The methods for determining the value of transactions are established by a regulation of the Minister of Finance. The transfer pricing methods are currently in use: comparable uncontrolled price; resale price; cost plus; profit split; and transactional net margin. The Estonian regulation recognises the "best method rule" for selecting the applicable transfer pricing method.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The system of corporate earnings taxation currently in force in Estonia is a unique system, which shifts the moment of corporate taxation from the moment of earning the profits to the moment of their distribution.

Until 31 December 2008, payments upon proceeds from liquidations, payments upon capital reductions and redemption or return of participation in a company were treated as capital gains of the natural person or non-resident recipient and shareholder. From 1 January 2009, these payments will generally be subject to corporate income tax in the hands of the payer: an Estonian company at the moment of distribution.

The implicit way to distribute profits is to do so through fringe benefits, gifts and donations, as well as expenditures and payments unrelated to business activity.

All of these profit distributions are taxed at a rate of 21/79 (or slightly over 26.6 per cent). This tax rate should not be deceiving. It is still the same rate of 21 per cent, as in the provisions for the taxation of salaried work payments. The difference is that 21 per cent is applied to gross payments and 21/79 is applied to net payments.

The resident legal person and the non-resident legal person acting through its permanent establishment registered in Estonia carrying out profit distribution has to pay 21/79 of the amount of profits distributed.

The income tax rate on:

- payments to a non-resident for services provided in Estonia;
- royalties; and
- payments made to a non-resident artiste, sportsman or sportswoman for activities conducted in Estonia,

is 10 per cent, unless a bilateral tax treaty between Estonia and the treaty partner specifies for a lower rate or exemption.

4.2 When is that tax generally payable?

Given the nature of the distribution tax, the relevant taxable period is the calendar month. The tax is payable by the 10th day of the month following the taxation period, i.e. the calendar month when the profits were distributed.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Corporate income is tax levied on:

- corporate profits distributed in the tax period; and

- taxable gifts, donations and representation costs, expenses and payments unrelated to business.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Since profits are not taxable upon generation, the profit shown in commercial accounts have no implications to the corporate income tax.

4.5 Are there any tax grouping rules? Do these allow for relief in Estonia for losses of overseas subsidiaries?

There are no special tax grouping rules in Estonia.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Retained profits are exempt from tax, whilst the rate of corporate income tax is currently 21/79 on the net amount of distributed profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The tax system in Estonia consists of state taxes provided for in and imposed by Acts concerning taxes and local taxes imposed by a rural municipality or city council in its administrative territory pursuant to law.

The following are other state (national) taxes:

- social tax;
- land tax;
- gambling tax;
- customs duty;
- excise duties (on fuel, packaging, alcohol, tobacco and electricity); and
- heavy goods vehicle tax.

The companies could be subject to the national taxes mentioned above.

4.8 Are there any local taxes not dealt with in answers to other questions?

The local taxes that are imposed by a rural municipality or city council regulation in compliance with the conditions provided by the Local Taxes Act are:

- sales tax;
- boat tax;
- advertisement tax;
- road and street closure tax;
- motor vehicle tax;
- animal tax;
- entertainment tax; and
- parking charges.

In September 2010, the Local Taxes Act abolished local municipalities' rights to establish sales taxes and boat taxes in their administrative area, as of 2012.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains are treated as ordinary income of resident companies, but they are taxed only where there is a profit distribution.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No, the tax imposed on capital gains is the same as that imposed on business profits.

5.3 Is there a participation exemption?

No, there is no participation exemption.

5.4 Is there any special relief for reinvestment?

No, there is no any special relief for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No taxes are imposed upon the formation of a subsidiary, except for state fees and notary fees.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no other such significant taxes or fees.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch are determined in the same way as for local companies, taking into consideration the specifications provided in the Income Tax Act. These are fringe benefits, gifts, donations and costs of entertaining guests, distributed profits, and expenses and payments not related to business made pursuant to commercial accounts.

The taxation basis for permanent establishments in Estonia was changed as of January 1, 2011. At present, taxation takes place when profits attributable to a permanent establishment are withdrawn from the permanent establishment in monetary or non-monetary form. Repatriated profits are not compared anymore to the value of the assets brought into the permanent establishment, but are immediately taxable upon repatriation.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

A branch shall pay income tax as a resident company, taking into consideration the specifications provided in the Income Tax Act.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

If its residency, prescribed on the basis of an international agreement ratified by the Parliament of the Republic of Estonia, differs from the residency prescribed pursuant to law, or if the agreement prescribes more favourable conditions for taxation of the income of non-residents than those provided by law, the provisions of the international agreement will apply.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax or other tax is imposed as a result of a remittance of profits by the branch.

7 Overseas Profits

7.1 Does Estonia tax profits earned in overseas branches?

Resident companies and permanent establishments of the foreign entities (including branches) are subject to income tax only in respect of all distributed profits (both actual and deemed), including dividends and other profit distributions, fringe benefits, gifts, donations and representation expenses and payments not related to business.

When a resident company or a non-resident legal person acting through its permanent establishment in Estonia has received payments from abroad, the income tax paid abroad may be deducted from the taxable amount of profit distributed in Estonia. Income tax paid in a foreign state on the income which was the basis of the payment not taxable in Estonia shall not be taken into account for deduction.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

A resident company (including a general or limited partnership) shall pay income tax on profit distributed as dividends or other profit distributions upon payment thereof in monetary or non-monetary form.

The income tax is not charged on dividends if:

- the resident company paying the dividend has derived the dividend which is the basis for the payment from a resident company of a Contracting Party to the EEA Agreement (hereinafter Contracting State) or the Swiss Confederation, which is taxable with income tax (except for companies located within a low tax rate territory) and at least 10 per cent of such company's shares or votes belonged to the company at the time of deriving the dividend;
- the dividend is paid out of profit attributed to a resident company's permanent establishment located in a Contracting State or the Swiss Confederation;
- the company paying the dividend has derived the dividend which is the basis for payment from a company of a foreign state not specified above (except for a company located within a low tax rate territory) and at the time of deriving the dividend, the company owned at least 10 per cent of the shares or votes of such company, and income tax has been withheld from the dividend or income tax has been charged on the share of profit which is the basis thereof (only the income tax subject to payment pursuant to law or an international agreement shall be taken into account); and
- the dividend is paid out of the profit attributed to a foreign permanent establishment of a resident company and such profit is subject to income tax (only the income tax subject to payment pursuant to law or an international agreement shall be taken into account).

7.3 Does Estonia have "controlled foreign company" rules and if so when do these apply?

Estonia has no traditional "controlled foreign company" rules (hereinafter CFC rules) for corporate taxpayers. The Estonian CFC rules apply only to resident individuals.

Income tax is charged on the income of a legal person located in a low tax rate territory and controlled by Estonian residents, irrespective of whether the legal person has distributed any profits to taxpayers or not. A territory is considered a low tax regime if the tax rate charged on profits earned or distributed amounts to less than 7 per cent. However, a legal person is not deemed to be located in a low tax rate territory if more than 50 per cent of its annual income is derived from real business activity or its country or territory of location will forward information about the income of CFC.

The Estonian Government publishes a "white list", which lists all countries and territories not considered to have a low tax regime. White listed countries are automatically considered as jurisdictions with adequate tax systems and specific anti-avoidance measures targeting low-tax jurisdictions are not applied to transactions with legal persons located in the white listed countries or territories. The list comprised mainly of Member States, income tax treaty partners and certain other OECD countries.

The Estonian Tax and Customs Board also publishes an informational "black list" for the purpose of advising taxpayers to be careful in transactions with companies located in listed countries. The "black list" is not legally binding, and the fact that a particular country is not on the list does not mean that the CFC provisions will not be applicable.

A legal person is deemed to be controlled by Estonian residents if one or several legal or natural persons who are Estonian residents own at least 50 per cent of the shares, votes or rights to the profits of the legal person directly or together with associated persons.

The income of a foreign legal person is deemed to be the taxable income of a resident if the condition prescribed above is fulfilled and the resident owns at least 10 per cent of the shares, votes or rights to the profits of the legal person directly or together with associated persons. The part of the gross income of a foreign legal person specified above which is attributable to a resident taxpayer is deemed to be the income of the taxpayer. The part attributable to a taxpayer is a proportional part of the income of the legal person, which corresponds to the holding of the taxpayer in the share capital, total number of votes or rights to the profits of the legal person. The part of the profits that already have been taxed is tax exempt upon actual distribution.

Resident natural persons shall declare the shares, votes and rights to the profits of a legal person located in a low tax rate territory which were held by them in the calendar year in their income tax returns.

8 Anti-avoidance

8.1 Does Estonia have a general anti-avoidance rule?

There is no general anti-avoidance rule in Estonia.

Tax authorities' rights and obligations to prevent and identify tax avoidance are specified in the Taxation Act.

If it is evident from the content of a transaction or act that the transaction or act is performed for the purposes of tax evasion, conditions which correspond to the actual economic content of the transaction or act apply (substance over form principle). Ostensible transactions shall not be taken into account upon taxation. If an ostensible transaction is entered into in order to conceal another transaction, the provisions concerning the concealed transaction apply upon taxation.

A taxable person is required to notify a tax authority of all facts known to the taxable person which are or may be relevant for taxation purposes. A taxable person shall not prevent a tax authority from performing procedural acts.

The keeping of accounts and accounting for taxation purposes shall be organised in a manner which enables an overview to be obtained within a reasonable period of time of the conduct of transactions and of facts relevant for taxation purposes, including revenue, expenditure, assets and liabilities.

A tax authority may, by way of estimation, establish facts which are the basis for making an assessment of tax payable. Estimation is permitted if the written evidence which is necessary to make an assessment of tax is incomplete, insufficient or unreliable or has been destroyed or is missing and if it is not possible to establish the facts on which the tax liability is based by means of any other evidence. Estimation is also permitted if the expenditure of a taxpayer who is a natural person exceeds his or her declared income and if the taxpayer fails to provide evidence proving that the expenditure has been incurred out of income which was taxed earlier or which is not subject to tax or out of loans taken. Estimation shall be based on the information collected in a matter, as well as on the business indicators and expenditure of the taxable person and comparisons with information ascertained in other similar tax matters.

If, upon verification of the correctness of payment of taxes, a justified doubt arises that, after imposition of a financial claim or obligation, the compulsory execution thereof may become considerably more difficult or impossible as a result of the activities of the taxable person, the tax authority may submit an application to an administrative court to be granted permission for the performance of the enforcement actions before the imposition of a financial claim or obligation (e.g. to apply for a prohibition on the disposal of a property to be entered in the register, to make a claim for payment against financial claims and proprietary rights, etc.).

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is not such requirement.

If it is evident from the content of a transaction or act that the transaction or act could be interpreted as evasion of payment of taxes, the tax authority provides, on the application of a taxable person, a binding assessment of taxation of an act or set of acts to be performed in the future. An application for a preliminary decision shall be submitted in writing to the tax authority and it shall include an exhaustive description of the planned act and analysis of the circumstances significant in terms of taxation, as well as an assessment of the applicant concerning the legal basis for the taxation of the act.

The tax authority shall disclose the summary of a preliminary decision on taxation of the acts of general importance and of the acts repeatedly described in applications on its website. When disclosing the summary, a tax authority shall take guidance from the obligation to maintain tax secrecy and shall not disclose data which enables identification of persons involved in the act.

Appendix 1

No.	Country	Beginning of validity	Riigi Teataja (State Gazette)
1	Republic of Latvia	01.01.2002 (retroactively)	RT II 2002, 33, 157
2	Kingdom of Norway	01.01.1994	RT II 1993, 32/33, 108
3	Kingdom of Denmark	01.01.1994	RT II 1993, 34, 109
4	Kingdom of Sweden	01.01.1994	RT II 1993, 35, 110
5	Republic of Lithuania	01.01.2006	RT II 2005, 24, 83
6	Republic of Finland	01.01.1994	RT II 1993, 37, 113
7	Federal Republic of Germany	01.01.1994 (retroactively)	RT II 1997, 20, 94
8	United Kingdom of Great Britain and Northern Ireland	01.01.1995	RT II 1994, 32/33, 139
9	Republic of Poland	01.01.1995	RT II 1994, 32/33, 140

10	Kingdom of the Netherlands	Protocol amending the convention between the Kingdom of the Netherlands and the Republic of Estonia, with protocol 01.01.2005 (retroactively)	RT II 2006, 6, 10
		Protocol amending the convention between the Kingdom of the Netherlands and the Republic of Estonia, with protocol 01.01.2010	RT II 2009, 11, 27
11	Republic of Iceland	01.01.1996	RT II 1994, 30/31, 131
12	Czech Republic	01.01.1996	RT II 1995, 1, 1
13	Canada	01.01.1996	RT II 1995, 44, 199
14	French Republic	01.01.1996 (retroactively)	RT II 1998, 16/17, 31
15	Ukraine	01.01.1997	RT II 1996, 42, 172
16	Republic of Belarus	01.01.1999	RT II 1998, 16/17, 30
17	Republic of Moldova	01.01.1999	RT II 1998, 33/34, 63
18	Republic of Ireland	01.01.1999	RT II 1998, 33/34, 62
19	United States of America	01.01.2000	RT II 1998, 40/41, 94
20	People's Republic of China	01.01.2000	RT II 1998, 52, 119
21	Republic of Kazakhstan	01.01.2001	RT II 2000, 16, 96
22	Italian Republic	01.01.2001	RT II 1998, 18/19, 32
23	Republic of Austria	01.01.2003	RT II 2002, 29, 134
24	Kingdom of Belgium	01.01.2004	RT II 2000, 25, 153
25	Republic of Armenia	01.01.2004	RT II, 2003, 2, 6
26	Republic of Malta	01.01.2004	RT II 2003, 2, 7
27	Portuguese Republic	01.01.2005	RT II 2004, 20, 83
28	Republic of Croatia	01.01.2005	RT II 2004, 19, 82
29	Swiss Confederation	01.01.2005	RT II 2004, 18, 79
30	Republic of Hungary	01.01.2005	RT II 2004, 19, 81
31	Kingdom of Spain	01.01.2005	RT II 2004, 41, 150
32	Romania	01.01.2006	RT II 2005, 26, 89
33	Republic of Turkey	01.01.2006	RT II 2005, 4, 12
34	Slovak Republic	01.01.2007	RT II 2005, 26 ,88
35	Republic of Slovenia	01.01.2007	RT II 2006, 13, 36
36	Hellenic Republic	01.01.2007	RT II 2006, 26, 69
37	Grand Duchy of Luxembourg	01.01.2008	RT II 2007, 1, 2
38	Republic of Singapore	01.01.2008	RT II 2007, 19, 55
39	Georgia	01.01.2008	RT II 2007, 23, 66
40	Republic of Azerbaijan	01.01.2009	RT II 2008, 26, 73
41	Republic of Bulgaria	01.01.2009	RT II 2008, 33, 100
42	Republic of Macedonia	01.01.2010	RT II 2009, 15, 39

43	Isle of Man	01.01.2010	RT II 2009, 30, 86
44	State of Israel	01.01.2010	RT II 2009, 30, 87
45	Republic of Serbia	01.01.2011	RT II 2009, 31, 93
46	Republic of Korea	01.01.2011	RT II 2009, 31, 92
47	Republic of Albania	01.01.2011	RT II 2010, 4

Jaak Siim

Aivar Pilv Law Office
Vabaduse väljak 10
Tallinn 10146
Estonia

Tel: +372 6 191 630
Fax: +372 6 404 653
Email: jaak@apilv.ee
URL: www.apilv.ee

Jaak Siim is an attorney in Tallinn, Aivar Pilv Law Office. He is a graduate of the University of Tartu, Institute of Law (2004). He joined Aivar Pilv Law Office in 2008, having previously worked for Estonian Customs Board and Estonian Tax and Customs Board. In 1999 he started his career as a specialist in the Legal Division of the Customs Enforcement Department of the Customs Board. Next he worked in the Legal Department of the Tax and Customs Board as the head of the Customs Law Division (2004-2005) and as the head of Special Proceedings Division (2005-2008). Jaak Siim has given lectures at Tallinn School of Economics in the field of customs law (2005-2006) and at different seminars. Jaak has been a member of the Estonian Bar Association and the International Fiscal Association (IFA) since 2009.

Ilmar-Erik Aavakivi

Aivar Pilv Law Office
Vabaduse väljak 10
Tallinn 10146
Estonia

Tel: +372 6 191 630
Fax: +372 6 404 653
Email: ilmar-erik.aavakivi@apilv.ee
URL: www.apilv.ee

Ilmar-Erik Aavakivi is a graduate of the University of Tartu, Faculty of Law (1995), and holds a scientific degree of magister iuris from University of Tartu (1999). He joined Aivar Pilv Law Office in 1998 having previously worked for Tallinn City Government and Law Office Ehasoo & Benevolenskaja. Ilmar-Erik Aavakivi has experience in representing the client, the Republic of Estonia, in an investor-state dispute initiated by Finnish and German banks under ICSID Convention. Ilmar-Erik is a member of the Estonian Bar Association since 1996 and fellow (member) of the Centre for International Legal Studies since 2003.

AIVAR PILV
LAW OFFICE

Aivar Pilv Law Office was founded in 1993. During the 15 years of activities we have thoroughly explored the wishes and needs of our clients. Our main aim is to render high-quality legal assistance on an internationally recognised level, which can be characterised by flexible and client-orientated service. Aivar Pilv Law Office has rendered legal assistance to Estonian and international business enterprises, as well as to public institutions. Our attorneys have diverse experience in representing the interests of the clients in different fields of law, including:

- civil law (contract law, property law, real estate law, corporate law, private international law, insurance law etc.);
- litigation and arbitration;
- bankruptcy and reorganisation;
- mergers and acquisitions;
- intellectual property and trademarks;
- tax and customs law;
- building and planning law;
- public procurement and competition law; and
- administrative (court) proceedings.

Aivar Pilv Law Office is a member of the international law offices' chain **TAGLaw** which guarantees the availability of legal assistance to our clients through trustworthy partners in different parts of the world.

For more information please visit our website at www.apilv.ee.

Finland

Ossi Haapaniemi

Hannes Snellman Attorneys Ltd

Outi Raitasuo

1 General: Treaties

1.1 How many income tax treaties are currently in force in Finland?

Finland has an extensive treaty network with appr. 100 tax treaties (including all kinds of tax treaties) currently in force or coming into force.

1.2 Do they generally follow the OECD or another model?

Finnish tax treaties generally follow the OECD model. Since the treaties are often tailored to the Finnish or a foreign tax system, there are a few exemptions from the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. Finland follows the so-called dualistic method. Therefore tax treaties must be incorporated into Finnish law by an act enacted by the Parliament.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, Finnish tax treaties do not incorporate anti-treaty shopping rules. However, the treaty with the US contains a limitation of benefits clause and the treaties with the UK and Ireland contain a limitation of relief clause. Pursuant to the general opinion in legal literature, domestic anti-avoidance rules can be applied in case of artificial arrangements. Furthermore, some treaties exclude certain entities from the scope of application.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

No. Tax treaties prevail over domestic legislation regardless of whether the domestic legislation is introduced prior or subsequent to them. However, please see what is stated on the use of anti-avoidance rules above, under question 1.4.

2 Transaction Taxes

2.1 Are there any documentary taxes in Finland?

Please see what is stated under question 2.5 below, regarding transfer tax.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes, Finland has VAT. In principle, all sales of goods and services are subject to VAT, however, the rate of VAT may vary. The standard rate is 23%. Besides the standard rate, there are reduced rates for certain supplies: 13% on e.g. foodstuffs; 9% on e.g. books and medicine.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In principle, all sales of goods and services are subject to VAT. However, certain supplies are exempted from VAT as permitted or required by Community Law. The following goods or services are exempted from VAT: i) financial and insurance services; ii) educational services; iii) medical services; iv) the selling and leasing of real property; and v) most corporate transactions such as transfers of business, and the sale and exchange of shares. However, VAT liability may arise if a transaction involves a transfer of assets located in Finland, with the exception of a transfer of a business or the removal of assets from Finland.

Even though the sale of real property itself is VAT-exempt it may trigger an obligation to recover VAT deductions made in respect of certain investments in the property, covering a ten-year period prior to the sale.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

When goods and services are supplied for a business subject to VAT, the VAT paid is fully recoverable. If only a part of the business is subject to VAT, only the VAT related to this business is recoverable. Certain goods or services used for entertainment purposes are, however, excluded from the general right of deduction.

2.5 Are there any other transaction taxes?

Yes, there is a transfer tax which is payable on the transfer of real property located in Finland and the securities of Finnish companies. The rate of the transfer tax is 4% of the transfer price of a real property and 1.6% of the transfer price of securities. However, the transfer tax is not payable on the transfers of publicly listed securities.

The party liable to pay the tax is the transferee of the real property or securities. If the transferee is neither a resident of Finland, a Finnish branch of a foreign credit institution, nor a financial services or fund management firm, the transferor must collect the tax from the transferee, as the tax authorities may collect the tax from transferor.

2.6 Are there any other indirect taxes of which we should be aware?

There are excise duties levied on alcohol, tobacco products, liquid fuels, electricity, sweets, waste, oil waste and oil damage. Furthermore, there are custom duties for goods imported from outside the internal EU market.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

In the absence of a tax treaty and provided that the EC Parent-Subsidiary Directive (90/435/EEC) does not apply, dividends paid to a non-resident company are taxed at source. The rate of the withholding tax is 28% (an increase to 30% is planned for 2012). However, dividends paid to a recipient residing in the European Economic Area ("EEA") are also exempted from tax in such cases where a similar, Finnish recipient would be exempted from tax. This may grant an exemption from withholding tax, e.g. for certain foreign investment funds and charitable entities. This amendment, which came into force in 2009, is based on the practice of the Court of Justice of the European Communities. Thus, any recipients of Finnish dividends within the EEA should consider reclaiming the withheld taxes retroactively.

Dividends paid to a Finnish permanent establishment ("PE") of a non-resident company are not subject to a withholding tax but are taxed as an income of the PE.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid to a non-resident are taxed at source, and thus subject to a withholding tax of 28% (an increase to 30% is planned for 2012), unless tax treaty provisions or the EC Interest and Royalty Directive (2003/49/EC) prevent taxation in Finland. However, the royalties paid to a Finnish PE of a non-resident company are not subject to a withholding tax but are taxed as an income of the PE.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

According to the internal law of Finland, interest paid to a non-resident is usually exempt from taxation in Finland, so no withholding tax is payable on interest payments. However, interest paid to a loan comparable to equity may be subject to a withholding tax.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Finnish tax law does not include a thin capitalisation rule. However, it is possible, in cases involving a clear tax avoidance situation, to apply the general anti-avoidance rule to deny the tax deductibility of interest on excess debt and to treat it as dividend for the purposes of withholding taxes. Due to recently enacted restrictions in deductibility of interest in many European countries, Finland has been considering similar restrictions including possible thin capitalisation rules. So far, no government bill has, however, been given on this subject.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

No, there are not any "safe harbour" provisions. However, in order to avoid problems in the deductibility of interest payments, the (at) arm's-length principle should be applied.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not applicable in Finland.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

As mentioned above under question 3.4, Finland has for some time been considering introducing restrictions to the deductibility of interest costs. So far, no government bill has been given, but in 2009 the Ministry of Finance published a report on potential alternatives for restricting interest deductions. The suggestions for restricting interest deductions include, among others, traditional thin capitalisation rules, interest deduction restrictions based on income statements (similar to e.g. the German EBIT / EBITDA based restriction), general anti-avoidance rules and withholding taxation of interest income for non-residents.

It is notable that even though no new restrictions have been introduced in the legislation level, the Finnish tax authorities have in tax practice adopted a stricter approach in matters concerning the deductibility of interest based on anti-avoidance rules (e.g. debt push downs). In addition, there is, e.g., a pending case in which the debt has been reclassified as equity based on transfer pricing rules.

3.8 Does Finland have transfer pricing rules?

Yes. The transfer pricing rules apply the arm's-length principle to all transactions between both domestic and international group companies. The rules also lay down a documentation obligation in cross-border situations.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Corporate income in Finland is subject to a flat rate tax of 26% (2011). A reduction of the corporate income tax rate to 25% is planned for 2012.

4.2 When is that tax generally payable?

Corporate tax is payable annually, approximately eleven months after the end of the financial year, but due to the advance tax system it is generally paid as monthly instalments throughout the financial year. The amount paid in the monthly instalments is determined on the basis of an estimate of the taxable income during a respective tax year provided by the taxpayer, or an estimation made by the authorities based on the taxable income of the previous year. If advance taxes are paid, the amount of taxes paid is deducted from the annual final payment.

There is also a possibility to make a supplementary tax payment within four months after the end of the accounting period of the respective tax year, to avoid cumulative interest on the final tax payment.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for corporate income is generally the statutory commercial accounts of the respective accounting period. However, this is subject to certain adjustments for tax purposes.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Certain expenses are not deductible for tax purposes and there are certain differences between the depreciation of assets for accounting and tax purposes.

There are also some tax free income items such as tax-free capital gains (see the answer to question 5.3 below) and dividends. Dividends derived from non-tax treaty countries outside of the European Union and 75% of the dividends from publicly listed companies received by non-listed companies which have an ownership stake of less than 10% are, however, not exempted.

Differences may also take place in connection of the taxation of income of a controlled foreign corporation ("CFC", please see answer to question 7.3 below) or income from a partnership (in both cases shareholder's or partner's share of a CFC's or partnership's income is taxable and actual distributions are exempted).

4.5 Are there any tax grouping rules? Do these allow for relief in Finland for losses of overseas subsidiaries?

No, Finland does not have group taxation. However, under the group contribution regime, group contribution between two Finnish resident companies or PEs is deductible, provided that certain preconditions are met. A group contribution is taxable income for the receiving entity and tax-deductible for the paying entity.

By giving a group contribution to a PE with debt, it may be possible to get a "double dip" on interest in some cross-border situations.

Cross-border group contribution is generally not allowed, but there are still pending cases related to situations where the group contribution has been given to a loss-making liquidated subsidiary in another EU country.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, tax is not imposed at a different rate upon distributed profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Finland has a municipal real property tax payable on owning real property, including buildings. The amount of real property tax varies between 0.3% and 3% of the value of the real property determined for tax purposes, depending on the real property and its use.

4.8 Are there any local taxes not dealt with in answers to other questions?

In addition to the taxes mentioned earlier, there are no other relevant local taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Generally, capital gains and losses are taxed as ordinary business income at the same rate of 26% (planned reduction to 25% in 2012) and the losses can be carried forward for ten years. However, there are a few limitations to the deductibility of losses derived from a passive (non-business) income source and from fixed asset shares. Capital losses attributable to the passive income source can only be deducted from capital gains arising from the same source and the losses can only be carried forward for five subsequent years. Regarding fixed asset shares, please see what is stated under question 5.3 below.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No. Capital gains are considered a part of business income and therefore taxed at a flat rate of 26% (planned reduction to 25% in 2012).

5.3 Is there a participation exemption?

Yes. A company can make tax-exempt capital gains by disposing of shares, provided that the conditions listed below are met. Correspondingly, losses from the disposal of such shares are non-deductible.

The tax exemption requires that the disposed shares:

i) give entitlement to an ownership of at least 10% of the share capital in the target company;

ii) have been owned for at least one year;

iii) are determined as fixed assets of the vendor;

iv) are not shares in a housing or a real estate company; and

v) are shares of either a Finnish company or a company subject to the EC Parent-Subsidiary Directive; or that there exists a tax treaty between Finland and the resident State of the company disposed of which must be applied to any dividend paid to the vendor.

Further, the exemption requires that the vendor is not deemed a private equity investor. In some cases the private equity investor status may be beneficial when holding fixed asset shares, since a private equity investor may be able to utilise the goodwill, included in the purchase price of the shares.

If these preconditions are not met, capital gains are taxable, as well as losses deductible against capital gains made on the disposal of shares during the five years following the disposal.

5.4 Is there any special relief for reinvestment?

Yes, there is a possibility to make a deduction corresponding to a taxable gain incurred in connection with (i) insurance compensation received due to the destruction of fixed assets by fire or other damage if new assets are acquired or the old ones are repaired within a span of two years, or (ii) capital gain from the sale of business premises if new premises are acquired within two years.

Other reliefs for reinvestment include exempted share exchange and business transfer provisions, where the capital gain incurred from the sale of shares or business assets is, in certain cases, exempted if the shares of the recipient are received as consideration. The tax is deferred until the shares received as consideration are sold in a taxable sale.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed upon the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no other significant taxes or fees of that kind.

6.3 How would the taxable profits of a local branch be determined?

Generally, all branches are obliged to arrange bookkeeping in accordance with Finnish GAAP. However, there are no specific rules which determine the profits allocable to a Finnish branch. In practice, non-resident companies are taxed on their income derived from Finland and PE's are taxed on all income attributable to the permanent establishment.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax. However, provided that a PE is constituted, branches are subject to the general corporate tax in Finland and taxed on the net profit attributable to the branch.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

No, apart from non-discriminatory rules (in case the branch forms a PE).

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, there would not be a withholding or other tax imposed in such cases.

7 Overseas Profits

7.1 Does Finland tax profits earned in overseas branches?

The profits of a Finnish company's branches abroad are generally included in the company's taxable income. A foreign tax credit is available for the branch's foreign taxes. Under some tax treaties, the branch's income may be exempted from Finnish tax (exemption method).

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by a Finnish company from a non-resident company are in many situations tax-exempt. Dividends derived from non-tax treaty countries outside of the European Union are, however, 100% taxable income for a Finnish company. Furthermore, 75% of the dividends from publicly listed companies received by non-listed companies which have an ownership stake of less than 10% are subject to the corporate income tax.

7.3 Does Finland have "controlled foreign company" rules and if so when do these apply?

There are CFC rules in place in Finland. The shareholder's share of a CFC's income is taxable as shareholder's income and actual distributions are exempted. A foreign company controlled by a Finnish tax resident may generally be regarded as a CFC, if the actual income tax level of the company is less than 3/5 of the corporate income tax level in Finland. There are important exceptions from this general rule. These concern e.g. companies mainly engaged in industrial production or shipping activities in the country of tax residence, companies resident in tax treaty countries (if neither subject to special tax reliefs nor resident in a black-listed tax treaty country) and companies resident in EEA countries or tax treaty countries with which Finland has sufficient information exchange arrangements in place (if *de facto* established and conducting business in that country).

8 Anti-avoidance

8.1 Does Finland have a general anti-avoidance rule?

There is a general anti-avoidance rule for preventing tax avoidance. According to the anti-avoidance rule, a legal form of a situation, or a measure which does not correspond to the true nature or purpose of the matter, shall be taxed as if the correct form had been used. In order to avoid the application of the anti-avoidance rule, the arrangement in question must have other than tax-related justifications (i.e. business reasons).

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no such requirement.

Ossi Haapaniemi

Hannes Snellman Attorneys Ltd
P.O. Box 333
00131 Helsinki
Finland

Tel: *+358 9 2288 4296*
Fax: *+358 9 2288 4323*
Email: *ossi.haapaniemi@hannessnellman.com*
URL: *www.hannessnellman.com*

Ossi Haapaniemi heads the tax group at Hannes Snellman. His fields of expertise include public and private M&A, capital markets, financial instruments, incentive schemes, EU tax law and tax litigation. Haapaniemi's career to date has included positions as tax auditor at a provincial tax office, tax manager at Arthur Andersen, as well as a director in charge of structuring and taxation of M&A and capital markets transactions at Evli Corporate Finance (later Evli Bank). He has vast experience and in-depth knowledge of corporate taxation, especially of financial instruments, corporate finance transactions and incentive schemes. He is a frequent speaker at seminars and has written numerous articles and books on taxation. In 2006, he successfully defended his tax law dissertation on the Tax Treatment of Stock-Based Incentive Schemes. He has been the Finnish IFA branch reporter in 2000 (the hybrid financial instruments) and 2009 (the foreign exchange issues).

Outi Raitasuo

Hannes Snellman Attorneys Ltd
P.O. Box 333
00131 Helsinki
Finland

Tel: *+358 9 2288 4263*
Fax: *+358 9 2288 4323*
Email: *outi.raitasuo@hannessnellman.com*
URL: *www.hannessnellman.com*

Outi has a broad international experience that ranges from mergers and acquisitions, company law and tax planning to asset financing transactions. Outi is a co-writer of books on tax planning and agency and distributorship agreements. She has won IFA's Mitchel B. Carrol Prize for her LL.M. thesis (University of Toronto). Outi's field of expertise include corporate and international taxation as well as structuring and taxation of M&A. She holds a board membership in a listed company.

HANNES SNELLMAN

Hannes Snellman is a Nordic law firm with a strong foothold in Russia. We focus on Transactions and Conflict Management in Copenhagen, Helsinki, Moscow, St. Petersburg and Stockholm. Hannes Snellman is perfectly suited to serve clients locally and cross-borders within these markets as well as to act as a gateway into them.

Hannes Snellman was founded a hundred years ago in 1909. Today the firm employs some 300 highly motivated, skilled and service-minded skilled professionals.

Hannes Snellman is ranked in the top tier by all major ranking publications, including all eminent tax-related expert guides and publications.

Hannes Snellman's tax group specialises in taxation and structuring of public and private M&A transactions, capital markets transactions, financial instruments, venture capital and other collective investment funds, incentive schemes and EU tax law.

Chapter 17

France

Yves Rutschmann

Bredin Prat

Marion Méresse

1 General: Treaties

1.1 How many income tax treaties are currently in force in France?

France has signed bilateral income tax treaties with around 120 countries or overseas territories and an increasing number of Tax Information Exchange Agreements ("*TIEAs*").

Income tax treaties have recently been signed with Hong-Kong and Panama but are not yet in force. The income tax treaty with Denmark ceased to apply as from January 1, 2009 and has not been renewed. An amendment to the bilateral income tax treaty was signed with Belgium in 2009 but is not yet in force.

1.2 Do they generally follow the OECD or another model?

Most of the tax treaties signed by France follow the OECD model, subject to certain specifications and reservations.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Tax treaties, once they have been ratified by the French Parliament and the President of the French Republic, apply directly without having to be incorporated into French law.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

As set forth in the OECD model, tax treaties frequently contain anti-treaty shopping rules for dividends, royalties and interests, notably by referring to the notion of "beneficial owner". Some provisions are more specific (e.g. the "limitation of benefits" article included in the treaty signed with the U.S, the similar one in the treaty signed with Japan, the "limitation of tax reliefs" article included in the treaty signed with Cyprus and the new anti-abuse article of the treaty signed with Switzerland).

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Once duly ratified, tax treaties override any existing or subsequent domestic law (except the Constitution), provided that the other contracting party applies the treaty.

2 Transaction Taxes

2.1 Are there any documentary taxes in France?

France does not levy any stamp duties on documents evidencing transactions.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Any supply of goods and services made for consideration, within the French territory, by an entity that independently carries on an economic activity (such as industrial or commercial transactions), is generally subject to VAT. The standard rate for VAT is 19.6%, but some products/services, such as food, books, medicines or catering, are subject to lower rates (5.5% or 2.1%).

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

French law provides for a number of transactions that are VAT-exempt subject to certain conditions, the main ones being exportations or intra-EU deliveries, certain banking and financial activities, insurance and reinsurance operations or transfers of a totality of assets ("*universalité totale ou partielle de biens*").

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

As a general rule, entities liable to VAT may recover VAT charged on goods and services used in the course of their business for transactions subject to VAT. Entities that are not liable to VAT may not recover VAT. As a general rule, entities that are partially liable to VAT (i.e. entities carrying on activities subject to VAT and activities which are not subject to VAT) may only partly recover VAT (i.e. after application of a VAT *pro-rata*).

2.5 Are there any other transaction taxes?

Transfers of corporate rights and certain types of assets give rise to transaction taxes, which apply to the transfer price – or the fair market value, whichever is higher – at a fixed, progressive or proportional rate.

Regarding the sale of corporate rights, the following rates apply:

- 3%, capped at EUR 5,000, for the transfer of shares issued by a "*société anonyme*", a "*société en commandite par actions*", or a "*société par actions simplifiée*", except if they qualify as non-listed real estate companies ("*sociétés à prépondérance immobilière*"). No tax is due upon the sale of listed companies' shares when no deed has been drawn up for the transfer;

- 3% - uncapped - for the transfer of corporate rights issued by corporate entities, the capital of which is not divided into shares. Except for real estate companies, a relief equal to EUR 23,000 divided by the total number of shares is applied to the value of each share; and
- 5% - uncapped - for the transfer of shares issued by non-listed real estate companies, irrespective of their form.

Regarding the sale of assets, the following rates generally apply:

- 5.09006% for the transfer of real-property assets located in France (however, in some cases, such transfers may be subject to VAT instead); and
- free up to 5% for the transfer of a going-concern (3% on the part of the price that exceeds EUR 23,000 up to EUR 200,000, and 5% over EUR 200,000).

2.6 Are there any other indirect taxes of which we should be aware?

Some activities or transactions may be subject to specific taxations (e.g. custom duties on goods imported from outside the EU, excise duties on wine, liquor or tobacco).

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends paid by a French company subject to CIT to a non-resident are in principle subject to a 25% withholding tax (or 19% for EU-resident individuals, subject to certain conditions). Such rates may be reduced or eliminated under tax treaties. However, the withholding tax rate is 50% for dividends paid outside of France in a Non-Cooperative State or Territory (a "*NCST*"), with respect to the exchange of certain tax information (such states or territories are listed each year by the French authorities).

No withholding tax applies on dividends paid by a French subsidiary subject to CIT to its EU parent company (within the meaning of the EU Directive 90/435), if the recipient has directly held (or has undertaken to hold) at least 10% of the shares of the subsidiary for at least two years.

Anti-abuse provisions apply when the beneficiary is ultimately controlled by non-EU resident companies and when the main reason or one of the main reasons for the structure is to take advantage of the withholding tax exemption.

The French withholding tax may be reduced or cancelled in certain specific cases to conform to EU law. The French tax authorities have for example admitted that, pursuant to the ECJ's "*Denkavit*" decision dated December 14, 2006, dividends distributed by a French subsidiary subject to CIT, to its parent company subject to CIT, located in the EU and holding at least 5% in the subsidiary' share capital for at least two years, may, subject to certain conditions, benefit from a withholding tax exemption. Pursuant to a French case law dated February 13, 2009 "*Sté Stichting Unilever Pensioenfonds Progress*", an exemption is also likely to apply to pension funds located in the EU, with respect to dividends received from French subsidiaries.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid by a French company to a non-resident are generally subject to a 33 1/3% withholding tax, which may be reduced or eliminated under tax treaties. However, if the non-resident is located in a NCST, the rate of the withholding tax is 50%. However, this 50% withholding tax does not apply to certain royalties if the company proves that the transaction is real and its main purpose and effect are not to transfer income into a NCST.

No withholding tax applies on royalties paid by a French company to an EU resident company, both subject to corporate income tax, if one of those two companies has directly held (or has undertaken to hold) at least 25% of the share capital of the other for at least two years, or if a third company has directly held (or has undertaken to hold) at least 25% of the shares of the first and the second companies for at least two years.

Anti-abuse provisions apply when the beneficiary is ultimately controlled by non-EU resident companies and if the main reason or one of the main reasons for the structure is to benefit from the withholding tax exemption. Such provisions also apply in case of excessive royalty payments (but only to the fraction that is not considered to be at arm's length).

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest payments made by a French company to non-residents are generally not subject to any withholding tax, but for interest payments made outside of France in a NCST, which are subject to a 50% withholding tax (except if such payments are received with respect to certain contracts entered into before March 1, 2010), unless the company proves that the main purpose and effect of the transaction are not to transfer income into a NCST.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

- Interest paid by a French company to its direct shareholders is deductible for the fraction that does not exceed a certain interest rate (the "statutory interest rate threshold"), which is based on the average annual rate used by banking establishments for minimum two-year maturity loans granted to companies (e.g. 3.82% for the fiscal year 2010), provided that the borrowing company's share capital is fully paid up.
- Moreover, the tax deductibility of interest paid by a French company on loans and advances granted by related enterprises (i.e. enterprises that: (i) directly or indirectly control the company; (ii) are controlled by the company; or (iii) are controlled by an enterprise that directly or indirectly controls the company), is capped to the higher of:
  - the aforementioned statutory interest rate threshold; or
  - the rate that the French company may have obtained from unrelated financial institutions under comparable circumstances.

Interest that does not exceed the above-described interest rate limitations is not tax-deductible for the fraction that exceeds the highest of the following thresholds, unless said fraction is lower than EUR 150,000:

- the amount of said interest multiplied by the ratio of 1.5 x the company's net equity/the average amount of indebtedness owed to related enterprises over the relevant fiscal year (the "debt-equity ratio");
- 25% of the company's adjusted earnings before tax and

exceptional items; and

- the amount of interest received by the company from related enterprises.

Subject to certain conditions, interest disallowed for a given fiscal year pursuant to the second set of limitations will nonetheless be deductible from the company's taxable income of the following fiscal years.

Thin capitalisation rules do not apply to certain financial operations or enterprises (e.g. cash pooling arrangements, credit institutions, etc.).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

A "safe harbour" provision authorises the tax deduction of interest paid to related enterprises, irrespective of the second set of limitations (see question 3.4) if the company evidences that its own debt-to-equity ratio does not exceed the debt-to-equity ratio of its group.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

For fiscal years closed as from December 31, 2010, the scope of French thin capitalisation rules has been broadened to loans granted by non-related parties but guaranteed by related parties, subject to specific safe harbours:

- public issuance bonds;
- guarantees consisting in the sole pledge of the borrower's shares or of receivables against the borrower (or of shares of an entity of the same tax consolidated group which directly or indirectly holds the borrower);
- guarantees granted following the reimbursement of a prior debt falling due by reason of a takeover of the debtor; and
- guarantees granted for loans contracted prior to January 1, 2011 to acquire shares or refinance such acquisitions.

Draft guidelines of the French tax authorities on these new rules are under study.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No tax relief applies to interest paid or due by a French company to a person located in a low tax jurisdiction (as defined in question 3.8 below), unless the paying company proves that the interest corresponds to real transactions and is not excessive.

Moreover, no tax relief applies to interest paid or due by a French company to a person located in a NCST, unless the company proves that (i) the interest corresponds to real transactions and is not excessive, and (ii) the main purpose and effect of the transaction are not to transfer income into a NCST.

These restrictions also apply to any interest payment made on a bank account held by a financial institution located in a low tax jurisdiction or a NCST.

In addition, the tax deduction of interest payments may be challenged by the French tax authorities if the debt incurred by the local company does not comply with the normal management of the company, i.e. for instance, if the French company's indebtedness is excessive with respect to its ability to face the payment of the interest and the reimbursement of the debt over a reasonable period of time.

Finally, French tax authorities may also try to challenge the deduction by qualifying the loan as an equity instrument instead of a debt instrument.

3.8 Does France have transfer pricing rules?

Under French law, profits indirectly transferred by a French company controlling or controlled by a foreign company, through an increase or decrease of purchase or sale prices or through any other means, such as payment of excessive royalties, are taxable in France.

French tax authorities must prove both the indirect transfer of profits and the control between the French and the foreign company, unless the latter is located in a low tax jurisdiction (i.e. a jurisdiction where it pays less than half of the income tax it would have paid if established in France).

French and foreign companies may negotiate advance pricing agreements with the French tax authorities and the relevant foreign authorities.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The standard CIT rate is 331/3%, to which a 3.3% surcharge (based on the amount of CIT less a relief of EUR 763,000) is added, resulting in an effective CIT rate of 34.43%.

French law provides for a number of temporary CIT exemptions (e.g. newly created companies, companies established in certain parts of the French territory). Moreover, companies which have an annual turnover lower than EUR 7,630,000 and whose fully paid-up share capital is at least 75% held by individuals or by similar companies, are subject to a reduced CIT rate of 15% on their first EUR 38,120 of profits, and are exempt from the 3.3% surcharge.

Special rates apply for long-term capital gains (see question 5.1).

4.2 When is that tax generally payable?

CIT is prepaid in four instalments (on March 15th, June 15th, September 15th, and December 15th), which are assessed on the previous financial year taxable results, subject to specific provisions for the first instalment. The balance, if any, is due on the 15th of the fourth month following the end of the fiscal year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

CIT is based on commercial accounts pursuant to French GAAP, subject to specific adjustments for tax purposes.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main adjustments made on the commercial accounts, so as to compute CIT, are the following:

- excessive depreciation, provisions or expenses that are not deductible for tax purposes, CIT and other non-deductible taxes, interest disallowed under thin capitalisation rules, net long-term capital losses on certain assets, share in the profits of look-through entities for tax purposes and positive results of the marked-to-market valuation of certain specific financial instruments have to be added back; and

- the amount of dividend received by the company which benefits from the French participation exemption regime has to be deducted, minus 5% of the amount of the dividend. Net long-term capital gains, non-tax-deductible provisions added back to the commercial result of the concerned fiscal year, shares in the losses of look-through entities for tax purposes and distribution received from such entities and the negative result of the marked-to-market valuation of certain specific financial instruments also have to be deducted.

4.5 Are there any tax grouping rules? Do these allow for relief in France for losses of overseas subsidiaries?

A French company, or a French branch of a foreign company, holding directly or indirectly (either through a French company or, subject to certain conditions, through an EU-resident company or a Norwegian or Icelandic company) at least 95% of the capital and voting rights of other French companies or branches of foreign companies, may elect to form a tax-consolidated group with said subsidiaries or branches. All the tax-consolidated group's members must be subject to French CIT and have the same financial year; the parent company must not be held at 95% or more by another French company subject to French CIT, either directly or indirectly through companies subject to CIT and held by 95% or more by such other French company.

The group head company is liable to CIT on the group taxable result, which is calculated by adding all members' profits and losses, subject to certain adjustments (such as the neutralisation of certain intra-group transactions).

Except for small and medium-sized enterprises and subject to specific conditions, French tax law does not expressly allow for relief of losses incurred by non-French subsidiaries. The possibility to offset losses incurred by subsidiaries located in the EU and held at 95% or more by a French tax consolidated company against French tax consolidated profits, pursuant to ECJ's "*Marks & Spencer*" decision dated 13 December 2005, seems debatable in the absence of case law from the French highest courts or administrative guidelines on this matter.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

The CIT rate does not depend on whether or not the profits are distributed or retained; the same rate applies in both situations.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Apart from social security charges, the main taxes applicable to enterprises are:

- A wage tax ("*taxe sur les salaires*") is due by employers that are not subject to VAT on at least 90% of their previous year's turnover. It is assessed on the amount of salaries and benefits in kind paid to employees and the applicable rate goes from 4.25% to 13.6%.
- A 3% annual tax on real estate is due by any French and foreign entity, which directly or indirectly owns real estate assets or rights over such assets located in France. The tax is assessed on the fair market value of such assets. Various exemptions apply: the tax is not due by entities which own French real estate assets representing less than 50% of their French assets, by listed entities and their wholly-owned subsidiaries, by retirement funds or non-profit organisations subject to certain conditions.
- Other national taxes apply such as apprenticeship tax, tax on corporate cars, etc.

4.8 Are there any local taxes not dealt with in answers to other questions?

- Since January 1, 2010, companies engaged in a business in France are no longer subject to the former business tax ("*taxe professionnelle*") but to a new local tax ("*Contribution Economique Territoriale*" or "CET"), subject to certain exemptions. Such tax consists of: (i) a land tax generally assessed on the cadastral value of developed or undeveloped property/land ("*Cotisation foncière des entreprises*"), at a rate differing from one local authority to another; and (ii) a tax based on the added value of companies whose turnover exceeds EUR 152,500 ("*Cotisation sur la valeur ajoutée des entreprises*"), at a rate of 1.5%. Some allowances apply depending on the companies' turnover. The total amount of the CET is capped to 3% of the added value, upon request of the taxpayer, and cannot be lower than a certain amount of *Cotisation foncière des entreprises*, as defined by the local authorities.
- Real property tax on developed property/undeveloped land ("*taxe foncière*") is based on the net cadastral value of said property/land (50%/80% of the cadastral value). The rate differs from one local authority to another.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains are subject to CIT at the standard rate, except for capital gains mentioned below.

For fiscal years opened as from January 1, 2011, capital gains on the following fixed assets, when held for at least two years before sale, are exempt, except for a 10% recapture of the net capital gain, resulting in an effective taxation of 3.44%:

- shareholdings recorded as "*titres de participation*" under French GAAP; and
- shares qualifying for the parent-subsidiary tax-regime or shares that have been acquired by way of a takeover bid by the initiator, when those shares are booked in a "*titres de participation*" account or in a special sub-account named "shares eligible to the long-term capital gains regime" of the relevant account.

A specific tax regime applies to capital gains on shareholdings in real estate companies ("*sociétés à prépondérance immobilière*") qualifying as long-term investments "*titres de participation*" for tax purposes:

- a 19% rate applies to shareholdings in listed real estate companies; and
- the standard CIT rate applies to shareholdings in non-listed real estate companies.

A 15% rate finally applies to:

- shareholdings in certain high risk mutual funds and venture capital firms held for five years or more (however, subject to certain conditions, the capital gain realised upon the disposal of such shareholding could benefit, totally or partially, from the aforementioned exemption); and
- proceeds deriving from the licensing of patents, patentable

inventions and industrial manufacturing processes and sales of such intellectual property rights, under certain conditions.

Moreover, capital gains mentioned above are generally subject to the 3.3% surcharge (see question 4.1). The aforementioned reduced rates do not apply to the transfer of shareholdings in companies established in a NCST.

For fiscal years closed as from December 31, 2010, taxation of capital gains and deduction of losses incurred upon the transfer of shares held for less than two years to a related party is deferred until the shares are effectively transferred to a non-related party (for capital gains, such regime is optional).

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

See question 5.1.

5.3 Is there a participation exemption?

See question 5.1.

5.4 Is there any special relief for reinvestment?

No relief for reinvestment is provided under French tax law with respect to capital gains taxation.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

As a general rule, contributions made in exchange for shares are tax-exempt.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no specific taxes or fees.

6.3 How would the taxable profits of a local branch be determined?

A foreign company's French branches are subject to CIT under the same rules as French companies on the profits they made within the French territory, as if they operated independently from the company of which they are a permanent establishment.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Such branches are subject to French CIT. Their after-tax profits are deemed to be distributed to their foreign shareholders, and thus subject to a 25% withholding tax (or 50% for NCSTs), which may be reduced or cancelled under tax treaties. It does not apply to branches of an EU-resident company subject to CIT.

The withholding tax can be revised on the basis of the amount of effectively distributed profits, or if the branch proves that such profits have been distributed to a French resident.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As a general rule, a branch cannot benefit from tax treaty provisions as it is not, as such, considered as a resident within the meaning of the tax treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

See question 6.4.

7 Overseas Profits

7.1 Does France tax profits earned in overseas branches?

Under French law, profits earned in overseas branches are not subject to CIT in France.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by a French company from non-resident companies are subject to CIT. However, under the parent-subsidiary regime, the taxation at CIT for such dividends is limited to a 5% recapture if the French company holds at least 5% of the share capital of its foreign subsidiary for at least two years.

For fiscal years opened as from January 1, 2011, the parent-subsidiary regime does not apply to dividends received from companies established in NCSTs. Moreover, for fiscal years closed as from December 31, 2010, this regime is no longer applicable in situations where a dividend distribution is followed by a transaction occurring less than two years after the acquisition of the shares of the distributing company and resulting in an exchange of shares, for which the parent company does not claim for a deferral of taxation of the gain or loss deriving from such exchange.

7.3 Does France have "controlled foreign company" rules and if so when do these apply?

Under French CFC rules, if French companies subject to CIT carry out the business of an enterprise in low tax jurisdictions (as defined in question 3.8), or hold, directly or indirectly, more than 50% of shareholdings or financial or voting rights in an entity established in such countries, the profits generated by those enterprises or entities are subject to CIT in France. The ownership threshold is reduced to 5% if more than 50% of the foreign entity is held by French companies acting in concert or through entities controlled by the French company.

These CFC rules do not apply to profits generated by entities established in EU-countries unless the scheme is artificial, or, subject to certain conditions, if the profits of the foreign enterprise or entity derive from an industrial or commercial activity effectively performed in the low tax jurisdiction (in this respect, more stringent conditions apply for entities established in NCSTs). According to the French tax authorities' guidelines, the CFC rules also do not apply if the French company can prove that the principal effect of the activities performed by the foreign enterprise or entity is not to transfer profits to low tax jurisdictions.

8 Anti-avoidance

8.1 Does France have a general anti-avoidance rule?

Under French tax law, tax avoidance schemes may be challenged under abuse of law provisions ("*abus de droit*") (including the cases of fraud), if the scheme is (i) fictitious, or (ii) real, but: (a) seeks the benefit of a literal application of a provision or a decision that (b) would be contrary to the intentions of their authors; and (c) was motivated by the sole intent of avoiding or alleviating the tax burden of the taxpayer.

An 80% penalty applies to tax reassessed under the abuse of law procedure, reduced to 40% if the taxpayer is neither the main initiator of the scheme nor its main beneficiary.

Moreover, French tax law provides for a range of specific anti-avoidance regimes, such as, for example, regulations limiting transfer pricing (see question 3.7) and the CFC regime (see question 7.3).

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Under current law, there are no mandatory disclosure obligations concerning tax-planning schemes.

Yves Rutschmann

Bredin Prat
130 rue du Faubourg Saint Honoré
75008 Paris
France

Tel: +33 1 4435 3500
Fax: +33 1 4289 1073
Email: yvesrutschmann@bredinprat.com
URL: www.bredinprat.com

Yves Rutschmann is a partner at Bredin Prat specialising in French and international tax. He has developed a particular expertise in tax issues relating to French and cross-border mergers, corporate restructuring and private equity transactions. Prior to having joined Bredin Prat, he was an associate at CMS Bureau Francis Lefebvre (1995-2002). Yves Rutschmann graduated from the French business school *Hautes Etudes Commerciales* (HEC, 1992) and the University of Paris Law School (Maîtrise and D.E.S.S. in French Business and Tax Law, 1994). He has been a member of the Paris Bar since 1995. He is also fluent in English.

Marion Méresse

Bredin Prat
130 rue du Faubourg Saint Honoré
75008 Paris
France

Tel: +33 1 4435 3500
Fax: +33 1 4289 1073
Email: marionmeresse@bredinprat.com
URL: www.bredinprat.com

Marion Méresse joined Bredin Prat in 2011. She graduated from the French business school Hautes Etudes Commerciales (HEC, 2009) and the University of Paris II Panthéon Assas (Master in International Tax Law, 2009). She is also fluent in English.

Chapter 18

Germany

Richard Engl

P+P Pöllath + Partners

Gerhard Specker

1 General: Treaties

1.1 How many income tax treaties are currently in force in Germany?

Income tax treaties with 90 countries were in force on January 1, 2011. Moreover, negotiations on first-time treaties are carried on with 10 countries in Eastern Europe, South America, Asia and Africa. 38 treaties are going to be amended in the near future. A treaty with Liechtenstein has been signed for the first time and will come into force soon.

1.2 Do they generally follow the OECD or another model?

Germany's tax treaties are usually based on the OECD model. Therefore, the official commentary to the OECD model may be used for the interpretation of most provisions in the German treaties. However, some of the treaties, especially those with developing countries, incorporate elements of the UN model treaty. The treaty between Germany and the United States reflects many peculiarities of the United States treaty policy.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

According to German constitutional law, treaties must be incorporated into national law by the federal legislator. This requires the consent of both chambers of the parliament in the form of a federal law. Therefore, the federal law implementing tax treaties must be approved by the *Bundestag* and the *Bundesrat* and is finally signed by the Federal President (*Bundespräsident*) and promulgated in the Federal Law Bulletin (*Bundesgesetzblatt*).

This legislative procedure has to be distinguished from the process of ratification of the treaty by exchanging documents in which (in case of Germany) the Federal President declares that the requirements for the internal applicability of the treaty have been met. Only upon such ratification does the treaty become binding under international law.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, Germany's tax treaties did not include anti-treaty shopping rules. However, such rules have been adopted, in particular in many of the more recent treaties. Several treaties contain general anti-abuse clauses that may be interpreted in a way to permit the application of domestic anti-abuse rules within the scope of the treaty provisions. If the application of such anti-abuse clauses leads to double taxation, some of the treaties oblige the countries to open the mutual agreement procedure. This type is represented by about 13 treaties, especially the one with Switzerland.

Upon consultation between the parties, several treaties allow the application of the tax credit method instead of the exemption method to avoid a double tax exemption of income or to counter arrangements that lead to an abuse of the treaty (e.g. the treaties with Austria, Denmark, India, Mexico, Norway, Pakistan, Poland, Russia, Singapore, Sweden, United Kingdom, Ukraine, USA, Venezuela, and Vietnam). Furthermore, some treaties exclude the application of reduced withholding tax rates for dividends, royalties or interest payments if such treaty benefits are claimed without reasonable economic justification (e.g. Ghana, Korea, Kazakhstan, Mexico, Russia, United Kingdom, and Uzbekistan).

A detailed and very complex limitation-on-benefits clause is part of the treaty between Germany and the United States. This clause has become even more rigid as of 2008 after the new protocol amending the U.S./Germany treaty has become effective.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In principle, tax treaties incorporated into German law prevail over statutory law, as provided for in the German General Tax Code. However, this conflict rule, like tax treaties after their implementation, has the status of ordinary statutory law and competes against the general "*lex specialis*" and "*lex posterior*" rules. Tax treaties are not superior to ordinary law and, therefore, domestic legislation may override a tax treaty that was concluded previously if it is expressly aimed at abrogating the treaty provision by establishing a deviating rule. Treaty overrides have been used by the German tax legislator for about 20 years, mainly in order to combat tax structures and schemes that it suspected of being abusive. Notwithstanding the effective priority, constitutional admissibility and legality of such a "*lex posterior*" under domestic German law, treaty overriding by the legislator constitutes an infringement of international law, which can only be invoked by the other treaty state.

2 Transaction Taxes

2.1 Are there any documentary taxes in Germany?

Germany does not levy any stamp duties on transactions and has abolished the capital transfer tax.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The German Value Added Tax Act is based on the EC Directive 2006/112/EC, i.e. on the common system of value added tax (the former Sixth EC Directive). The standard rate of VAT is currently 19% (as of 2007); a reduced rate of 7% applies to a limited number of supplies of goods or services.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

There are several tax exemptions for certain supplies of goods or services. The most relevant of these exemptions apply to:

- financial services by banks or other financial institutions (waiver of tax exemption possible);
- the transfer of shares in a corporation or interest in a partnership (waiver possible);
- the transfer of real property (waiver possible); and
- the lease of real property (waiver under certain conditions possible).

The waiver of a tax exemption is allowed only if the respective services are rendered to a taxable party ("entrepreneur") for its respective business. The transfer of a business as a going concern, however, is not only tax-exempt but is not a taxable event at all. The sale of a real property that is leased out generally constitutes a transfer of a business as a going concern that is not taxable.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input VAT on supplies is fully recoverable by an "entrepreneur" if the respective supplies are wholly used to render taxable supplies that are not tax-exempt. Input VAT on supplies that are used to render tax-exempt supplies is, in principle, not deductible. However, especially for several cases of tax-exempt cross-border supplies, the deduction of input VAT is allowed. If an "entrepreneur" renders both taxable and tax-exempt services, input VAT on supplies for both has to be split up according to the respective percentage of taxable supplies to determine the deductible part of input VAT.

The most notable restriction concerns the letting of real property: on such a supply, a waiver of the tax exemption is permitted only if the lessee uses (or intends to use) the property exclusively for supplies subject to tax on its part. This rule results in a loss of input VAT to lessors letting real property, e.g. to banks, insurance companies or doctors or for residential purposes.

2.5 Are there any other transaction taxes?

The transfer of German real property is subject to German Real Estate Transfer Tax at a rate of 3.5% up to 5% of the purchase price, or – in case there is no consideration – of the property's value. The basic tax rate is 3.5% but has been increased by many German states recently (4% for real property located in Saarland; 4.5% for real property located in Berlin, Hamburg, Sachsen-Anhalt, Niedersachsen and Bremen; 5% for real property located in Brandenburg, Thüringen, Nordrhein-Westfalen and Schleswig-Holstein; increases by further German states are expected). Real Estate Transfer Tax also becomes due if 95% or more of the interests in a partnership owning German real property are transferred within a period of five years or if 95% or more of the shares in a corporation owning German real property are acquired by the same party (or affiliates of such party).

2.6 Are there any other indirect taxes of which we should be aware?

German Insurance Tax applies at a standard rate of 19% on the payment of insurance premiums for several types of insurance contracts. Excise duties are levied on certain kinds of goods, e.g. on fuel.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

The general withholding tax rate for dividends paid by a German corporation to non-resident shareholders was raised to 25% as of 2009 (20% until 2008). Non-resident corporations, however, may generally apply for a refund of 40% of the tax withheld on the dividends received. Thus, their effective withholding tax rate will equal the general Corporate Income Tax rate in Germany (15%). Moreover, a further refund or total relief from the withholding tax on dividends may be available according to a tax treaty or the EC parent-subsidiary directive, however this is subject to Germany's anti-treaty shopping rules which provide for certain substance requirements (currently subject to EU dispute resp. unilateral reduction of some of the substance requirements).

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalty payments by a local company to non-residents are, in principle unilaterally, subject to a 15% withholding tax on the gross amount. Under most German tax treaties, the withholding tax on royalty payments is reduced to between 0% (in particular in treaties with OECD countries) and 10%. Within the European Union no withholding tax is due on royalties paid by a German company (or a European company that has a German branch) to an associated company in another Member State of the EU, according to the EC Interest and Royalties Directive 2003/49/EC, as incorporated into German law.

However, any reduction or exemption (by treaty or EC Directive) is granted only upon prior application.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

No withholding tax on interest payments to non-residents is levied, unless the amount of the interest depends on the profits of the borrower or the terms and conditions of the loan are not at arm's length and, therefore, result in treatment of the interest as constructive dividends.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

As of 2008, a general limitation to the deduction of interest payments was introduced regarding both shareholder loans and all third party loans. According to the so-called interest deduction ceiling ("*Zinsschranke*"), interest expenses exceeding interest earned (net interest) will only be deductible up to 30% of the corporation's EBITDA. The interest deduction ceiling will apply:

(a) if the overall net interest exceeds €3m; and

(b) in case the corporation does not belong to a group of companies:

- if "harmful debt financing" occurs, i.e. debt financing by shareholders, related parties or third party lenders with recourse to such shareholders, and interest paid/owed for such debt exceeds 10% of the overall net interest; or

(c) in case the corporation belongs to a group of companies:

- if "harmful debt financing" occurs in any group company and the financing shareholder, related party and/or third party who have recourse to a shareholder or related party is not part of the group; or
- the equity ratio of the tax-paying company is lower than the one of the consolidated group.

Net interest that is not deductible under these rules becomes deductible, however, up to the amount of EBITDA carried forward from the preceding five years. The remainder of non-deductible net interest is carried forward into the following years.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The interest deduction ceiling is only applied (and then to all interest) if the overall net interest charge of the borrowing corporation exceeds €3m. To the extent by which the net interest charge does not exceed 30% of the corporation's EBITDA, the interest deduction ceiling does not apply and interest expenses are fully deductible.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The interest deduction ceiling (in force as of 2008) extends to loans granted by third parties, anyway. A guarantee given by a parent company with respect to a third party loan may have an additional negative effect insofar as it may be considered as "harmful debt financing" and, therefore, prevent the application of an "escape clause" (see question 3.4 above).

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no such restrictions (except treatment as a constructive dividend, as mentioned in question 3.3 above).

3.8 Does Germany have transfer pricing rules?

Generally, transactions between related parties with German corporations involved must comply with the dealing-at-arm's-length principle. Apart from tax treaties, this principle is also part of domestic German law, which, as of 2008, provides for much more detailed rules according to which an "acceptable" market price has to be computed for tax purposes. Also, more detailed documentation requirements were introduced over the past years with regard to cross-border transactions.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The aggregate tax burden of corporations was reduced from almost 40% to just around 30% by the Corporate Tax Reform 2008.

As of 2008 the German Corporate Income Tax rate went down from 25% to 15%. In addition, Solidarity Surcharge of 5.5% is levied on the amount of Corporate Income Tax due, resulting in an aggregate tax rate of 15.825%.

German corporations are also subject to Trade Tax. The basic Trade Tax rate is 3.5% as of 2008; it is supplemented by the application of a multiplier fixed by the respective municipality that varies from a minimum rate of 200% (prescribed by federal law), up to around 500% in the large cities. Therefore, the effective Trade Tax rate ranges from 7% to around 17.5%. As of 2008, the amount of Trade Tax due is not treated as business expense anymore and, therefore, cannot be deducted from the Corporate Income Tax base as well as the Trade Tax base itself. As a result, corporations are subject to Corporate Income Tax (including Solidarity Surcharge) and Trade Tax at a combined rate of at least 22.825% and up to 33.325%.

4.2 When is that tax generally payable?

Both Corporate Income Tax and Trade Tax are assessed on an annual basis. However, the determination of the corporation's taxable income may refer to a 12-month period deviating from the calendar year. In addition, corporations are obligated to quarterly pre-payments of Corporate Income Tax and Trade Tax, based on an estimate of the current year's tax amount due.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In principle, the corporation's net income determined according to German commercial accounting principles is also the Corporate Income Tax base. However, tax law provides for several adjustments for tax purposes, e.g. restrictions on the deduction of certain business expenses or 95% exemptions for dividends received or capital gains derived from the sale of shares in other corporations.

The corporation's net income for Corporate Income Tax purposes also serves for the computation of the Trade Tax base, which is, however, subject to further specific adjustments. There are several add-backs and also exclusions for Trade Tax purposes exclusively, e.g. the add-back of 25% of interest payments on debt, the add-back of 12.5% of lease payments for immovable fixed assets, 5% for movable fixed assets and 6.25% for royalties.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

For tax purposes, the commercial accounting principles are overruled by several tax accounting provisions, mainly to restrict accounting options allowed by commercial law to prevent taxpayers from influencing their tax base. For example, tax rules with regard to the valuation and depreciation of assets or the accumulation of accruals have been tightened and restricted repeatedly over the past years.

As of 2009, tax accounting options may be exercised independently from the commercial balance sheet. As a consequence, assessments in the tax balance sheet may deviate from those in the commercial balance sheet.

4.5 Are there any tax grouping rules? Do these allow for relief in Germany for losses of overseas subsidiaries?

German tax grouping rules for Corporate Income Tax purposes (*Organschaft*) require a more than 50% shareholding in a subsidiary and a profit and loss absorption agreement according to German commercial law concluded by the group parent company and the subsidiary and executed for a period of at least five years. As a result, the subsidiary's net income is attributed to the group parent company for Corporate Income Tax and Trade Tax purposes. However, only subsidiaries in the legal form of a German corporation or European Stock Corporation (SE) who have their legal seat or place of management in Germany can be part of such tax group. Therefore, a German tax group cannot have foreign group members and does not allow cross-border use of losses as losses from foreign subsidiaries cannot be offset within the tax group.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Under the rules of the current shareholder relief system (in force since 2002 and staying on as of 2008), the corporation's Corporate and Trade Tax rate is not reduced in case of profit distributions.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The German Property Tax (Net Worth Tax) has not been levied any more since 1997 for constitutional reasons.

Real Estate Tax is levied on German real estate; the respective tax rate is fixed by the municipalities and is applied to the value of the real property.

The transfer of property including business assets and participations in partnerships and corporations by way of succession or donation is subject to German Inheritance and Gift Tax. Although the valuation rules have been completely revised by the recent reform of the Inheritance and Gift Tax Act (as of 2009), business assets are still subject to favourable valuation rules if certain conditions are met.

4.8 Are there any local taxes not dealt with in answers to other questions?

No significant local taxes apply to corporations (apart from the right of the municipalities to fix the multiplier applicable to the Trade Tax rate; see question 4.1 above, and to the Real Estate Tax rate).

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

In principle, capital gains are included in the tax base of Corporate Income Tax and Trade Tax. However, the German Corporate Income Tax Act provides for a 95% tax exemption of capital gains received by corporations on the disposition of shares in German or foreign corporations. The tax exemption applies irrespective of a minimum shareholding or a minimum holding period. In return, losses from the sale of such stakes are disregarded for tax purposes and not deductible from the tax base.

Capital gains received by individuals on the sale of shares in corporations are taxable if the shares belonged to a business or if the individual's participation in the corporation exceeded a threshold of 1% of the capital. In these situations, 40% of such capital gains are tax-exempt. Capital gains received by individuals from the sale of shares (<1%), which were held as private assets, are subject to a flat tax of 25% as of 2009, irrespective of the holding period. Until 2008, such capital gains were taxable (to the extent of 50%) only if the respective shares had been held less than one year.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains received by corporations are not subject to a special tax rate but to a partial tax exemption. The same applies to capital gains received by individuals if the participation was held among their business assets or exceeded 1% of the capital (for the extent of the respective tax exemption, see question 5.1). Capital gains received by all other individuals, however, are subject to a special flat rate of 25% as of 2009 (see question 5.1). In principle, this tax rate will apply to all kinds of capital income of individuals.

5.3 Is there a participation exemption?

The 95% tax exemption for capital gains also applies to dividends received by a corporation. A minimum shareholding or a minimum holding period is not required for Corporate Income Tax purposes, whereas for Trade Tax purposes the 95% tax exemption of dividends (not that of capital gains) requires a minimum shareholding of 15% as of the beginning of the respective fiscal year.

5.4 Is there any special relief for reinvestment?

A rollover relief is available if capital gains from the disposition of certain assets (especially real property) are reinvested in the acquisition of similar assets within a period of four years. Due to the extensive capital gains exemption (see question 5.1), no rollover relief is available upon the disposition of shares by corporations.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The formation of a subsidiary is not subject to any special taxes in Germany.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No special taxes would be incurred, but notary fees on the notarisation of the articles of incorporation would become due on the formation of a German limited company (*GmbH*) or stock corporation (*AG*).

6.3 How would the taxable profits of a local branch be determined?

For tax purposes, a branch located in Germany is treated like an economically separate entity, although it is legally a part of the parent company. Thus, the taxable profits of the branch are determined according to the direct method. In order to separate the proper earnings of the branch from those of the parent company, separate tax accounting including the attribution of capital, assets, business expenses and income to the branch for tax purposes is required. However, the separate entity approach does not include the exchange of goods and services between branch and parent company, which is disregarded for tax purposes.

The German branch of a foreign head office in the legal form of a corporation is subject to German Corporate Income Tax and Trade Tax as if it were a German corporation. It is, therefore, for example, entitled to the 95% exemption of dividends received from other corporations and of capital gains derived from the sale of shares in other corporations in the same way as a German corporation (see questions 5.1 and 5.3).

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

The taxable income of a branch is, in principle, computed according to the same rules as they are applicable to any other German business taxpayer.

There is no branch profits tax in Germany; the remittance of profits by the branch to its head office is irrelevant for German tax purposes.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

The head office, but not the branch itself, is entitled to treaty benefits because a branch is legally a part of its head office and not a resident for tax treaty purposes. However, non-discrimination clauses in tax treaties usually oblige the contracting states to treat branches like corporations resident in their jurisdiction. For European Union Member States, a discrimination of branches would also be prohibited by the freedom of establishment.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax applies to the remittance of profits by a German branch to its head office.

7 Overseas Profits

7.1 Does Germany tax profits earned in overseas branches?

Profits earned in foreign branches are not subject to German Trade Tax (see question 4.1) but included in the Corporate Income Tax base of German corporations. However, these profits are usually exempt from German income taxation under Germany's tax treaties or subject to a credit system provided for by a tax treaty or by German national law.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Foreign dividends received by German companies are subject to the general exemption system for dividends, providing for a 95% exemption for dividends received by a corporation (see question 5.3).

7.3 Does Germany have "controlled foreign company" rules and if so when do these apply?

The German "controlled foreign company" rules apply to foreign corporations that are subject to low taxation (an income tax rate below 25%) and controlled by shareholders resident in Germany holding more than 50% of the capital or the vote of the foreign corporation. Then, passive income earned by these foreign corporations is treated as taxable income of the German shareholders. Passive income is all income that is not active income, as defined by the German Foreign Tax Act. These rules do not apply to controlled foreign companies resident in EU/EEA Member States if the shareholders provide evidence for economic substance of the foreign corporation in the respective Member State.

8 Anti-avoidance

8.1 Does Germany have a general anti-avoidance rule?

The German General Tax Code provides for a general anti-avoidance rule with respect to all kinds of taxes. This rule allows the German tax authorities to disregard the legal form of a transaction agreed upon among the parties, if such transaction is regarded as an abuse of legal arrangements without valid reasons other than tax savings not intended by the respective tax act.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no special disclosure rule for avoidance schemes. However, the burden of proof for the above-mentioned valid reasons rests with the taxpayer. In 2007, a legislative initiative by the German government to introduce a disclosure rule that would oblige taxpayers to disclose avoidance schemes in advance to the Federal tax authorities failed.

Germany

Richard Engl

P+P Pöllath + Partners
Fünf Höfe, Kardinal-Faulhaber-Str. 10
80333 Munich
Germany

Tel: *+49 89 2424 0490*
Fax: *+49 89 2424 0999*
Email: *Richard.Engl@pplaw.com*
URL: *www.pplaw.com*

Richard Engl is a German tax consultant (*Steuerberater*) and joined P+P Pöllath + Partners in 2007. He has practised tax law since 1976 and was a partner in a leading German tax and law firm (1982-1995) and thereafter self-employed. He is well recognised by independent rankings as one of Germany's leading senior tax advisers.
He focuses on advising multinationals in corporate tax law, pre- and post-acquisition restructuring, international cross-border transactions (both in- and out-bound and including transfer pricing issues and solving tax audit disputes) and reorganisations. His publications include articles on taxation, and he is author as well as editor of special books dealing with legal and tax aspects of the reorganisation of groups of companies. He studied at the University of Regensburg and the Penn State University (PA).

Gerhard Specker

P+P Pöllath + Partners
Potsdamer Platz 5
10785 Berlin
Germany

Tel: *+49 30 2535 3220*
Fax: *+49 30 2535 3999*
Email: *Gerhard.Specker@pplaw.com*
URL: *www.pplaw.com*

Dr. Gerhard Specker was admitted to the bar and joined P+P Pöllath + Partners in 2006.
He specialises in German and international tax law, including tax structuring for acquisitions (M&A) and tax litigation. He studied law at the Universities of Münster and Rome (*Roma Tre*) and worked as assistant at the Institute of Tax Law at the University of Münster; Ph.D. in 2005.
He is the author of various articles on German tax law. In addition, he is also a lecturer at postgraduate courses of studies at the Universities of Münster and Potsdam.

P+P Pöllath + Partners
Attorneys-at-Law · Tax Advisors
www.pplaw.com

P+P

P+P Pöllath + Partners is an internationally operating law firm, whose 33 partners and nearly 100 lawyers in Berlin, Frankfurt and Munich specialise in legal and tax advice.

P+P advisors have been consistently ranked at the top of professional listings in national and international surveys. In 2011, many P+P partners have been ranked as "leading" or "highly recommended" in M&A, private equity, real estate, private clients and tax.

P+P offers creative and state-of-the-art full service expertise and independent judgment to entrepreneurs, businesses, investors, management, investment banks, etc. in the following areas:

Transactions

- mergers & acquisitions
- corporate
- private equity / venture capital / alternative assets
- investment fund formation / structuring / screening
- tax structuring
- real estate transactions
- listings and delisting
- succession
- dispute resolution

Asset Management

- trusts, foundations
- private clients
- succession
- financial products
- tax rulings, audits

P+P is completely independent and cooperates with leading professionals in other firms in Germany and other jurisdictions, as well as with other advisors, banks, etc. The majority of our clients are based outside Germany.

For more information (including on *pro bono* work and P+P foundations) please visit our website @: www.pplaw.com

Greece

Elisabeth Eleftheriades

KGDI Law Firm

Panagiotis Pothos

1 General: Treaties

1.1 How many income tax treaties are currently in force in Greece?

As of January 1 2011, there are 54 bilateral income tax treaties in force to which Greece is a party. Following the exchange of the necessary notifications in 1995, the treaty signed in 1986 with Czechoslovakia applies to both the Czech Republic and Slovakia. Greece's income tax treaty network covers all of the EU Member States, as well as the following countries: Albania; Armenia; China; Croatia; Egypt; Georgia; Iceland; India; Israel; Korea (Rep. of); Kuwait; Mexico; Moldova; Norway; Russia; South Africa; Switzerland; Turkey; Ukraine; the USA; and Uzbekistan. In addition, the most recent bilateral income tax treaties signed are with Azerbaijan, Canada, Morocco, Qatar, Saudi Arabia, Serbia & Montenegro and Tunisia.

1.2 Do they generally follow the OECD or another model?

Almost all income tax treaties that Greece has entered into have been drafted alongside the OECD Model Tax Convention on Income and Capital. However, each tax treaty must be examined separately, since variations do exist as a result of negotiations between contracting states. By exception, the treaties with the USA and the UK deviate from the Model as they were concluded before the adoption of its first draft in 1963.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Treaties signed by Greece are not automatically incorporated into Greek law. According to Article 36.2 of the Greek Constitution 1975/1986/2001/2008, treaties are domestically enacted upon ratification by virtue of a statute voted by the Greek parliament, promulgated by the President of the Greek Republic and published in the Official Government Gazette. Of course, treaties specify the dates upon which they enter into force, as well as upon which their provisions take (even retroactive) effect.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Most treaties signed by Greece do not incorporate anti-treaty shopping rules or limitation of benefits articles. An exemption to the above rule is the treaty signed with Luxembourg, which provides that its provisions do not apply to the so-called Luxembourgian holding companies. However, recent treaties to which Greece is a party (such as those in force with Belgium, Ireland, Malta, Mexico, Portugal, Spain and Ukraine) include provisions denying the granting of treaty benefits concerning interest and royalties if related payments are effected mainly for the purpose of taking advantage of treaty provisions and not for *bona fide* commercial reasons.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

According to Article 28 of the Constitution, international treaties ratified by Greece prevail over any contrary statutory provision and therefore may not be overridden by any, other than constitutional, existing or subsequently introduced rules of domestic law.

2 Transaction Taxes

2.1 Are there any documentary taxes in Greece?

In the past, stamp duties had been the main documentary Greek tax. However, the field of application of stamp duty taxation has been significantly reduced, mainly due to its substitution by VAT since 1987. Pursuant to the applicable legislation, analogous stamp duties are applicable at varying rates (1% to 3%, which are increased by a supplementary charge, equal to 20% of each rate, levied in favour of the Agricultural Insurance Organisation) to certain transactions exempted from VAT, such as third party (non-entrepreneurs) fees, rental payments from the letting of properties used for business purposes, loan contracts (loans granted by banks are exempt), payment of directors' fees, sale of movable goods by an individual to any party, etc. On the other hand, fixed stamp duties are payable only in relation to projects, budgets, studies and reports drawn up by engineers and architects submitted to public authorities responsible for issuing building permits or approving public works projects, as well as in relation to various permits issued or renewed by public authorities.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Greek VAT legislation is in line with the provisions of the Sixth European Council Directive (Greece has partially adjusted the Greek VAT Code to the provisions of the recast VAT Directive

2006/112/EC). The standard VAT rate is set at 23%, whereas the reduced rates are set at 13% and 6.5%. Furthermore, upon fulfilment of specific conditions, the above VAT rates are reduced by 30% (i.e. to 6.9% 3.9% and 1.95% respectively), as regards the islands in the prefectures of Lesvos, Chios, Samos, the Dodecanese, the Cyclades, and the Aegean islands of Thasos, Samothrace, the northern Sporades and Skyros.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

On the condition that the place of supply is within the Greek territory, VAT is imposed at every stage of the manufacturing and distribution process and more specifically on the following categories of transactions:

i) supply of goods or services for consideration within the Greek territory by a taxable person;

ii) importation of goods into Greece;

iii) intra-community acquisition of goods, other than new means of transport, effected in Greece for consideration by a taxable person or by a legal entity (not being a taxable person), which acquires goods from another Member State above the threshold of €35,000;

iv) intra-community acquisition of new means of transport effected in Greece for consideration; and

v) goods or services used by the entrepreneur for his personal purposes or the purposes of his personnel.

On the other hand, Greek VAT law provides for two categories of exemptions:

i) those with retention of the right to deduct input VAT (e.g. exports, intra-community supplies, importation/supply/chartering of certain ships and aircrafts, services connected with the transport of persons), which are therefore treated as zero-rated supplies; and

ii) those without retention of the right to deduct input VAT (e.g. services of hospitals, medical and paramedical professions, supply of goods and services closely related to social welfare and insurance, services of general education and vocational training, most banking services, most financial transactions, letting and leasing of immovable property).

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Taxable persons are entitled to fully deduct the tax charged on goods and services supplied to them (input VAT) from the tax collected by them (output VAT), provided that they use those goods and services in connection with transactions subject to VAT or in connection with transactions exempted from VAT but with retention of the right to deduct input VAT (see above under question 2.3). On the other hand, input tax relating to goods and services wholly used in the course of exempted (without retention of the right to deduct input VAT) or non-business supplies, is not recoverable.

If taxable persons are involved in both taxable and exempt supplies, VAT on expenditure, which may not be directly attributable to either supply, is apportioned using the ratio of taxable output (excluding VAT) to the total output (excluding certain revenues).

With regard to capital goods, input VAT recovery is subject to a 5-year settlement commencing in the year of acquisition.

At the end of the financial year, excess output tax is paid to the tax authorities, whereas excess input tax is either carried forward or, if such carry-over is impossible, refunded.

There is no entitlement to recovery in the following cases:

i) purchase or importation of tobacco industry products;

ii) purchase or importation of alcoholic beverages not to be used in taxable activities;

iii) receptions, recreation and hospitality generally;

iv) provision of accommodation, food, drinks, transport and recreation for the personnel or representatives of a company;

v) purchase or importation of passenger vehicles with up to nine seats intended for private use, motorcycles, motorised pedal cycles, water-borne crafts and aircrafts for pleasure or sporting purposes and the costs of fuel and maintenance for such conveyances; and

vi) purchase and importation of types of packaging covered by delivery guarantee.

2.5 Are there any other transaction taxes?

The transfer for consideration of the title of real estate located in Greece is subject to real estate transfer tax. The tax, being assessed on the higher between the objective value of the real estate and the consideration provided in the contract, is borne by the buyer. The objective value system covers almost all Greek urban areas and has been introduced in order to eliminate disputes between the tax authorities and taxpayers, concerning the basis of assessment of real estate transfer tax. The rates are 8% for the first €20,000 and 10% for any excess. An additional tax in favour of the municipality is also levied at a rate of 3% of the real estate transfer tax calculated above. VAT is imposed with regard to the first transfer by constructors of ownership and other rights on buildings, for which the building licence is issued on or after 1 January 2006.

Furthermore, the sale of shares in corporations not listed on the Athens Stock Exchange are subject to a special transaction tax at the rate of 5%, calculated on the higher amount between the contractual sale price and the imputed sale price, which is assessed on the basis of a specific formula. However, if a gain is realised from the sale of non-listed shares, the 5% tax does not extinguish the income tax liability and the gain is added to the taxable income, with a credit being given for the 5% tax paid. The above special tax does not apply if the seller of shares is resident in a tax treaty country and does not have a permanent establishment in Greece.

Finally, the proceeds from the sale of shares in corporations listed on the Athens Stock Exchange are subject to tax at the rate of 0.2 % if acquired before December 31 2011. Said tax shall be substituted by a capital gains tax for shares acquired as of January 1 2012 (see question 5.1).

2.6 Are there any other indirect taxes of which we should be aware?

In the case of imports from non-EU countries, the Common External Customs Tariff of the EU is applicable. The rates of import duties vary on the basis of the classification of the imported goods.

In addition, private and public passenger vehicles, vehicles for transport of goods and motorcycles (either imported or locally produced) are subject to classification duties, which are assessed on the basis of the vehicles' engine size and, in case of used vehicles, their age.

Furthermore, various consumption duties are levied on special commodities such as alcohol, tobacco, petroleum products, etc.

Besides the above, a turnover tax is imposed on insurance companies. Such tax is payable on insurance premiums and all charges accruing from insurance contracts, and its rate varies according to the sector of insurance (e.g. 20% for fire insurance premiums, 4% for life insurance premiums and 10% for premiums for other sectors).

Finally, an annual contribution of 0.6% is imposed on the average outstanding monthly balance of each loan granted by a bank to a Greek resident. The rate is reduced to 0.12% with respect to housing loans. Loans between banks, loans to the Greek State, loans funded by the EIB and loans granted to persons residing in small islands are exempted from said contribution.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

A withholding tax at the rate of 25% is imposed on profits distributed by Greek locally resident companies (SA's and LtD's) as dividends or interim dividends to their shareholders, whether physical persons or legal entities, resident or non-resident within FY 2012 onwards. Such withholding tax exhausts the tax liability of the beneficiaries. This withholding exhausts any further tax liability for resident individuals. Especially for individuals taxed at a rate lower than 25%, the difference is recovered.

The above withholding tax does not apply to dividends paid between associated companies, falling within the scope of the EU Parent-Subsidiary Directive, as incorporated into Greek law.

If the recipient of the dividend income is a resident of a State with which Greece has concluded an income tax treaty for the avoidance of double taxation, the withholding tax rate provided by said treaty, if more beneficial to the recipient, will apply.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In principle, royalties paid by a local company to a non-resident company without a permanent establishment in Greece or a non-resident individual, who does not exercise any profession or business in Greece, are subject to withholding tax at a rate of 25%. The local company paying the royalties deducts the amount of withholding tax at source. Once the tax has been thus withheld, the income tax liability of the non-resident in respect of the royalty income concerned is exhausted.

It should be noted that, with respect to the EC Interest and Royalties Directive, Greece enjoys a transitional regime, according to which it shall levy a withholding tax on royalty payments effected between associated EU companies at a rate of 5% for a four-year period commencing on July 1 2009, at the end of which (i.e. on June 30 2013) it shall abolish any taxation on such payments.

If the recipient of the royalty income is a resident of a State with which Greece has concluded an income tax treaty for the avoidance of double taxation, the withholding tax rate provided by said treaty, if more beneficial to the recipient, will apply.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest paid by a local company to a non-resident company without a permanent establishment in Greece is subject to a withholding tax at a rate of 40%. The tax thus withheld is final and terminates the income tax liability for the interest income concerned. On the other hand, interest paid by a local company to a non-resident individual, who does not exercise any profession or business in Greece, is subject to a withholding tax at the rate of 20%, extinguishing any tax liability of the recipient related to the interest earned. The local company paying the interest deducts the amount of withholding tax at source. Once the tax has been thus withheld, the income tax liability of the non-resident in respect of the interest income concerned is exhausted. On the other hand, interest derived directly by non-residents from bonds and other interest-bearing securities, including zero-coupon bonds, issued by resident companies, is exempted from Greek tax.

With respect to the EC Interest and Royalties Directive, Greece enjoys a transitional regime, according to which it shall levy a withholding tax on interest payments effected between associated EU companies at a rate of 5% for a period of four years commencing on July 1 2009, at the end of which (i.e. on 30 June 2013) it shall abolish any taxation on such payments.

If the recipient of the interest income is a resident of a State with which Greece has concluded an income tax treaty for the avoidance of double taxation, the withholding tax rate provided by said treaty, if more beneficial to the recipient, will apply.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

For the first time, but in a rather simplified form, thin capitalisation provisions have been introduced into the Greek tax system, pursuant to which accrued interest of loans or credits, which are paid or credited to related enterprises on the basis of agreements concluded on or after July 22 2009, are deducted, on the condition that the relation of these loans or credits to the net assets of the enterprise does not exceed the ratio of 3:1 on average per fiscal year, whereas accrued interest on loans and credits exceeding this ratio are not deductible.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There is no safe harbour by reference to which tax relief for interest is assured. However, leasing and factoring companies, special securitisation vehicles registered in Greece, financial institutions, stock brokers, and asset management companies are exempted from the scope of application of the above "thin capitalisation" provisions.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Interest from loans granted by non-related enterprises and guaranteed by a parent company is deductible, although these loans are added to the total amount of loans received by the company in order for the abovementioned ratio (under question 3.4) to be calculated.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Interest payments deriving from loans received for the acquisition of shares or parts of domestic or foreign companies or even for the acquisition of an enterprise are not deductible when the acquired shares are transferred within 2 years from their acquisition.

Interest payments to entities established in black-listed countries (i.e. non-EU countries which have not executed a Treaty of Mutual Administrative Assistance with Greece and other 12 countries in tax issues) as well as to entities located in beneficial tax regimes (i.e. countries where the income tax rate is equal or lower than 60% of the corresponding Greek tax rate) are not deductible. In order to escape the anti-avoidance rules, the taxpayer can evidence the *bona fide* nature of the transactions falling within the abovementioned scope.

3.8 Does Greece have transfer pricing rules?

The principal transfer pricing provision of Greek tax law incorporates the arm's length principle (Article 39 of Law 2238/1994, Greek Income Tax Code, and ITC). The main provisions were replaced with a new Article 39 and the introduction of a new Article 39A.

The law provides for the following:

- Where domestic affiliated enterprises are involved in transactions for the sale of goods or for the provision of services, and the price or the fee is unjustifiably higher or lower than that which would have been agreed in transactions carried out with another enterprise under the market circumstances prevailing at the time the transaction took place, the difference (in the price or fee) is assumed to be business profit. This difference increases the net business profits of the enterprise without jeopardising the validity of its books and records.
- Where the sale of goods or provision of services takes place between domestic and foreign affiliated enterprises under financial terms different from those that would have been agreed between unrelated enterprises, profits which would have been earned by the Greek enterprise, if such terms did not apply, but which the Greek enterprise did not realise because of the said terms, are treated as business profit. This profit increases the net business profits of the enterprise without jeopardising the validity of its books and records.
- With respect to inter-corporate transactions carried out between foreign and Greek enterprises, the latter are obliged to maintain transfer pricing documentation; if differences are noted during the audit, the case is referred by the competent audit authority to a specific Committee.
- The new provision applies to enterprises related to each other in a relationship of direct or indirect substantial administrative or financial dependence or control.
- In case of non-compliance with the provisions of Article 39 of the ITC, a fine of 20% is imposed on the additional net profits arising, irrespective of the imposition of additional taxes, if any, surcharges and other penalties currently provided for under the law.
- The new regime applies to income or expenses arising during financial years for which the obligation to file an income tax return arises with effect from January 1 2011 and onwards.

According to the new Article 39A of the ITC, all domestic enterprises operating under any legal form in Greece (including permanent establishments) and qualifying as an enterprise affiliated to a foreign enterprise are obliged to provide data and information required for the documentation of transactions between them.

Domestic enterprises which are members of multinational groups can fulfil their transfer pricing documentation obligation through the maintenance of a "documentation file" consisting of:

- The "*basic documentation file*" is common for all the enterprises of the group and contains common uniform information for all the affiliated companies and branches of the group. The "basic file" includes the data in the basic file of the Ministry of Development, as well as certain additional data, such as: (i) a general description of the affiliated companies of the group participating in the transactions being audited, and of the transactions themselves, but not only of the transactions which relate to the Greek companies in the group; (ii) a list of cost allocation agreements; and of court decisions concerning the members of the group, related to the determination of the transactions' prices; and (iii) written declarations from each enterprise-member of the group for the provision of supplementary information.
- The "*Greek documentation file*", which supplements the "basic file" and contains additional information related to the Greek enterprises of the group (this information appears also to be included in the Greek file prepared for the purposes of the Ministry of Development). By virtue of a decision of the Minister of Finance, the particular issues that are necessary for the application of the above will be determined as well as the language in which the above information, methods, manners and procedures for the determination of the prices for such transactions, whereas the content of the file provided for in Article 26 of Law 3728/2008 will be taken into account in the course of the issuance of the above decision.

Enterprises whose gross annual income does not exceed EUR 1.5 million must maintain simpler and limited documentation which will be determined by virtue of a decision of the Minister of Finance. Further, transactions between the same enterprises which concern the same subject matter and do not exceed an annual limit of €200,000 are also exempted.

The documentation maintained by domestic enterprises must be delivered to the competent tax authority in the course of an audit, upon the auditor's request within a 30 days deadline.

The above will apply to transactions effected in fiscal years for which the obligation to file an income tax return arises from January 1 2011 onwards.

Article 105 (4) of the ITC provides that the arm's length principle set out in Article 39 of the ITC will apply to the commercial or economic cooperation between the foreign head office and the Greek branch of a foreign entity.

All treaties concluded by Greece for the avoidance of double taxation include a transfer pricing article identical or substantially similar to Article 9 of the OECD Model Convention. In addition, Greece has implemented the EC Arbitration Convention (Convention 90/436/EEC of July 23 1990 on the Elimination of Double Taxation in connection with the Adjustment of Profits of Associated Enterprises, as amended) with respect to the 26 other Member States (Laws 2216/1994, 3537/2007 and 3417/2005).

The Ministry of Development has introduced transfer pricing documentation rules for financial year 2008 and onwards (Law 3728/2008), in parallel with the rules of the Ministry of Finance. The tax authorities will be notified by the auditors of the Ministry of Development where a violation has been identified.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of income tax on profits of domestic corporations is set at (20%) for accounting periods commencing from January 1 2011 and thereafter.

An additional tax of 3% is levied on gross income derived from immovable property. Such additional tax cannot exceed the tax calculated on the company's income.

A special tax regime applies to resident, as well as non-resident companies owning and operating Greek-flagged ships.

4.2 When is that tax generally payable?

Income tax on corporate profits is payable in eight equal monthly instalments; the first of which must be paid upon the timely filing of the annual income tax return. The latter must be filed within four months and ten days from the end of their accounting year. The other seven instalments must be paid on the last working day of each of the months following the month in which the return was filed. Corporations must also effect an advance payment equal to 80% of the tax corresponding to declared income at the end of the accounting period, which is refunded if in excess of the final income tax liability of the following year. Such rate of advance payment is increased to 100% in the case of resident banks and branches of non-resident banks operating in Greece.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Net income before distribution, arising from operations either at home or abroad, constitutes the tax base for corporate income tax further to adjustments on the tax return. Such income is derived from the company's profit and loss account, which is prepared on the basis of its official accounting books maintained in accordance with the regulations of either Greek GAAP and the Greek Code of Books and Records or International Accounting Standards/International Financial Reporting Standards. Please note that all Greek listed companies and their consolidated participations are subject to mandatory IFRS application. In determining the net income of the company, those deductions from its gross income specifically authorised by law and directly associated with the business activity of the company are allowed.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

For the purposes of assessing a company's annual corporate income tax base, the following adjustments take place:

i) non-deductible expenses are added to net profits;

ii) profits from participation in other entities that have been subject to income tax are deducted therefrom;

iii) tax-free or specially taxed income is further deducted therefrom (in the case of banks and insurance companies only part of the tax-free or special taxed income is deducted);

iv) the part of the debt interest, if any, relating to tax-free income, specially taxed income and income from participations is added thereto (such rule does not apply to banks, insurance companies, mutual funds and investment companies);

v) 5% of tax-free income, specially taxed income and income from participations, which however cannot exceed 20% of the company's expenses, is further added thereto (such rule does not apply to banks, insurance companies, mutual funds and investment companies); and

vi) taxable profits of a company are increased by the amount of tax-free or specially taxed income that corresponds to the distributed profits grossed up by the respective tax.

Besides the above, please note that IFRS rules are not recognised by Greek administration for tax purposes. Hence companies may either hold statutory accounting according to Greek GAAP and publish IFRS compliant financial statements or hold statutory account directly in IFRS and hold at the same time an adjustment book, which retraces all differences from the statutory account, to support the tax return. The main differences between statutory tax calculation and IFRS tax arise due to: different amortisation rules; potential tax free income; tax adjustments; and permanent differences.

4.5 Are there any tax grouping rules? Do these allow for relief in Greece for losses of overseas subsidiaries?

There are no tax grouping rules in Greece, i.e. each legal entity is treated for tax purposes as a separate taxpayer.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Corporate income tax rate does not differ upon distributed, as opposed to retained, profits, since the previous regime providing for a different rate on distributed and retained profits was abolished and thus never came into play.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Real Property Tax ("RPT") at a rate of 0.6% shall be due annually on the total objective value of land owned by all types of legal entities, whereas 0.1% is imposed on self-used properties (buildings).

As of January 1 2003, an additional special real estate tax is imposed on companies, which have ownership or usufruct on real estate located in Greece. The applicable tax rate for such tax has increased from 3% to 15% as of January 1 2010. Given that said tax has been introduced in order to discourage the ownership by offshore companies of real estate located in Greece, various exemptions are provided by law (e.g. Greek or EU-based corporations with registered shares, companies listed on a stock exchange, companies with gross revenues from other activities higher than those revenues derived from the exploitation of real estate in Greece, etc.).

Finally, the owners of cars, trucks and motorcycles are obliged to pay annual circulation tax based on the vehicle's engine capacity.

4.8 Are there any local taxes not dealt with in answers to other questions?

Greek local authorities benefit from various taxes and duties paid to them directly or indirectly (e.g. through the electricity bills), the most important of which are the following: tax on electrified spaces; real estate duty; duty for the provision of cleaning and lighting services; duty for the use of communal spaces, etc.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Under Greek tax legislation, capital gains from the sale of fixed assets (except ships) are treated as ordinary business income. Gain or loss is calculated on the basis of the difference between the sale price and the value of the asset as in the company's books.

However, gains from the disposal of a business as a whole or a branch, of units in a partnership or a limited liability company, of a participation in a joint venture (other than a construction joint venture) or in a joint ownership of rights governed under civil law; of any right related to the exercise of the company's business (such as patents, industrial property etc.), of licences of vehicles destined for public use; as well as gains from any amount paid by a lessee to the lessor in excess of the agreed lease payment, from the assignment of any leasing rights, as well as from the waiver of a right to participate in a capital increase of a partnership or a limited liability company or of leasing rights, are subject to a flat rate tax of (20%), which is not final since the company must include the relevant item in its taxable profits subject to corporate income tax at the ordinary rate, with a credit being granted for the advance tax paid. As to taxation imposed on transfer of non-listed shares, see question 2.5 above.

Taxation of gains derived by resident companies from the sale of shares acquired until December 31 2011 in Greek/foreign corporations listed on the Athens/foreign Stock Exchange, as well as from derivatives traded on the Athens Derivatives Exchange or on a similar foreign market, is deferred if the gains are transferred to special reserves to offset future losses from the sale of the above shares or products respectively. However, capital gains deriving from the sale of listed shares acquired as of January 1 2012 shall be subject to taxation according to the general provisions (20% corporate income tax).

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

As aforementioned, capital gains from the disposal of both fixed assets and business as a whole, branch etc. are included in the taxable profits subject to corporate income tax. Currently, there is no difference between the capital gains tax rate and the corporate income tax rate (i.e. 20%).

5.3 Is there a participation exemption?

No participation exemption is provided under Greek tax law.

5.4 Is there any special relief for reinvestment?

No relief for reinvestment is provided under Greek tax law.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Any contribution (either in cash or in kind) to the share capital on the formation of a company is subject to a capital duty at the rate of 1%. It should be noted that a capital duty at the rate of 1% is also imposed on fixed or working capital provided by a non-EU resident foreign company to its Greek branch.

In addition to the above, a duty of 0.1% in favour of the Greek Competition Committee is imposed on the capital of SA's upon incorporation or increase thereto.

Finally, legal and notary fees, as well as publication costs, are payable upon the formation of a company.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

The computation of taxable income of a Greek branch of a foreign entity follows the same rules provided for companies. Please note that any profits or losses incurred by the foreign enterprise abroad are not taken into consideration for the determination of the taxable income of its Greek branch. If the Greek branch remits profits from tax-free income or specially taxed income to its foreign head office, then such income is adjusted and taxed.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

A Greek branch of a foreign entity is subject to corporate income tax at the same rates applicable to resident companies.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

In principle, the establishment of a Greek branch by a foreign enterprise creates a permanent establishment of that entity in Greece and therefore precludes it from the privileges of tax treaty provisions. However, a Greek branch of a foreign head office enjoys the benefits derived from the non-discrimination provision included in the income tax treaties signed by Greece.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Profits remitted by Greek branches to their head office suffer 25% withholding tax. The taxable moment is payment or mere credit of the profits to the head office.

7 Overseas Profits

7.1 Does Greece tax profits earned in overseas branches?

Resident companies are taxed on their worldwide income. Therefore, profits earned in overseas branches shall be taxed at the normal income tax rate.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by a local company from a non-resident company would be taxed as normal business income and be subject to the applicable corporation tax at a 20% rate, which is imposed on domestic and foreign-sourced income. However, 20% tax is withheld upon repatriation, which is set off against the 20% corporation tax imposed on its total income (zero effect). Any tax paid in the foreign company's country for the same income should be deducted up to the amount of Greek tax corresponding to the said income. Nevertheless, dividends received from participations in EU subsidiaries under the conditions of the EU Parent-Subsidiary Directive are exempt from corporate tax, provided they are sheltered in a tax-free reserve account as of March 31 2011. In the case that the dividends are further distributed, the 25% withholding tax on dividends shall apply, subject again to the conditions of the EU Parent-Subsidiary Directive or a reduction under the applicable treaty.

7.3 Does Greece have "controlled foreign company" rules and if so when do these apply?

In principle, no "controlled foreign company" (CFC) rules exist in Greece. Nevertheless, quasi CFC rules apply merely for participations in EU transparent entities.

8 Anti-avoidance

8.1 Does Greece have a general anti-avoidance rule?

In principal, no such anti-avoidance rule of general effect is in force. Nevertheless, quite recently Greece has introduced anti-avoidance provisions applicable to several transactions with "targeted" entities, i.e. entities established in black-listed countries and countries with beneficial tax regimes. Such rules also apply for sales to the above mentioned "targeted entities" as well as transactions in which such entities are interposed. In order to escape the anti-avoidance rules, the taxpayer can evidence the *bona fide* nature of the relevant transactions.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No such requirement applies.

Elisabeth Eleftheriades

KGDI Law Firm
28, Dimitriou Soutsou Str.
GR 115 21, Athens
Greece

Tel: +30 210 817 1626
Fax: +30 210 685 6657
Email: e.eleftheriades@kgdi.gr
URL: www.kgdi.gr

Elisabeth Eleftheriades is a Partner at KGDI Law Firm and heads the Tax department. Prior to joining the firm she was a Senior Lawyer in the tax & legal department of one of the big-four audit firms (Moscow, Jan 1998 - May 1999 and Athens, June 1999-June 2002). She has handled the legal aspects of several M&A and project finance transactions (drafting and negotiation, particularly in the energy sector) and has coordinated the firms' tax department advising on the tax aspects of the transactions.

Panagiotis Pothos

KGDI Law Firm
28, Dimitriou Soutsou Str.
GR 115 21, Athens
Greece

Tel: +30 210 817 1509
Fax: +30 210 685 6658
Email: p.pothos@kgdi.gr
URL: www.kgdi.gr

Panagiotis works for the Tax Department. His field of expertise includes Corporate Taxation, Tax structuring of foreign investments, Tax incentive legislation in mergers & acquisitions, Tax audits and Litigation before the Administrative Courts. Panagiotis acts particularly for international investors in cross-border transactions (focusing in the Energy and Construction sectors) and advises major Greek based enterprises and subsidiaries of MNEs in various industries (Financial and Insurance, Pharmaceutical, Automotive and Telecommunications) regarding all aspects of Greek taxation. He also has experience in advising Bidders in the context of major Public Private Partnership and Concession projects and represented major petroleum and trading corporations before the tax authorities and courts of law. Before joining the firm, he was a Senior Manager in the tax department of one of the big-four audit firms in Athens (Aug 2007 - June 2011) and prior to this a Senior Associate in the tax department of highly respected law firms.

KG DI
LAW FIRM
KYRIAKIDES GEORGOPOULOS & DANIOLOS ISSAIAS

In April 2006, two long established and renowned Greek Law Firms, **Kyriakides Georgopoulos Law Firm** (1933) and **Daniolos Issaias & Partners Law Firm** (1923), the latter specialising mainly in Maritime Law decided to merge to form Greece's largest Multidisciplinary Law Firm in order to cover the needs of their respective clients in all fields of legal practice.

KGDI advises corporate clients on tax aspects pertaining to M&A projects, share deals and group restructurings. In addition, the firm offers specific advice on the indirect issues arising from securitisation and PPP projects undertaken and has been vigorously involved in commenting from a tax perspective on debt & equity issuances (including covered bonds, derivative transactions, IPOs etc.). Finally, the firm continues to stand for clients in tax litigation against the fiscal authorities in all administrative courts.

Moreover, our multi-disciplinary teams of lawyers also have experience in practice areas consisting of Capital Markets, Corporate & Commercial, Banking and Project Finance, Dispute Resolution, Energy, Labour & Employment, M&A, Maritime Law, Natural Resources & Utilities and Real Estate Development providing a client focused service with a constructive approach to legal practices. KGDI LAW FIRM has offices in Athens, Piraeus and Thessaloniki.

Iceland

LOGOS legal services

Bjarnfredur Olafsson

1 General: Treaties

1.1 How many income tax treaties are currently in force in Iceland?

Iceland has 32 tax treaties in force, one which is a multilateral treaty between the Nordic countries, to which Iceland, Sweden, Norway, Finland, Denmark and the Faroe Islands are parties. The Ministry of Finance aims at building an even more extensive treaty network and is therefore negotiating with new treaty partners.

1.2 Do they generally follow the OECD or another model?

Icelandic Tax treaties generally follow the OECD model. All new treaties follow the OECD model except the new Icelandic-US treaty.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Icelandic law provides the government of Iceland with the authority to negotiate, and enter into, tax treaties with other countries. Once the treaty has entered into force, according to its provisions and after the treaty has been published in the Official Gazette of Iceland (in Icelandic; *stjórnartíðindi*), it is, according to practice, in force in Iceland.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, Iceland has not incorporated anti-treaty shopping rules or limitation of benefits articles, except in the new Iceland-US treaty, which incorporates a limitation of benefits clause. Each treaty should always be reviewed individually. There is also a new general CFC legislation in force in Icelandic domestic tax legislation.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

No, they are not.

2 Transaction Taxes

2.1 Are there any documentary taxes in Iceland?

Stamp duty is levied on: bills of exchange (0.25%); deeds on immovable property, vessels, etc. (0.4%); formation fund of limited partnership (0.5% or 1.5%); issued shares of public companies (0.5%); loan documents, bonds, etc. (1.5%); and the formation fund of partnerships (2%).

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Iceland has a VAT system, as per the Value Added Tax Act, no. 50/1988, under which VAT is levied at all levels of supply of goods and services. There are two rates of VAT:

- the standard rate of VAT is 25.5% (this rate applies to any supply of goods or services which is not exempt or subject to the reduced rate of VAT); and
- a reduced rate of VAT which is 7% (this rate applies for example to food, rental of hotel rooms, CDs, books and magazines, electricity and water for heating).

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Certain transactions are excluded from VAT, most importantly:

- financial and banking services;
- insurance services;
- health services, social services, education, libraries, art, sports, passenger transport and postal services; and
- rental of real property.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input tax is only recoverable by a taxable person, i.e. a person who is required to be registered for VAT. If the Input tax, in any settlement period, exceeds the output tax, the taxable person is entitled to a refund. Any person excluded from registration would not be entitled to such recoveries.

2.5 Are there any other transaction taxes?

No, there are no other transaction taxes levied (*lagðir á*) in Iceland.

2.6 Are there any other indirect taxes of which we should be aware?

Excise duties are levied on various goods. Custom and excise duties may apply.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Foreign individuals and legal entities are subject to a withholding tax on dividends. The applicable withholding rate for individuals is 20%, and the applicable rate for legal entities is 18%. If the recipient is a foreign limited company in a jurisdiction which is a member of the European Union or the European Economic Area, the withholding tax can be refunded after a tax assessment. Accordingly, the net result can be 0% for EEA/EU limited companies if they file for a refund. However, it should be noted that such refund will be permitted only to the extent that carryover losses have first been settled.

Alternatively, the applicable withholding tax rate can be reduced in accordance with an applicable tax treaty that Iceland has entered into.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In the absence of a tax treaty, royalties paid by resident companies to non-resident companies are subject to taxation. The application of withholding tax is unclear as the tax liability is net-based.

Royalties paid to non-resident companies are subject to a withholding tax of 20%.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Icelandic tax law provides for withholding tax on outbound interest payments from Iceland. However, the applicable rate will depend on whether the recipient is an individual or a legal entity. The applicable rates are:

- 20% if the recipient is an individual. However, withholding tax shall not apply to income from interest up to the amount of ISK 100,000 in each taxable year.
- 18% if the recipient is a legal entity. The withholding tax might however be reduced depending on each individual Tax Treaty that Iceland has ratified.

3.4 Would relief for interest so paid be restricted by reference to “thin capitalisation” rules?

Iceland does not yet have any thin capitalisation rules in force.

3.5 If so, is there a “safe harbour” by reference to which tax relief is assured?

This is not applicable in Iceland - see question 3.4.

3.6 Would any such “thin capitalisation” rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not applicable in Iceland - see question 3.4.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No, there are not, however, any interest charges between related parties would need to be at arm´s length.

3.8 Does Iceland have transfer pricing rules?

No. However, the Icelandic tax law provides for a general arm’s length rule, which requires that business terms should generally be decided on at an arm’s length basis.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The general corporate income tax is 20%.

4.2 When is that tax generally payable?

Companies are required to make advance income tax payments on the first day of each month of the tax year until the assessment is completed, except in January and the month in which the assessment is completed. The instalments are determined as a percentage of the previous year’s tax liability, i.e. 8.5% per month for 10 months. Any tax liabilities remaining when the final tax has been assessed must be paid in monthly instalments during the rest of the tax year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base).

In general terms, the tax follows the commercial accounts subject to certain tax adjustments. Resident companies are taxable on their worldwide income and expenses incurred in acquiring, securing and maintaining taxable income are generally deductible.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Timing of income and costs can differ.

4.5 Are there any tax grouping rules? Do these allow for relief in Iceland for losses of overseas subsidiaries?

Group tax consolidation is permitted in Iceland. With consolidated treatment one company’s losses, within the group, can immediately be set off against other companies’ profits, within the group. Resident companies may elect group consolidation if one company owns 90% of the shares in another company, or if 90% of the shares in the latter company are owned by a number of companies that are all members of the same jointly taxed group. Group consolidation may not be extended to a non-resident subsidiary of a resident parent company and relief for overseas subsidiaries is therefore not allowed.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Tax is not imposed at a different rate upon distributed, as opposed to retained, profits in Iceland.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

A company employing employees is subject to paying an 8.65% social security tax that is levied on all wages. Municipal real estate tax is levied on commercial real estate and varies from one municipality to another, but is generally around 1.7% for the property's value. Other minor taxes are the farmers' charge (1.2%) levied on farming, and the industrial charge (0.8%), which is levied on the turnover of industrial companies.

4.8 Are there any local taxes not dealt with in answers to other questions?

There is a tax levied on financial institutions, at the rate of 0.041%. The tax base is the year and total debt of the taxable person.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

The corporate income tax is levied on the worldwide income of businesses, which includes general business profits and capital gains. Furthermore, Icelandic tax law provides a possibility of no capital gains taxation on disposal of shares held by a company shareholder as it may be able to get a full deduction against the capital gains income. However, such deduction is permitted only to the extent that carryover losses have first been settled. Such deduction is furthermore contingent upon the disposing company shareholder holding at least 10% of the issued share capital of the relevant company at the date of the disposal. Should the abovementioned condition be satisfied, the company shareholder should be entitled to a deduction against the capital gain, with the only exception being that the shares sold may not be shares in a low tax jurisdiction company. If the shares are held by an individual then an 18% tax is applicable on the capital gain.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The same 18% rate of corporate income tax applies to both business profits and capital gains, although the effective rate for capital gains from shares may be 0% if the companies are entitled to a full deduction against the capital gains income; see question 5.1.

5.3 Is there a participation exemption?

No, but net taxation is achieved by providing a deductible expense; see questions 5.1 and 5.2.

5.4 Is there any special relief for reinvestment?

Reinvestment relief was abolished for the 2008 income year when capital gains on the disposal of shares held by corporate shareholders were effectively not taxed. Reinvestment of companies in real estate and permanent operational assets can be used to defer taxation on income from the sale of such assets.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary. There is a stamp duty on the issuance of shares in public limited liability companies.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no significant taxes or fees that would be incurred by a locally-formed subsidiary but would not be incurred by a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

The tax base is income allocated to the branch minus the deductible cost allocated to the branch; however there are no specific rules on how to allocate income to branches and very little practice. The tax rate is 20% if the company is: (i) a public limited company; (ii) a private limited company; or (iii) a limited partnership. Other legal entities are subject to a tax rate of 36%.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profit tax in Iceland.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A foreign branch would only benefit from tax treaty provisions in Iceland's treaty with its country of residence.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax would be imposed as the result of a remittance of profits by the branch.

7 Overseas Profits

7.1 Does Iceland tax profits earned in overseas branches?

Yes, unless exempted by a tax treaty.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Only if the non-resident company is not taxed in a similar manner as the local company and in principle the same conditions apply as to capital gains (see section 5).

7.3 Does Iceland have "controlled foreign company" rules and if so when do these apply?

The tax authorities can request information about the business of foreign branches or foreign subsidiaries of an Icelandic company.

8 Anti-avoidance

8.1 Does Iceland have a general anti-avoidance rule?

No, there is not.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is not.

Bjarnfredur Olafsson

LOGOS legal services
Efstaleiti 5
103 Reykjavik
Iceland

Tel: *+354 5400 300*
Fax: *+354 5400 301*
Email: *bjarnfredur@logos.is*
URL: *www.logos.is*

Bjarnfreður Ólafsson joined LOGOS in 2006 as a partner in the Tax Department from Taxis Law Firm, which he co-founded in 1999. His practice covers all direct taxes, international tax and value-added tax. He has extensive experience in corporate finance, mergers and acquisition, and corporate restructuring.
Bjarnfreður Ólafsson has written various articles and papers on foreign and domestic business law. He is the co-author of the Commissioner of the Inland Revenue's handbook on VAT (1998).
He served as an independent director on the board of Iceland's largest bank, Kaupthing Bank, since 2003.
He holds an LL.M degree from the University of Miami and is a member of the Icelandic Bar Association.

LOGOS
LEGAL SERVICES
SINCE 1907

Times have changed since Sveinn Björnsson, the future first President of Iceland, established his law firm in 1907. However, the basic principles upon which Björnsson built his success remain. In today's business environment integrity, professionalism and experience are still the guiding lights of LOGOS legal services, making it the leading law firm in Iceland.

In recent times Icelandic business has been growing fast, inside and outside of the borders. LOGOS has been growing with, and alongside those businesses. Our international affairs are now also operated from our London and Copenhagen offices, providing our full range of services and expertise. These services are already being put to good use by our clients, including some of the country's largest companies seeking their fortune abroad as well as prestigious international clients looking for insights, legal advice, and assistance in gaining a firm foothold in the unique Icelandic business arena.

This step is also important for a knowledge-driven law firm. The London and Copenhagen offices offer our staff fresh challenges and opportunities to enhance their extensive experience and post-graduate expertise that bring them to the podium, as scholars and lectures, in several universities in Iceland.

Not so many years ago no-one would have believed that an Icelandic law firm could have such an impressive presence in London and Copenhagen. I, however think that this demonstrates the unique strength of LOGOS, and that it would have made Mr. Björnsson extremely proud.

The competitive edge of LOGOS is the result of the systematic recruitment of the finest crop of professionals. LOGOS also commits itself to the sharing of information, knowledge and experience within the firm, allowing people to grow to their maximum potential. Dynamic workgroups are active in several fields of law, taking on important internal work, driving innovation and ultimately sharing knowledge and result.

The firm's specific areas of practice include Tax, Aviation and Transport, Banking and Finance, Competition, Construction and Projects, Employment, Restructuring and Bankruptcy, EU/EEA, Intellectual Property, Information Technology, Insurance, Litigation and Arbitration, Media and Entertainment, Mergers and Acquisitions, Private Equity and Security, and Telecoms.

Chapter 21

India

Aliff Fazelbhoy

Astha Chandra

ALMT Legal

1 General: Treaties

1.1 How many income tax treaties are currently in force in India?

India has entered into over 81 comprehensive Double Taxation Avoidance Agreements (DTAAs) and about 15 limited agreements, with respect to merchant shipping and income of airlines. Whilst India does have a DTAA with some tax havens like Mauritius and Cyprus, it does not have DTAAs with many other tax havens like the British Virgin Islands, Cayman Islands, Isle of Man, etc.

Apart from the DTAAs, India has currently entered into Tax Information Exchange Agreements (TIEAs) with various countries such as Bermuda in October 2010, and the Bahamas and the Isle of Man in February 2011.

1.2 Do they generally follow the OECD or another model?

No, they generally follow the UN Model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

No, as per the authority granted under Section 90 of the Income Tax Act, 1961 (the Act), the Central Government can enter into DTAAs with governments of other countries. In India, it is not necessary to obtain parliamentary approval to enter into DTAAs with other countries. The relevant DTAA comes into force, on a mutually agreed date, by the two participating countries and on the issuance of notification by the Central Government.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Yes, some DTAAs like the India-UAE and India-USA contain limitation of benefits articles. Further, as stated above, the government is taking several measures to obtain information for controlling tax evasion and taxing unaccounted income by entering into TIEAs with many countries.

Also, recently *vide* Finance Act, 2011, certain anti-avoidance measures have been introduced under the domestic tax laws, by insertion of a new Section 94A under the Act. The objective of introducing this section is to discourage transactions by a resident assessee with persons located in any country or jurisdiction which does not 'effectively' exchange information with India. The Central Government can now notify such country or jurisdiction as a Notified Jurisdictional Area (NJA). If an assessee enters into a transaction where one of the parties to the transaction is a person located in a NJA, there are several consequences which may then follow which *inter-alia* include: (i) all the parties to the transaction shall be deemed to be the associated enterprises and accordingly all the transfer pricing provisions shall apply to such transaction; and (ii) any payment made to a person located in the NJA shall be liable to withholding tax at the rate in force under the Act / DTAA or at 30%; whichever is higher, etc.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Not at present. However, if the provisions of domestic law are more favourable to the assessee, compared to the treaty provision, then as per Section 90(2) of the Act, the provision of the Act will apply to the extent they are more beneficial to the assessee.

The Direct Tax Code Bill, 2010 (DTC), which is proposed to be introduced from 1 April 2012, contains specific treaty override provisions in cases where general anti-avoidance rules (GAAR), controlled foreign company (CFC) and branch profit tax provisions are invoked/levied.

2 Transaction Taxes

2.1 Are there any documentary taxes in India?

Yes. Stamp duty is payable on all instruments listed in the schedule of the relevant Stamp Act. This schedule is broad enough to cover most types of instruments. In India, most of the states have their respective Stamp Acts listing the instruments liable to stamp duty, in the absence of which the provisions of the Indian Stamp Act, 1899, which is a central legislation, will apply.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes. Domestic sale of goods are taxed under separate legislations, i.e. the state Value Added Tax Acts (VAT Act/s) and the Central Sales Tax Act, 1956 (CST Act), depending on whether the goods are sold within a state or between two states.

Goods which are sold within a state are taxed in accordance with, and at the rate specified in, the relevant state VAT Act. Rates under VAT Acts vary depending on the nature of goods. For e.g., under the Maharashtra VAT Act, the general rate of VAT is 12.5%.

However, certain specified goods are taxed at a lower rate of 1% (e.g. precious metals and stones) or 5% (e.g. IT products, industrial inputs) or at a higher rate of 20% - 30% (e.g. liquor, tobacco).

Goods which are sold between two states are taxed in accordance with and at the rate specified in the CST Act; 3%. This rate is, however, applicable to a sale of goods between two registered dealers only. If goods are sold by a registered dealer in one state to a person in another state who is not a registered dealer, then generally the rate of tax is that which is specified in the local VAT Act.

Presently 32 states and union territories have implemented VAT laws. The remaining three union territories of Andaman and Nicobar Islands, Chandigarh and Lakshadweep are governed by the Central Sales Tax Act, 1956.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

VAT is levied only on the sale of movable goods. Immovable properties are excluded from the purview of VAT. Further, VAT laws of various states provide exemption to various classes of goods.

Service tax is levied on the provision of certain notified services under the Finance Act, 1994, as amended from time to time by subsequent Finance Acts.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Yes, it is generally recoverable by all businesses by means of input credit. For availing the input credit, a dealer has to be a registered dealer for the purpose of VAT laws. However, an input tax credit is not allowed in certain cases such as taxes paid in other states, taxes paid in respect of exempt goods, goods transferred as gifts, etc.

2.5 Are there any other transaction taxes?

Yes, securities transaction tax is levied on sale and purchase of listed securities and units of some mutual funds, dividend distribution tax on the distribution of profits by the company, research and development cess on import of technology, etc.

2.6 Are there any other indirect taxes of which we should be aware?

Yes, there are several other indirect taxes payable in India as provided hereunder:

- custom duty payable on importation of goods;
- anti-dumping and safe guard duties;
- excise duty on manufacture of goods;
- property tax on immovable properties;
- *octroi* and entry tax on transport of goods between certain city/area limits;
- entertainment tax on exhibition, horse races etc.; and
- luxury tax on hospitality services such as hotels, lodging houses, clubs, etc.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Section 115-O of the Act states that in addition to the income tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends shall be charged at an additional income tax at the rate of 15% plus applicable surcharge and education cess thereon.

Further, under the provision of Section 10(34) of the Act, dividend income is exempt in the hands of a recipient, including a non-resident. Hence, no withholding tax is imposed on any company for payment of dividend to its shareholders. However, if a non-resident shareholder receives dividend on which dividend distribution tax has not been paid for any reason, income tax is payable at the rate of 20% plus an applicable surcharge and education cess thereon under the provision of Section 115A(1)(a)(i). This would need to be withheld when remitting the dividends.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Yes. Under the Act, the withholding tax rate on royalties paid to non-residents is 10% plus applicable surcharge and education cess thereon if such payment is made pursuant to an agreement entered into after 1 June 2005. However, in case there is a DTAA which provides for a more favourable withholding tax rate than provided under the Act, the non-resident payee may opt to be governed by the provisions of the relevant DTAA. For e.g. India-UAE DTAA provides for a tax rate of 10%, thus reducing the tax marginally since surcharge and cess are not included.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Yes. Under the Act, the withholding tax rate on interest paid to non-residents is 20% plus applicable surcharge and education cess thereon, subject as above to a lower withholding provided in any applicable DTAA. For example, the India-Singapore DTAA provides for the withholding tax rate of 10% in case the interest arises from a loan granted by a bank carrying out the *bona fide* banking business or by a similar financial institution and a withholding tax rate of 15% in all other cases.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

No, presently India does not have any thin capitalisation rules. However, the DTC proposes to introduce the concept of thin capitalisation rules in the Indian tax regime in a limited manner. These rules are being introduced under the GAAR provisions in order to restrict the tax evasion by companies who infuse more debt than equity by allowing for re-characterisation of debt into equity and *vice-versa*.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

No, India does not have a safe harbour regime at present. However, Section 92CB of the Act gives power to the Central Board of Direct

Taxes (CBDT) to make safe harbour rules for the purposes of determination of arm's length price under transfer pricing regulations but no such rules have been notified till date.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Not applicable at present. Once the DTC is notified, the new rules will have to be studied to determine the effect.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Interest payable to an offshore associated enterprise must comply with the arms length principles under current transfer pricing regulations.

3.8 Does India have transfer pricing rules?

Yes, Section 92 to 92F of the Act deals with the provisions relating to transfer pricing. These rules currently apply only to international transactions among associated enterprises.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The rate of tax for corporate profits of a domestic company is 30% plus an applicable surcharge and education cess thereon. For the financial year 2011-2012, the surcharge is 5% on the base rate if the total income is in excess of INR 10,000,000 (10 million) and education cess is 3% on the base rate and surcharge.

The rate of tax on corporate profits of foreign companies is 40% plus an applicable surcharge and education cess thereon. For the financial year 2011-2012, the surcharge is 2% on the base rate if the total income is in excess of INR 10,000,000 (10 million) and education cess is 3% on the base rate and surcharge.

Further, Section 115JB provides for levy of Minimum Alternate Tax (MAT) where the tax liability of a company (Indian or foreign) under the normal provisions of the Act is lower than 18.5% of the book profit, and thus the book profit of the company shall be deemed as total income of the company and 18.5% of book profit shall be deemed as tax liability.

4.2 When is that tax generally payable?

Advance tax is payable under Section 211 of the Act, based on the estimate of corporate profits on or before the following dates each year:

- on or before 15 June – not less than 15% of such advance tax;
- on or before 15 September – not less than 45% of such advance tax, reduced by the amount, if any, paid by the earlier instalment;
- on or before 15 December – not less than 75% of such advance tax, reduced by the amount, if any, paid in the earlier instalment or instalments; and
- on or before 15 March – the whole amount of advance tax as reduced by the instalments, if any, paid in the earlier instalment or instalments.

Any shortfall in advance tax is required to be paid by 31 March, failing which at the time of filing tax returns, interest is to be paid along with the return at the prescribed rates. Tax returns are required to be filed by companies within six months of the end of the financial year, i.e. by 30 September of each year and by 30 November, where the company is required to furnish a report from an accountant under Section 92E of the Act pertaining to international transaction(s).

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax payable is on net profits pursuant to the commercial accounts. Some items of expenditure may be disallowed or reduced if the rates of deduction prescribed in the Act are different than the rates used in the commercial accounts. For example, in case of depreciation, it may be calculated on a straight line method for accounting purposes, whereas, the Act provides that for computing profits for income tax purposes, the depreciation shall be calculated on a written down value method and also the rates for depreciation provided under the Act are different than the rates used in the commercial accounts.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Please refer to our response to question 4.3. Also the provisions on MAT as described in response to question 4.1 may become applicable.

4.5 Are there any tax grouping rules? Do these allow for relief in India for losses of overseas subsidiaries?

No, each company is treated as an independent entity for tax purposes.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No. However, an additional tax, i.e. dividend distribution tax (DDT) is required to be paid by a domestic company on distribution of its profits to the shareholders at the rate of 15%. Once the DDT is paid by the company on the distributed profits, the shareholder is no more liable to pay tax on the distributed income. Refer to our response to question 3.1 above for details.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

No material other national taxes.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are certain property and municipal taxes which vary from state to state.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Yes, part 'E' of Chapter IV of the Act specifically deals with capital gains. The rate of taxes is different based on various circumstances like period of holding the asset, the nature of asset, etc.

The rate of tax on capital gains is determined on the basis of whether the capital gain would qualify as a short-term capital gain or a long-term capital gain under the Act. Capital gains arising as a result of transfer of a capital asset within 36 months are considered short-term capital gains and capital gains arising from transfer of assets after 36 months (in case of shares the period is reduced to 12 months from 36 months) are considered long-term capital assets. A long-term capital gain is taxed at the rate of 20% and a short-term capital gain is taxed at the normal income tax rates.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Yes, the rate of tax imposed upon capital gains is different from the rate imposed upon business profits except in the case of short-term capital gains (other than short-term capital gains from listed securities), where the rate of tax imposed is the same.

5.3 Is there a participation exemption?

Yes. Capital gains from the sale of shares listed on a stock exchange are exempt, provided that securities transaction tax has been paid. Exemption from capital gains may be available to an investor under the provisions of the relevant DTAA. For example, under the India-Mauritius DTAA, capital gains arising in the hands of a Mauritius resident company from the sale of shares held by it in an Indian company would be subject to tax only in Mauritius and not in India. Similar exemptions apply under the India-Cyprus DTAA and India-Singapore DTAA, subject to certain conditions.

5.4 Is there any special relief for reinvestment?

Yes. Exemptions are available if the capital gains are from the sale of long-term assets and are invested in specified assets and in some cases also in residential properties. For example, long-term capital gains arising from the sale of a residential house property are exempted from tax if such gains are reinvested to acquire another residential house property, subject to certain conditions.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Stamp duty and registration fees are chargeable on the charter documents of the company, i.e. the Memorandum of Association and Articles of Association at the time of its formation.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

A subsidiary of a foreign company incorporated in India is treated on par with an Indian entity for corporate income tax and the tax rates and exemptions as applicable to a domestic company would equally apply to a subsidiary of a foreign company. A subsidiary also has to pay DDT on profits repatriated to its shareholders. A branch though taxable in the first instance at a higher rate does not need to pay any DDT on repatriation of profits.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits would be calculated in the same manner as the profits of a domestic company but taxable at the rate prescribed for foreign companies, which is currently 42.024% (inclusive of surcharge and education cess). A branch can however repatriate its net profit after tax to its parent company without payment of DDT, unlike a company which has to pay DDT.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Not at present. However, the DTC proposes to introduce the concept of branch profit tax at the rate of 15% on the branch profits of a financial year.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

No, the branch not being an entity in itself is at the very first instance not liable to be taxed as a resident of the country in which it is situated. It is the parent company of the branch which will be taxed to the extent of its profits attributable to the branch in India. Further, under the DTC, it is proposed that the provisions dealing with branch profit tax will override the DTAA provisions.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Not under the present Act.

7 Overseas Profits

7.1 Does India's tax profits earned in overseas branches?

Yes, under the provisions of the Indian tax laws a resident is taxed on its global income. Under Section 5 of the Act, a resident is taxed on the income which is received or deemed to be received by him in India, accrues or arises or is deemed to accrue or arise to him in India and the income which accrues or arises to him outside India. Hence, India does tax a resident company on profits earned in its overseas branches.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Yes, the receipt of dividends by a local company from a non-resident company is taxable in the hands of the local company at the applicable corporate rate of tax, which is currently 32.445% (inclusive of surcharge and education cess).

7.3 Does India have "controlled foreign company" rules and if so when do these apply?

No, not presently existing under the domestic tax laws. However, the DTC proposes to introduce CFC rules. Under the DTC, income (computed in accordance with the specified formula) attributable to a controlled foreign company will be included in the total income of the resident assessee and taxed in India as a residuary source of income at the applicable corporate rate of tax. These provisions will override the provisions of the DTAA and will apply in case of foreign companies, which satisfies the following conditions:

- for the purposes of tax, it is a resident of a territory with lower rate of taxation;
- the shares of such company are not listed on any stock exchange recognised by law of such territory;
- persons, resident in India, exercise control over the company;
- it is not engaged in active trade or business; and
- the specified income of the company determined in accordance with a specified formula exceeds INR 25,00,000 (2.5 million).

8 Anti-avoidance

8.1 Does India have a general anti-avoidance rule?

No, not presently existing under the domestic tax laws. However, the DTC proposes to incorporate GAAR for the first time in India. GAAR provisions will provide almost sweeping powers to the tax authorities and will empower them to declare any arrangement (a step in or a part of or the whole of) as an "impermissible avoidance arrangement", provided the same has been entered into with the objective of obtaining tax benefit and satisfy any one of the following conditions:

- it is not at arm's length;
- it represents misuse or abuse of the provisions of the DTC;
- it lacks commercial substance; or
- it is carried out in a manner not normally employed for *bona fide* business purposes.

If introduced as per the present proposal, GAAR will override the provisions of the DTAA.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is not.

Aliff Fazelbhoy

ALMT Legal
4th Floor Express Towers, Nariman Point
Mumbai, 400021
India

Tel: *+91 22 4001 0000*
Fax: *+91 22 4001 0001*
Email: *afazelbhoy@almtlegal.com*
URL: *www.almtlegal.com*

Aliff, who was a founding partner in another law firm in Mumbai, merged his practice with ALMT Legal in 2003 to enhance the firm's tax and M&A practice.
Aliff's tax experience includes advising on cross-border tax structuring, creation of permanent establishment, withholding tax issues, transfer pricing, characterisation of software payments, etc. as well as some indirect tax issues, particularly service tax and VAT. Aliff also advises on tax-related litigation and dispute resolution proceedings before various tax authorities, tribunals and courts.
Aliff's M&A and corporate practice is mainly focused on transactional work for domestic and international private equity funds and multinational companies. Besides his tax and M&A practice, Aliff has helped develop a thriving employment law practice for the firm.
Aliff has authored articles for international publications and been a panelist at various international tax and M&A conferences. Aliff has also been selected as one of India's leading lawyers for M&A practice by Asia Law and Practice for four consecutive years in their publication "Asialaw Leading Lawyers".

Astha Chandra

ALMT Legal
4th Floor Express Towers, Nariman Point
Mumbai, 400021
India

Tel: *+91 22 4001 0000*
Fax: *+91 22 4001 0001*
Email: *achandra@almtlegal.com*
URL: *www.almtlegal.com*

Astha obtained her LLB degree from Government Law College, Mumbai and has been enrolled with the Bar Council of Maharashtra & Goa since 2004. After working for two years with other reputed law firms in Mumbai, she joined ALMT Legal, Mumbai in January 2007 and rose to senior associate in 2009. Astha specialises in direct and indirect tax laws, including income tax, service tax, sales tax/value added tax (VAT), customs and excise laws.
At ALMT Legal, Astha works on several assignments including advice on cross border tax issues, permanent establishment, transfer pricing, characterisation of software payments, withholding tax, stock option plans etc. as well as advice on indirect tax issues to a variety of multinational and Indian clients. She is also involved in both direct and indirect tax litigation before various authorities, tribunals and courts in India. She also contributes in preparing conference papers and articles on income tax (domestic and international), service tax and VAT for various international tax conferences and seminars.

ALMT Legal
ADVOCATES AND SOLICITORS

ALMT Legal is a dynamic and progressive full service Indian law firm providing high quality Indian expertise with an international capability. With over 75 lawyers and 14 partners across offices in strategic commercial centres in Mumbai, Bangalore, New Delhi and London, ALMT has an established reputation as one of India's top bracket firms.

ALMT's practice areas encompass all aspects of Indian laws, including corporate and commercial, direct and indirect tax, employment, dispute resolution, banking and finance, capital markets, intellectual property and information technology, real estate, shipping, aviation and immigration laws.

In 2009 ALMT was ranked as the Most Active PE Legal Advisor in India by transactional intelligence and analysis provider Venture Intelligence and has continued its reign in the field of Private Equity throughout 2010. Also in 2009, ALMT provided legal advisory services in deals aggregating to more than USD 650 million. In 2008 the firm was named ACQ's Indian Commercial Law Firm of the Year.

Chapter 22

Ireland

Michael Ryan

McCann FitzGerald

Eleanor MacDonagh

1 General: Treaties

1.1 How many income tax treaties are currently in force in Ireland?

Ireland currently has double taxation treaties in effect, or coming into effect, on 1 January 2012, with 58 countries. Another 5 treaties have been agreed but are not yet in effect. The double taxation treaties in effect are with Albania (effective 1 January 2012), Australia, Austria, Bahrain, Belarus, Belgium, Bulgaria, Canada, China, Chile, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Greece, Hong Kong (effective 1 January 2012), Hungary, Iceland, India, Israel, Italy, Japan, Korea (Rep. of), Latvia, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mexico, Moldova, the Netherlands, New Zealand, Norway, Pakistan, Poland, Portugal, Romania, Russia, Serbia, Singapore, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom, United Arab Emirates, United States of America, Vietnam and Zambia. New agreements have been signed with Armenia, Bosnia & Herzegovina, Germany, Kuwait, Montenegro and Morocco. Protocols to existing agreements with Austria, Malaysia and South Africa have been signed and legal procedures to bring these into force are currently being followed. New agreements with Panama, Saudi Arabia, Thailand and Uzbekistan have been concluded and are to be signed shortly. Protocols to the existing agreements with Belgium and Switzerland have also been concluded and are to be signed shortly. Negotiations for new agreements with the following countries are at various stages: Argentina; Azerbaijan; Egypt; Tunisia; and Ukraine. Negotiations are ongoing for the revision of existing agreements with Cyprus, France, Italy, Korea and Pakistan.

1.2 Do they generally follow the OECD or another model?

Most follow the OECD model treaty.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Since the enactment of the Finance Act 2006 of Ireland, a double taxation treaty will have the force of law only after an Order has been approved by the Dáil, and a law has been enacted by the Oireachtas inserting a reference to the Order into Schedule 24A of the Taxes Consolidation Act 1997. Certain preferential tax treatments provided for in Irish domestic tax law, where one is dealing with a resident of a treaty country, can apply once a tax treaty has been signed by both Ireland and the treaty partner country.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, they do not contain "limitation of benefits" articles. However, the Ireland/USA Double Taxation Agreement does include a "limitation of benefits" article.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In general, once a double taxation agreement has obtained force of law in Ireland, it cannot be overridden by rules of Irish domestic law. The legislation giving effect to such double taxation agreements in Ireland expressly states "the arrangements shall, notwithstanding any enactment have force of law as if each such Order were an Act of the Oireachtas".

2 Transaction Taxes

2.1 Are there any documentary taxes in Ireland?

Stamp duty is chargeable in Ireland on certain instruments including those transferring ownership of property (including stocks and marketable securities) or in certain cases, agreements to transfer certain types of property. In order for an instrument to come within the charge to stamp duty, the instrument must either be executed in Ireland, or it must relate to property situated in Ireland or to any matter or thing to be done in Ireland.

The rate of duty applicable to transfers of stocks and marketable securities is 1%. For property other than shares and marketable securities, the rate of duty can be up to 6%, depending on the value of the transaction. There are special rates applying to residential property (1% or 2%). Stamp duty is usually payable within 30 days of the execution of the instrument. The buyer or transferee is usually accountable for the payment of the duty.

There are a number of exemptions from the charge of stamp duty, including the transfer of certain foreign securities, intellectual property rights and certain loans. In December 2009, the Revenue introduced a new electronic system for the stamping of instruments and the payment of stamp duty.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

VAT is charged in Ireland in respect of supplies of goods and services, acquisitions of goods and services (reverse supplies) from other E.U. Member States and imports into Ireland of goods or services (reverse supplies) from outside the E.U.

The standard rate of VAT is 21%, with lower rates of 13.5%, 9% and 0% applicable to certain supplies of goods and services.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

A number of supplies are either exempt from, or outside the scope of, VAT. These supplies include the provision of financial services, share issues and transfers, and the transfer of a business or part of a business between VAT registered persons. In addition, certain supplies are charged at 0%.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

A business that suffers VAT on its inputs (other then VAT on certain specified items such as entertaining, hospitality and petrol) will be entitled to recover such VAT, to the extent that the inputs are used for the purposes of its supplies that are liable to VAT or for the purposes of its qualifying activities (as defined in Section 12 of the VAT Act 1972, as amended). A business which is engaged wholly in VAT-exempt activities will not be able to recover VAT on its inputs.

2.5 Are there any other transaction taxes?

There are some levies that apply to certain insurance contracts and financial products.

2.6 Are there any other indirect taxes of which we should be aware?

In addition to VAT, customs duty is payable on goods imported from outside the E.U. Excise duty is payable on mineral oils, alcohol and tobacco. Excise duty is also payable on electricity from 1st October 2008. Vehicle registration tax is payable in respect of all vehicles which are to be kept permanently in Ireland.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

In general, Irish companies are obliged to deduct dividend withholding tax at the standard rate of income tax (currently 20%) from dividends and certain other distributions. However there are a number of exceptions to this requirement, including situations where the Parent/Subsidiary Directive applies and also where the dividend is paid to a resident of a country with which Ireland has a double taxation agreement that is in effect, or a company controlled by such persons, provided an appropriate declaration has been made.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In general, withholding tax at the standard rate of income tax (currently 20%) must be deducted from payments of patent royalties that are within the charge to Irish tax. This applies to payments in respect of patent royalties only. There is no obligation to withhold an amount in respect of tax from royalties in respect of the right to use secret processes, trademarks etc. that are not protected as patents, unless the right to use these secret processes, trademarks etc. are incidental to the rights protected by a patent or the payments constitute an annual payment which is pure income profit to the recipient.

However, there is an exemption from the obligation of an Irish resident limited company (or an Irish branch of an E.U. resident company) to deduct tax from royalty payments to a company resident in another E.U. Member State, where the following conditions are met:

- the recipient is the beneficial owner of the royalty payment;
- either the paying company or the recipient company owns directly at least 25% of the share capital of the other for an uninterrupted period of at least two years; or
- a third E.U. resident company owns directly at least 25% of the share capital of the payor and the recipient company for an uninterrupted period of two years.

Many of Ireland's double taxation agreements provide for a 0% tax rate to apply to payments of patent royalties.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In general, withholding tax at the standard rate of income tax (currently 20%) must be deducted from payments of yearly interest that are within the charge to Irish tax. Yearly interest includes any interest that is capable of arising for a period of at least one year. This includes interest arising where no period is defined, even though in practice, the period may be significantly less.

There are a number of exemptions from the obligation to withhold tax on payments of yearly interest. These include an exemption for interest payments made by a company in the ordinary course of a trade or business carried on by it to a company that is resident in an E.U. Member State or in a country with which Ireland has a double taxation agreement that is in effect, except where such interest is paid to that company in connection with a trade or business which is carried on in Ireland by that company through a branch or agency.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Ireland does not have "thin capitalisation" rules *per se*. However, in certain circumstances, interest payments made by a company to a non-resident related company may be treated as a distribution and no tax deduction will be available to the company in respect of such interest payments. Any such interest paid is taxable as distribution in the hands of the recipient and treated as a distribution for the purposes of Irish dividend withholding tax, unless otherwise exempt.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not applicable in Ireland.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not applicable in Ireland.

3.7 Are there any restrictions on tax relief for interest payments by a local company to a non-resident?

Other than the position set out in question 3.4, there are no restrictions of this kind. Relief is available in respect of interest incurred exclusively for the purposes of the trade and for some other qualifying purposes, irrespective of where the lender is based.

3.8 Does Ireland have transfer pricing rules?

Transfer pricing rules were introduced with effect from 1 January 2011. The main features of the rules applicable to trading transactions between associated persons are:

- recognition of the arm's length principle and the OECD Transfer Pricing Guidelines;
- application of the arm's length principle where trading profits are understated for Irish tax purposes;
- the scope is confined to related party dealings that are taxable at Ireland's corporate tax rate of 12.5%;
- exemption for Small and Medium Enterprises;
- companies are required to have documentation available in relation to their transfer pricing policies; and
- the new rules apply for accounting periods of companies beginning on or after 1 January 2011, but do not apply to transactions/arrangements where the relevant terms of those transactions/arrangements are agreed prior to 1 July 2010.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The standard corporation tax rate applicable to trading profits of an Irish tax resident company is 12.5%. Non-trading profits earned by a company, such as investment income, and the trading profits derived from certain types of activities, are generally taxed at a rate of 25%. Companies are also subject to tax on chargeable gains at a rate of 25%; see question 5.2 below.

4.2 When is that tax generally payable?

A company is obliged to file its tax return within nine months of the end of the tax year. The payment dates for tax due are dependent on whether the company is considered a "small company" (one whose corporation tax liability in the preceding accounting period does not exceed €200,000) or a "large company" (one whose corporation tax liability in the preceding accounting year exceeds €200,000).

For small companies, a preliminary corporation tax payment equal to at least 90% of the final liability for an accounting period, or 100% of the prior accounting period's liability, must be paid 1 month before the end of an accounting period (by the 21st of the month). The balance of the company's tax liability is due by the 21st day of the 9th month after the end of the accounting period. Thus, a small company which prepares accounts to 31st December 2011 should pay 90% of its corporation tax liability by 21st November 2011, and the balance of its tax liability by 21st September 2012 to avoid interest charges.

The preliminary tax payment for large companies occurs in two instalments. The first instalment is payable in the 6th month of the accounting period (by the 21st day of that month). This payment must equal either 50% of the corporation tax liability for the preceding accounting period or 45% of the corporation tax liability for the current accounting period. The second instalment is then payable in the 11th month of the accounting period (by the 21st day of that month) and the amount payable should bring the total preliminary tax paid to 90% of the corporation tax liability for the current year. The balance is then to be paid on filing of the company's tax return.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Corporation tax is charged on a company's income by reference to its commercial accounts prepared in accordance with generally accepted accounting principles for its accounting period. In computing its taxable income liable to corporation tax, a company will be allowed deductions for certain expenses and capital allowances will be available in respect of certain types of capital expenditure. Losses incurred in the current accounting period and losses forward from previous periods may be taken into account in computing taxable income.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

See question 4.3 above.

4.5 Are there any tax grouping rules? Do these allow for relief in Ireland for losses of overseas subsidiaries?

There are tax grouping rules in Ireland allowing the offset of losses incurred by a company against the profits of another group company in certain circumstances. The tax grouping rules also allow the payment of interest and charges between group companies without an obligation to deduct tax, the transfer of assets between group companies without triggering a liability to capital gains tax and the payment of dividends to a group company without an obligation to deduct tax.

An Irish resident company may claim relief for the losses of 75% of subsidiaries resident in an E.U. Member State or an EEA Member State with which Ireland has a double taxation agreement that is in effect, in certain limited circumstances. The loss must correspond to a loss that would generally be available for offset under the Irish rules, and must not be attributable to an Irish branch. In addition, the loss must not be available for offset in the current year, a prior year or a future year by the company making the loss, nor available for offset in another company in another E.U. Member State.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

In general, the same tax rate applies to distributed and retained profits. However, a close company (a company controlled by five or fewer participators or by participators who are directors (however many)), may be liable to pay a close company surcharge of 20% in respect of its undistributed estate and investment income to the extent it is not distributed within 18 months of the end of the accounting period to which it relates.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Income tax is payable by individuals and other non-corporate persons resident for tax purposes in Ireland. Income tax is charged at a rate of 20% on income up to the standard rate band, which is currently €32,800 for a single person. Income in excess of this is taxed at the marginal rate of 41%. Income tax can also apply to non-resident companies on receipt of Irish source income who do not trade through a branch or agency.

From 1st January 2011 a tax called the Universal Social Charge ('USC') is payable by individuals whose gross income per annum exceeds €4,004. The USC replaces the previous Income Levy and Health Levy and is charged at a rate of 2% on the first €10,036 and 4% on the next €5,980. Income in excess of this amount is charged at a rate of 7%. A surcharge of 3% is also charged on income from self-employment that exceeds €100,000 in a year.

Individuals are also liable to capital gains tax on chargeable gains arising on the disposal of assets at a rate of 25%, in respect of disposals made since 7th April 2009. A rate of 40% applies to disposals of certain foreign life assurance policies and foreign investment products.

Capital acquisitions tax is payable on gifts or inheritances, subject to various thresholds. The applicability of the thresholds will depend on the relationship of the recipient to the disponer. The rate of capital acquisitions tax on benefits taken on or after 8th April 2009 is 25%.

Commercial rates are levied on the occupiers of commercial and industrial properties by local authorities and it is proposed that certain charges will be levied on residential property from a date yet to be agreed. Social contributions and health levies can also arise.

4.8 Are there any local taxes not dealt with in answers to other questions?

Other than those mentioned above, there are no further Irish taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Yes; see question 5.2.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Where a company is within the charge to corporation tax, any capital gains realised on disposals of capital assets (other than development land) are subject to corporation tax at 25%.

5.3 Is there a participation exemption?

Section 626B of the Taxes Consolidation Act 1997 of Ireland as amended contains an exemption from capital gains tax on the disposal by a company of a substantial shareholding in a subsidiary company where certain conditions are met. In order to benefit from this exemption, the parent company must have held 5% of the subsidiary's ordinary share capital, and have been entitled to 5% of the profits available for distribution and 5% of the assets available for distribution on a winding up, for a period of at least 12 months. The subsidiary must be resident for tax purposes in the E.U. or in a country with which Ireland has a double tax treaty that is in effect. In addition, at the time of disposal, the subsidiary company must be a company whose business consists wholly or mainly of the carrying on of a trade, or the business of the parent company, the subsidiary and any subsidiaries of each of these companies taken as a whole consists wholly or mainly of the carrying on of a trade.

5.4 Is there any special relief for reinvestment?

No, there is not.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The formation of a subsidiary in Ireland by a parent company does not give rise to any Irish tax consequences for the parent company.

There is no capital duty in Ireland.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are not.

6.3 How would the taxable profits of a local branch be determined?

Non-Irish resident companies that operate in Ireland through a branch or agency are liable to Irish corporation tax on trading income arising directly or indirectly from the branch, and on any other income from property or rights used for the branch, wherever that income arises. These are normally determined by the accounts prepared for the branch. The standard rate of corporation tax of 12.5% applies to the trading profits of an Irish branch.

Non-Irish resident companies may also be subject to Irish income tax if they have any Irish source income, other than income from a trade carried on by a branch in Ireland. This is unless such income is otherwise exempt under Irish domestic law or relieved from Irish tax under the provisions of a double taxation treaty that is in effect with Ireland.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax, or any other taxes, applicable only to branches of non-resident companies in Ireland.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Only a company resident for the purposes of tax in Ireland can avail of Ireland's tax treaty network. Accordingly, an Irish branch of a non-resident company cannot benefit from the provisions of Ireland's double tax treaties. A branch can benefit from certain unilateral reliefs for overseas tax.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

The remittance of profits by the Irish branch of a non-resident company will not be subject to withholding tax in Ireland.

7 Overseas Profits

7.1 Does Ireland tax profits earned in overseas branches?

A company resident for tax purposes in Ireland is liable to Irish corporation tax on the profits earned through overseas branches.

Where such profits are also subject to tax in the country where they are earned, and Ireland has a tax treaty in force or signed with that country, the provisions of the treaty will apply.

Where a double taxation treaty does not exist with a particular country, a unilateral tax credit is available for the foreign tax paid and pooling of excess overseas branch tax credits is also possible.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

In general, dividends received by a company resident in Ireland for tax purposes, from a non-resident company, will be taxed at a rate of 25%. A credit will normally be available for overseas tax suffered on the profits out of which the dividend is paid where certain conditions are met.

Where dividends, which are paid out of trading profits, are received by a company resident for the purposes of tax in Ireland, from a company resident for tax purposes in an EU Member State, or a country with which Ireland has a tax treaty in force or signed, the receipts will be chargeable to corporation tax at a rate of 12.5%.

The reduced rate of 12.5% may also apply, subject to certain conditions being met; where the dividend is paid only partly out of trading profits; provided 75% or more of the dividend is payable out of trading profits and an asset qualification condition is satisfied; where companies are portfolio investors; or the company is owned directly or indirectly by a publicly quoted company.

7.3 Does Ireland have "controlled foreign company" rules and if so when do these apply?

Ireland does not have controlled foreign company rules.

8 Anti-avoidance

8.1 Does Ireland have a general anti-avoidance rule?

Section 811 of the Taxes Consolidation Act 1997 of Ireland, as amended, contains a general anti-avoidance provision to counteract certain transactions which have little or no commercial reality but are carried out primarily to create an artificial tax deduction or to avoid or reduce a tax charge.

Where the Revenue form a view that a transaction is a tax avoidance transaction, they will withdraw or deny any tax advantage arising as a result of the transaction. A transaction will not be a tax avoidance transaction, where it was undertaken with a view to the realisation of profits in the course of a business carried on by a taxpayer and was not undertaken primarily to confer a tax advantage. Similarly, a transaction which is undertaken to obtain the benefit of any relief, allowance or other abatement and does not result in a misuse or abuse of the provision having regard to the purpose for which it was provided, will not be a tax avoidance transaction.

Section 811A Taxes Consolidation Act 1997 allows a taxpayer to make a protective notification to the Revenue in respect of a transaction within 90 days of beginning a transaction, in circumstances where the taxpayer feels that there may be a risk that the transaction will be regarded as a tax avoidance transaction. Making a notification under section 811A will protect the taxpayer from interest and a surcharge should the Revenue successfully challenge the transaction as a tax avoidance transaction.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

A Mandatory Disclosure Regime for certain types of tax avoidance transactions is now part of the Irish tax code.

The regime places obligations, primarily on promoters of certain types of transactions, which have as their main benefit obtaining a tax advantage and meet certain criteria, to give details of those transactions to the Revenue. Provision has been made for the imposition of civil penalties for non-compliance.

Michael Ryan

McCann FitzGerald
Riverside One, Sir John Rogerson's Quay
Dublin 2
Ireland

Tel: +353 1 611 9230
Fax: +353 1 829 0010
Email: Michael.Ryan@mccannfitzgerald.ie
URL: www.mccannfitzgerald.ie

Michael heads the firm's Tax Group, having joined McCann FitzGerald from a global accounting firm. He has extensive expertise providing tax advice to a wide range of Irish companies, including banking, leasing and investment companies, and major investment projects into Ireland.

Michael is a past council member of the Irish Taxation Institute, and currently chairs the editorial board of the Irish Tax Review. He is the editor of the Institute Book on Corporation Tax, and a past member of the Tax Committee of the Consultative Committee of Accountancy Bodies in Ireland. He has also been an external examiner in taxation for the National College of Ireland, IFSC.

Eleanor MacDonagh

McCann FitzGerald
Riverside One, Sir John Rogerson's Quay
Dublin 2
Ireland

Tel: +353 1 611 9174
Fax: +353 1 829 0010
Email: Eleanor.MacDonagh@mccannfitzgerald.ie
URL: www.mccannfitzgerald.ie

Eleanor specialises in taxation law and practice and, since joining McCann FitzGerald in 2011, has led the expansion of the firm's tax advisory services to both domestic and international banking and financial services clients. She has developed particular expertise in relation to international tax structuring through Ireland, the taxation of capital markets products including derivatives, securitisation and structured finance and establishing investment funds and other tax-based investment products.

Eleanor is a member of the Tax Committees of each of the Irish Securitisation Forum and the Irish Funds Industry Association.

McCann FitzGerald

McCann FitzGerald is one of Ireland's premier law firms.

We provide the highest quality legal advice and representation to Irish and overseas clients. Our clients are principally in the corporate, financial and business sectors and we also advise government entities and many state bodies, pension funds, educational and charitable institutions and trusts.

The firm is owned by the partners and comprises some 61 partners and 290 lawyers and professional staff.

We are based in Dublin (our principal office), London and Brussels.

The firm is divided broadly into four main groupings of corporate, banking & financial services, dispute resolution and litigation and real estate (comprising also construction and private client capability). We also operate industry sector and specialist practice groups which comprise professionals from different groupings. In this way, we provide advice and representation on a strict basis of what is best for clients and their requirements.

Chapter 23

Israel

Meir Linzen

Herzog Fox & Neeman

Eldar Ben-Ruby

1 General: Treaties

1.1 How many income tax treaties are currently in force in Israel?

As of 2010, there are 50 double tax treaties to which Israel is a party and which are in force in Israel.

1.2 Do they generally follow the OECD or another model?

Israel's double tax treaties generally follow the OECD Model with the exception of a number of treaties (with Britain, Germany, Norway and Sweden) that were signed in the 1960s and 1970s, before the OECD Model became widely accepted.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Section 196 of the Israeli Income Tax Ordinance [New Version], 1961 (the "**Ordinance**") states that a double tax treaty which has come into force by virtue of an Order of the Minister of Finance will be valid notwithstanding any legislation. Whether this also applies to subsequently introduced legislation is a question that has not been determined under Israeli law.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Until the 1990s, none of Israel's income tax treaties included a "limitation of benefits" article. That said, a number of Israel's pre-1990s income tax treaties included "subject to tax" provisions (i.e. relief in the State of source was only available if the income was subject to tax in the State of residence) or clauses requiring that income is received in the State of residence as a condition to being eligible for tax exemption or relief in the State of source. In light of the increasing use of sophisticated tax planning and the growing phenomenon of treaty shopping, Israel has sought in recent years to include "limitation of benefits" articles in its new treaties. Since 1994, the majority of income tax treaties that came into force in Israel include some form of "limitation of benefits" provisions. The terms of these provisions vary substantially from treaty to treaty.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Regarding the question of whether the provisions of a double tax treaty may be overridden by anti-tax avoidance rules of domestic law, the Israeli tax authorities take the view that anti-avoidance provisions in domestic tax legislation may override the provisions of a double tax treaty, and accordingly, tax relief under a double tax treaty may be denied by virtue of the application of a domestic law anti-avoidance provision. This issue has been discussed by the District Court of Tel Aviv, which generally adopted the view of the Income Tax Authorities and which determined that the relevant treaty provisions should be read in light of the local anti-avoidance rules. This view is however, disputed by some legal academics.

There are a number of laws in Israel which are basic laws and form part of Israel's constitution. A question arises as to whether these laws do in fact override the relevant treaty provisions. It should be mentioned that the basic laws are general in their nature and mainly refer to specific human rights.

2 Transaction Taxes

2.1 Are there any documentary taxes in Israel?

No. Stamp duty was abolished in Israel for documents executed on or after January 1, 2006.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Israel has a value added tax (VAT) that is imposed under the Value Added Tax Law, 1975 (the "**VAT Law**"). The standard rate of VAT is currently 16%.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Under the VAT Law, VAT is charged on transactions in Israel and on the importation of goods into Israel. A transaction that is a sale of goods is deemed to take place in Israel if, in the case of a tangible asset, it was delivered in Israel or exported, and in the case of an intangible asset, if the seller is an Israeli resident. The VAT Law also specifies that certain transactions are zero-rated (principally, exports of goods and services) or exempt (such as certain financial services and certain real estate transactions). The provision of services to a non-resident is not generally zero-rated if the service relates to an asset situated in Israel or if the service is rendered to an Israeli party as well.

Charitable organisations and financial institutions are subject to a separate VAT regime. Financial institutions are subject to a 16% profit tax and 16% tax on the paid salaries (salary tax), subject to certain adjustments. Charitable organisations are only subject to a 16% salary tax on the paid salaries. The profit and salary taxes are economically equivalent to VAT.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Under the VAT Law, businesses are entitled to recover VAT costs in connection with goods or services used by the business to create its taxable (including a zero-rated) supply.

Regulations made under the VAT Law limit the ability of a business to recover VAT costs in certain circumstances, for example, if it is with regards to goods or services that are used for the benefit of the business's employees.

2.5 Are there any other transaction taxes?

There are transaction taxes in respect of transactions in real estate (including transactions involving rights in "real estate associations"). Real estate transactions are subject to acquisition tax, which is charged as a percentage of the value of the transaction. The rate of acquisition tax depends on the nature of the transaction and can reach a rate of up to 15%.

2.6 Are there any other indirect taxes of which we should be aware?

Israel imposes customs duties on certain imported goods and sales tax on certain imported and domestic goods. Israel also imposes various duties, e.g. trade levies and dumping levies, pursuant to the Trade Levy Law, 1991.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends paid by an Israeli resident company to a non-resident are generally subject to withholding tax at the rate of 20% (dividends received by a taxpayer who is a Significant Shareholder (i.e. holding 10% or more of the means of control in the company) at the time of distribution or during the preceding 12-month period, is subject to a tax rate of 25%) of the gross amount paid. In the case of dividends paid out of profits deriving from an "approved enterprise", as defined in the Encouragement of Capital Investments Law, 1959 (the "Capital Investments Law"), the rate of withholding tax is 15%, although under some circumstances this rate may be reduced to 4%. The rate of withholding tax imposed under domestic law may be reduced under an applicable income tax treaty. The rate of withholding tax on dividends under Israel's income tax treaties varies from 0% to 25%.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid by an Israeli company to a non-resident are subject to withholding tax at the rate of 25% of the gross amount paid. This withholding tax rate may be reduced by an applicable double tax treaty. The rate of withholding tax on royalties under Israel's income tax treaties varies between 0% and 15%.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest paid by a local company to a non-resident is generally subject to withholding tax at the rate of 20% (25% to a non-resident corporate or to a Significant Shareholder, as defined above) of the gross amount paid, although the Minster of Finance is authorised to exempt interest payments from withholding tax in certain circumstances. The withholding rate may be reduced by an applicable income tax treaty. The rate of withholding tax on interest under Israel's income tax treaties varies between 0% and 25%. In addition, interest paid to a foreign resident on a bond of an Israeli resident company that is traded in the Israeli stock exchange is exempt from Israeli income tax. This exemption does not apply to interest attributed to an Israeli permanent establishment of the foreign resident, and to certain other groups of related persons, service providers and employees.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

There are no "thin capitalisation" rules under Israeli domestic tax rules or under Israel's tax treaties.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

Not applicable; see question 3.4 above.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Not applicable; see question 3.4 above.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Not applicable; see question 3.3 above.

3.8 Does Israel have transfer pricing rules?

Section 85A of the Ordinance states that where there is a special relationship between the parties to an international transaction, as a result of which the price of the transaction results in a smaller profit than would have been realised if the transaction price had been set on arm's lengths terms, the transaction must be reported and taxed on the basis of its fair market value. Regulations published in 2006 stipulate certain methods that should be used in order to determine fair market value. The preferred method is to compare the price of the transaction in question with the price of a similar international transaction between unconnected parties. If this method cannot be used, then the taxpayer must use one of the following methods: (i) a comparison between the profitability rate of the transaction in question and a similar transaction; or (ii) a comparison between profit and loss allocation between the parties under the transaction in question and a similar transaction. If none of the above methods can be used, the taxpayer is permitted to use any other suitable method of comparison.

The Regulations do not specifically require the taxpayer to prepare an annual transfer pricing study. However, the tax assessing officer has the authority to demand a transfer pricing study at any time within 60 days. In addition, the taxpayer is required to describe the terms of any international transaction with a party with whom it has a special relationship (price, conditions, and the price and conditions of an arm's length transaction) in its annual tax return, to be set out in a special annex to the tax return.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The rate of tax on corporate profits in Israel is 25% in 2010 (and it is anticipated to be reduced in 2011 - to 24%, 2012 - to 23%, 2013 - to 22%, 2014 - to 21%, 2015 - to 20%, 2016 and thereafter - to 18%). The rate of corporate tax on profits deriving from an "approved enterprise", as defined under the Capital Investments Law, ranges from 0% to 25%.

4.2 When is that tax generally payable?

Corporate tax is generally assessed for the calendar year. Generally, the greater part of the tax is paid during the tax year through estimated advance tax payments. The final tax payment is made, together with the filing of the annual tax return, by 31 May, following the end of the tax year. It is possible, in certain circumstances, to obtain an extension for the filing and payment deadline.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for Israeli corporate tax is the company's net income, as determined under Israeli accounting principles, and adjusted in accordance with the provisions of the Ordinance and Regulations made there.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

There are differences between the accounting rules and the tax rules which are set out in the Ordinance and the Regulations thereto. The principal differences are as follows: (i) the amortisation rate according to the Ordinance differs from the applicable rate under the relevant accounting rules; (ii) there are segments or assets which are entitled to acceleration appreciation under the Ordinance; (iii) certain kinds of expenses are limited in respect of the ability to be deducted from income, such as expenses attributable to overseas travel, car expenses and similar expenses, which are determined under relevant regulations and are in the nature of benefits; (iv) there are certain exemptions, for example exemption from income generated from inflationary increases or from exchange differentials; and (v) another example of such differences is that since in most cases there are no tax grouping rules (as described below), then accounting income which derives under these rules is eliminated for the purpose of the tax return.

4.5 Are there any tax grouping rules? Do these allow for relief in Israel for losses of overseas subsidiaries?

Tax grouping rules exist under Israeli law for an Israeli resident "industrial" company or a company which is a holding company of industrial companies. An industrial company is a company which receives at least 90% of its revenues from an industrial facility engaged in manufacturing activities. An industrial company, or an industrial holding company, may file a single consolidated tax return in respect of itself and its subsidiaries, which are themselves industrial companies provided that all industrial companies included in the consolidation are part of a single assembly line or manufacturing process. An industrial holding company which has subsidiaries engaged in different assembly lines is entitled to consolidate its return only with the company or companies who have a single assembly line in which it has the largest capital investment. Other than this, there are no tax consolidation rules under Israeli tax law.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

In general, distributed and retained profits are taxed at the same corporate tax rate. Companies that hold an "approved enterprise" status under the Capital Investments Law are entitled to elect for a temporary corporate tax exemption in respect of profits deriving from the approved enterprise. Such tax exemption applies only in respect of undistributed profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes", above) - e.g. tax on the occupation of property?

As of January 1, 2000, the rate of property tax in Israel is 0%. There are currently no capital or net assets taxes levied in Israel.

4.8 Are there any local taxes not dealt with in answers to other questions?

A municipal tax ("*arnona*") is imposed on real property; the rate of which depends on the size, location and use of the property and also on the type of local authority.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Yes, there are special rules for the taxation of capital gains and losses in Israel. These rules are set out in Part E of the Ordinance. Capital gains and losses arising from transactions in Israeli real estate (including real estate associations) are taxed in accordance with the Land Taxation Law, 1963.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Real capital gains (that is, after adjustment for inflation) accruing to individuals are taxed at the rate of 20% (25% in a case of a sale of shares by a Significant Shareholder, as defined above). Real capital gains of companies are taxed at the rate of 25%. Where the asset that is sold was purchased prior to January 1, 2003, the tax rate is different and, roughly speaking, is based on an average of the above tax rate, the regular corporate tax rate and the marginal tax rate for individuals.

5.3 Is there a participation exemption?

As of January 1, 2006 corporations that are classified as Israeli Holding Companies are entitled to a participation exemption. The tax benefits available to an Israeli Holding Company include the following: (i) dividends which the Israeli Holding Company receives from its subsidiaries are tax exempt; (ii) capital gains from the sale of subsidiaries are tax exempt; (iii) dividend distributions from the Israeli Holding Company to its foreign shareholders are subject to a reduced withholding rate of 5%; (iv) interest income, dividends and capital gains that the Israeli Holding Company receives from securities which are traded on the Tel Aviv Stock Exchange are tax exempt; (v) interest received from certain financial institutions is tax exempt; and (vi) the Israeli Holding Company is not subject to the Israeli controlled foreign corporation regime. Israeli shareholders of the Israeli Holding Company are not entitled to the above benefits.

In order to qualify as an Israeli Holding Company, the company must be registered, and managed and controlled, in Israel. The company must be a private company and may not be created as a result of a tax-exempt reorganisation. The Israeli Holding Company must invest at least NIS 50 million (approximately USD 14 million) in its subsidiaries and the tax base of the Israeli Holding Company's subsidiaries may not be less than 75% of the tax base of its total assets. In addition, an Israeli Holding Company may not hold more than 20% of its assets in Israel (determined according to the cost base of the assets) or derive more than 20% of its income from Israel. At the subsidiary level, it is required that the subsidiary resides in a treaty country or in a country with at least a 15% corporate tax rate.

In addition, it is required that 75% or more of the subsidiary's income will be derived from a trade or business. It is also required that the Israeli Holding Company will hold at least 10% of its subsidiary's stock for a continuous period of at least 12 months.

5.4 Is there any special relief for reinvestment?

With regard to appreciated assets, a capital gain which arises in the case of a replaced asset is deferred until the sale of the new asset which replaced the old asset, subject to certain conditions. The principal condition is that the price purchase of the new asset will be higher than the sale price of the replaced asset.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed upon the formation of a subsidiary in Israel.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no significant taxes or fees that will be incurred by a locally-formed subsidiary but not by a branch of a non-resident company. However, repatriation of profits by a subsidiary by way of dividend distribution is subject to a withholding tax that would not apply in the case of repatriation of profits by a branch.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch 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.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

In general, there is no branch profit tax in Israel. However, in the case of a non-resident company that has "approved enterprise" status under the Capital Investments Law, its profits are subject to tax at the rate of 15%, in addition to the corporate tax that applies to such profits. The Income Tax Commissioner is authorised to defer payment of the 15% tax if it is shown that such profits remain in Israel and are used for the purpose of the company's business in Israel.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Since a branch will generally not be treated as a resident of Israel for tax purposes, it will not be eligible to benefit from the provisions of Israel's tax treaties. A branch will usually be entitled to the benefit of a "non-discrimination" article in Israel's treaties; however, there is currently no rule of law or court decision in Israel that would entitle the branch to obtain tax relief pursuant to a tax treaty to which Israel is a party.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No. (See question 6.4 above.)

7 Overseas Profits

7.1 Does Israel tax profits earned in overseas branches?

Yes. Israel taxes profits earned in overseas branches at the regular corporate income tax rate. The Israeli tax will generally be subject to a foreign tax credit for taxes paid in the source country.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Yes. A dividend received by a local company from a non-resident company is subject to tax at rate of 25%. Generally, a direct foreign tax credit would be available against the Israeli income tax liability. In addition, if the local company owns 25% or more in the means of control of the foreign company (or a lower percentage as provided in an applicable tax treaty), indirect foreign tax credit may be available. Indirect foreign tax credit is also available with respect to distributions made out of earnings of second tier foreign corporations that are 50% or more owned by the first tier foreign corporation.

7.3 Does Israel have "controlled foreign company" rules and if so when do these apply?

Yes. A controlled foreign company is a foreign corporation that satisfies the following conditions: (i) its shares or rights are not traded in a stock exchange (or if traded, less than 30% of its shares or rights were offered to the public); (ii) most of its income or profits are passive; (iii) the tax rate applicable to its passive income in the foreign country is not higher than 20%; and (iv) more than 50% (and in some cases 40%) in one or more of the means of control are held by Israeli residents subject to certain attribution rules or an Israeli resident has a veto right with respect to significant management decisions. An Israeli resident that holds 10% or more in one of the means of control in the controlled foreign company (subject to attribution rules) in one of these dates: (i) at the end of the tax year; or (ii) on a day in the tax year and on a date in the following tax year, will be deemed to receive a dividend from the controlled foreign company in an amount representing his share in the passive income of the company. The tax rate applicable to such deemed dividend is generally 25%. A foreign tax credit is available against such tax in an amount representing the amount that would have been withheld (or otherwise paid) at the source country by the foreign company had such company actually distributed a dividend.

8 Anti-avoidance

8.1 Does Israel have a general anti-avoidance rule?

Section 86 of the Ordinance is a general anti-avoidance provision which permits a tax assessing officer to disregard a transaction which is artificial or fictitious, or one of whose principal objectives is an improper avoidance or reduction of tax. In addition, even in the absence of express statutory provisions, the "substance over form" doctrine is generally an accepted principle of Israeli case law.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Regulations have been made under the Ordinance, which imposes a disclosure requirement with respect to certain defined categories of transactions.

Meir Linzen

Herzog Fox & Neeman
Asia House, 4 Weizmann Street
Tel Aviv 64239
Israel

Tel: *+972 3 692 2020*
Fax: *+972 3 696 6464*
Email: *linzen@hfn.co.il*
URL: *www.hfn.co.il*

Meir Linzen, senior partner and Herzog Fox & Neeman's managing partner, is regarded as one of Israel's leading tax experts. Meir heads the firm's Tax Department, the largest and best known in Israel. He specialises in tax planning for international and cross-border transactions and in addition has unique experience in tax issues relating to international mergers and acquisitions in Israel.

The Tax Department, headed by Meir, has been involved in the tax issues in most of the transactions handled by the firm, a number of which are considered among the largest in the Israeli market in recent years. Meir handles transactions that often involve multinational corporations active in Israel and advises on substantive tax issues with respect to acquiring local corporations, transfer pricing, benefits for investors and employee benefits.

Meir Linzen acts as the Vice Chairman of the Israeli Tax Committee of the Israel Bar Association. In addition, he has acted as a member of the public committee which was established by the Israeli government regarding taxation of trusts.

Eldar Ben-Ruby

Herzog Fox & Neeman
Asia House, 4 Weizmann Street
Tel Aviv 64239
Israel

Tel: *+972 3 692 2020*
Fax: *+972 3 696 6464*
Email: *ben-ruby@hfn.co.il*
URL: *www.hfn.co.il*

Eldar Ben-Ruby, a senior tax partner at HFN's Tax Department, specialises in international taxation issues and various investment funds at all stages of their corporate development. In addition, Eldar heads HFN's Private Equity and Investment Fund Formation team.

Eldar has considerable experience in tax planning and structuring for merger and acquisition transactions as well as in structuring, forming, and accompanying some of Israel's leading investment funds (most notably venture capital, buyout and hedge funds both in the primary and secondary markets).

Eldar Ben-Ruby is a member of the public committee regarding the tax implications of the IFRS rules and acts as a special tax counsel to the Israel Venture Association. He often lectures and advises government agencies on the special features and requirements of investment funds.

hfn HERZOG FOX & NEEMAN
LAW OFFICE

HFN's Tax Department is the largest and most broadly experienced tax team for international transactions of any law firm in Israel. The Department is pre-eminent not only due to the scope of its practice and its expertise in international tax planning, but also due to its influence on Israel's tax regime in general. HFN's tax lawyers have long been involved in structuring major international transactions, as well as obtaining landmark tax rulings which have shaped Israel's Hi-tech and venture capital industry.

Members of the department, with years of experience at the forefront of public discussions on major domestic and international tax issues, advise the Finance Ministry and various tax authorities on proposed legislation and tax policy issues and frequently play a role in the preparation and review of proposed changes to Israeli tax law and practice.

The Tax Department's work includes tax advice for Israeli and cross-border transactions of all types, including advice on multinational mergers, acquisitions, investments, project finance, transfer pricing, competent authorities procedures, and derivatives; tax advice to domestic and multinational corporations with respect to public offerings and private placements of equity, debt, and hybrid securities; tax advice regarding real estate acquisitions and municipal laws, financing, and restructuring related workout transactions.

Italy

Paolo Omodeo Salè

CBA Studio Legale e Tributario

Nicoletta Mazzitelli

1 General: Treaties

1.1 How many income tax treaties are currently in force in Italy?

Italy has a network of 88 income tax treaties currently in force.

1.2 Do they generally follow the OECD or another model?

The treaties are based and generally follow the OECD Model Convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. Tax treaties must be ratified by an ordinary law approved by the Italian Parliament.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Treaty abuse is usually prevented through "subject-to-tax" and "beneficial ownership" clauses, as provided for by the OECD Model.

The "limitation of benefit" clause is provided for in the Double Tax Treaty with the United States, currently in force.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Tax treaties cannot be overridden by domestic law, irrespective of whether they exist at the time the treaty is incorporated in the Italian law or they are introduced later. In case of a conflict between a provision of a tax treaty and domestic law, other than the Constitution, the tax treaty prevails. However, if more favourable to the taxpayer, the domestic rules shall apply.

2 Transaction Taxes

2.1 Are there any documentary taxes in Italy?

Almost all legal documents are subject to stamp duty *(Imposta di bollo)*. The tax ordinarily amounts to €14.62 every four pages or 100 lines of the document (every 100 pages in case of corporate ledgers). Deeds and legal documents executed in Italy must be registered with the Revenue Agency and are subject to Registration Tax *(Imposta di registro)* at rates that vary depending on the nature of the deed (up to 8% for the transfer of buildings). Also the taxable base may vary depending on the nature of the deed. Registration Tax may also apply to deeds and legal documents subject to VAT, but at a nominal fixed amount (€168). Deeds, agreements and legal documents executed outside the territory of the Republic of Italy are not subject to Registration Tax in connection with their execution and entry into force. However, they would be subject to registration in Italy in "case of use" (*caso d'uso*), i.e. when a document is: (i) deposited with a judiciary office for administrative purposes only; or (ii) deposited with a government agency or local authority, unless such deposit is mandatory by law or regulation or it is required in order for the relevant government agency or local authority to comply with its own obligations. The transfer of a going concern existing in Italy shall be registered in any case.

Transfers of real estate properties are also liable to cadastral and mortgage taxes, on the same taxable base and at tax rates set at 3% for buildings that are instrumental to the business activity.

Appeals, deeds, decrees, orders and the other documents relating to, *inter alia*, civil, criminal, tax and administrative proceedings, are subject to a single charge (the *contributo unificato per le spese degli atti giudiziari*), due up front, of up to €1,110, depending on the value of the proceeding.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The Italian value added tax (VAT) system conforms with the European directives. VAT is due on supplies of goods and services carried out in the course of a business activity or of the execution of an artistic or professional activity. VAT is levied at the following rates:

- Standard rate

The standard rate is 21%. As of September 16, 2011, the standard rate increased by 1%, as ordered by law no. 148, of September 14, 2011.

- Reduced rate

The reduced rate is 10% and applies to certain supplies of goods and services, including supplies of certain food and non-alcoholic drinks, passenger transport, catering, hotel accommodation, supplies of pharmaceutical products for human or veterinary medicine, supplies of gas and electricity for domestic use, some oil products, theatre and cinema, repair work on certain categories of real estate, etc.

- Super reduced rate

The super reduced rate is 4% and mainly applies to the supply of basic food stuff, books and other printed matter.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Italian VAT law provides for exemptions and exclusions, in line with the EU Directive no. 2006/112. Exemptions include banking and financial services, insurance services, sanitary and diagnostic services and transactions concerning shares, bonds and other securities, sales and leases of real estate properties (but with the option to tax in certain cases), as well as exemptions related to international transports, exports and intra-community supplies of goods.

Exclusions include the transfer or contribution in kind of going concerns, the transfer of goods as a consequence of mergers and demergers.

The 2010 VAT Package has acknowledged the provisions of EU Directive no. 2008/8/EC, related to the place of supply of services, introducing *inter alia* the application of a reverse charge in B2B transactions.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

VAT is recoverable as long as the purchased/imported goods or services are used for the purposes of carrying out taxable transactions or certain exempt transactions entitling to the recovery of VAT (such as export and international services).

The domestic law provides for:

- a total un-recoverability for VAT relating to operations not subject to VAT;
- a partial deduction (with a general *pro-rata*) for taxpayers carrying out both exempt and taxable activities;
- a partial deduction (to be determined on an objective base) for VAT on purchases related both to taxable and outside of the scope transactions; and
- limitations over the deduction for certain purchased/imported goods and services (e.g. motor vehicles, transports, drinks and food and entertainment expenses).

2.5 Are there any other transaction taxes?

No. The tax due on financial instruments' transfers (*Tassa sui contratti di borsa*), previously in force, was repealed starting from December 31, 2007.

2.6 Are there any other indirect taxes of which we should be aware?

The Italian tax system provides for excise duties levied on oil, energy products, electricity and particular classes of goods (e.g. alcohol and tobacco).

The Italian tax system also provides for so-called "pollution taxes". These consist of the tax on SO2 and NOX emissions, introduced in 1997, applying to large power plants, and so-called "carbon tax", levied on each tonne of carbon, petroleum coke and orimulsion consumed by combustion plants.

Loans granted by banks or other financial institutions with a duration exceeding 18 months are subject to a substitute tax, at a rate of 0.25%. The tax rate is equal to 2% for loans granted for the purchase of real estate properties other than those used as a main abode.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends paid to non-resident shareholders on participations not connected with Italian permanent establishments are subject to withholding tax at a rate of 27%, that will be decreased to 20% as of January 1, 2012. The rate is 20% on dividends on saving shares. The tax rate is 20% for shares held by pension funds incorporated in an EU or EEA Member State, included in a so-called "white list".

Italian law provides for a refund of up to 4/9 (1/4 as of January 1, 2012) of the withholding tax for non-resident shareholders, if the recipient proves that it has paid a final tax on the same dividends in the country of residence.

The withholding tax rate, if due, can be reduced in accordance with the relevant tax treaty.

Following the implementation of the EU Parent-Subsidiary Directive, dividends paid to EU parent companies are not subject to withholding tax if the parent holds at least 10% of the share of the capital of the Italian company, for at least one year.

Starting from the distribution of profits accrued in taxable years starting on or after 1 January 2008, the dividend withholding tax applies at a reduced rate of 1.375%, provided that the beneficial owner of the dividends is a company subject to a corporate tax in other EU or EEA Member State included in a so-called "white list".

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid by an Italian resident entity to a non-resident person are subject to a 30% withholding tax, to be levied on 75% of the relating amount. The withholding tax rate, if due, can be reduced in accordance with the relevant tax treaty.

Royalties paid to companies resident in another EU Member State may be exempted from withholding tax if the conditions set by Directive 2003/49 apply.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In general, interest payments to non-resident persons are subject to a withholding tax at the same rates applicable to interest paid to residents (i.e. 27%, reduced to 20% as of January 1, 2012 and 12.5% depending on the source of interest). Withholding tax rates can be reduced under double tax treaties.

No withholding tax applies to interest paid to non-resident persons on deposit accounts with banks and post offices. Interest paid to non-resident persons on Government bonds and on bonds issued by banks or listed companies, and with a maturity of at least 18 months, is exempt if the beneficial owner is a resident of a country with which Italy has an adequate exchange of information system.

As of January 1, 2012, the 27% rate applicable to interest on loans paid to persons resident in a country or territory outside the European Union with a preferred tax regime is reduced to 20%.

As of January 1, 2012, the withholding tax will apply at 5% on interest on secured loans, which is paid to non-resident companies that are not the beneficial owner and that use the interest received from an Italian company to re-pay interest which arose from their-own issued bonds.

Interest paid to companies resident in another EU Member State may be exempted from withholding tax if conditions set for by Directive 2003/49 apply.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Existing provisions limit the deduction of interest expenses, other than capitalised ones, up to an amount equal to interest income accrued in the same tax period. Any excess over that amount is deductible up to 30% of gross operating income (EBITDA).

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

See question 3.4 above.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The deduction of payable interest (see *supra* question 3.4) are limited to interest deriving from lease contracts, issued bonds (or any other similar debt security), loans and other kind of financial transactions (except for commercial debts), irrespective of the nature of the lender.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No, there are not.

3.8 Does Italy have transfer pricing rules?

The transfer pricing rules provided for by the Italian Law and Tax administration instructions are in line with the OECD Transfer Pricing Guidelines.

From 2010, documentation requirements have been introduced. Specifically, in case of tax audit, if the taxpayer has the necessary transfer pricing documentation, in case of assessment, penalties will not be charged. Otherwise, a penalty ranging from 100% to 200% of the tax due on the price adjustment will be imposed. Details in respect of the content of the transfer pricing documentations have been provided for by the Italian tax authorities in the *Provvedimento* no. 2010/137654.

A so-called "international ruling" procedure is available to companies with international activities to fix through an agreement with the Italian Tax Authority in advance and for a three fiscal year period tax issues relating to transfer pricing, interest, dividends and royalties.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The Italian Corporate Income Tax (so-called "IRES") applies to resident and non-resident corporations. Resident corporations are subject to IRES on their worldwide income (worldwide taxation), while non-resident entities are subject to IRES only in relation to the income regarded as sourced in Italy. The taxable period coincides with the financial year, as provided for by the law or by the memorandum of association. IRES is levied at a flat rate of 27.5%.

A corporate income tax surcharge commonly referred to as the "Robin Tax", is levied at the 10.5% rate for fiscal years 2011, 2012 and 2013 on companies operating in the energy sector who have registered in previous year gross revenues of at least 10 million Euros and 1 million Euros of corporate income tax base.

4.2 When is that tax generally payable?

IRES is payable in three instalments: an advance payment (divided in two instalments); and one settlement payment.

The advance payment shall be made for an amount equal to 100% of previous year's tax liability or on the base of the estimated tax liability for the current year, whichever is lower.

The advance payment is due:

- at the time a company pays the balance (see below) for the previous financial year, for an amount equal to 40%; and
- by the end of the 11th month of the tax period; the second advance payment equal to 60%.

The settlement must be paid by the 16th of the 6th month following the end of the financial year.

It is generally possible to pay taxes one month after the relevant deadline, with an additional charge of interest at the rate of 0.40%, calculated on the amount of the tax due.

Any surplus tax paid with respect to liability as per the tax return may either be carried forward and used to off-set other tax liabilities or claimed for refund.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The taxable base is the worldwide income shown on the profit and loss account of the relevant financial year, according to company law rules and adjusted according to the tax law provisions concerning business income. Exempt income and income subject to a final withholding tax are not taken into account in determining taxable income.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Taxable income for IRES purposes is subject to the following main adjustments:

- Dividends received paid by Italian resident corporations or corporations resident in countries with no privileged tax regimes are excluded from the taxable base, for an amount of up to 95% of their total gross amount.
- Straight-line depreciation of the costs of tangible assets is deductible up to the maximum amount established according to the depreciation rates provided by a Decree of the Ministry of Finance.
- Intangible assets can be amortised for a maximum of 50% of the cost per annum; trademarks cost and goodwill are deductible up to 1/18th of their amount.
- The cost of cars and other motor vehicles is fully deductible only if they are used for the purpose of the business activity (e.g. for car rental companies); otherwise, it is deductible for

40% up a cost of €18,075.99. If cars are assigned to employees, the cost is deductible at 90%, with no limits of costs. The same rules apply to maintenance services and operating expenses relating to cars and motor vehicles.

- Telecommunication services expenses can be deducted up to 80% of their amount.
- Adjustments to the profit shown in the commercial accounts may derive from the application of CFC rules.
- Provided that certain conditions are met, capital gains derived from the disposal of assets can be taxed over 5 years.

4.5 Are there any tax grouping rules? Do these allow for relief in Italy for losses of overseas subsidiaries?

Companies belonging to the same group can benefit from an optional system of taxation.

There are three different tax grouping rules:

- national consolidation;
- worldwide consolidation; and
- tax transparency.

National consolidation

In order to benefit from the regime, the controlled company must be Italian resident, while the controlling company may also be a non-resident company, provided that it is resident in a country with which a double tax treaty is in force and provided it has a permanent establishment in Italy whose assets include the participations in the Italian subsidiaries. The shareholding must be more than 50%, calculated either directly or indirectly.

Requirements are:

(i) an identical taxable period for all consolidated companies; and

(ii) a specific joint election to be filed with the Tax Authority within the 20 of the 6th month after the start of the consolidation period.

The option is irrevocable for three years and renewable for a period of three years and can be made also for selected subsidiaries only.

The entire taxable income (losses) of the subsidiaries is attributed to the parent company, regardless of the level of shareholding and any consideration paid within the tax group for the tax advantages arising from the consolidation is tax-free.

All companies participating to the tax consolidation are jointly and severally responsible for the combined tax liability.

Roll-over relief is provided on contributions and on the transfers of assets within that tax group.

Worldwide consolidation

A worldwide tax consolidation regime is available in order to consolidate foreign subsidiaries. Conditions to qualify for the regime are as follows.

The controlling company must be resident in Italy and it must be either a listed company or a holding controlled by individuals resident in Italy which has no other controlled companies either in Italy or abroad or, finally, a company controlled by the Italian State.

All foreign companies in which the Italian parent holds more than 50% of shares or voting rights shall be consolidated (so-called "all in, all out" principle).

All companies must have identical taxable periods and their accounts must be audited.

The taxable income is imputed to the controlling company resident in Italy only proportionally.

The regime is available under a tax ruling and upon election. The election is irrevocable for five years, and is subject to renewal for a period of three years. No election can be made by a parent company which has elected for domestic tax consolidation. The tax authorities may specify additional conditions when issuing the tax ruling. Foreign tax credits relating to the taxes paid abroad are deductible.

Tax transparency

Under a tax transparency system, the income of a company is taxed in the hands of the shareholders in proportion to their participation, i.e. the company's profits and losses are transferred to the shareholders regardless of whether profits are distributed.

A corporation can make the election only if the shareholders are all Italian resident corporations and the participation of each shareholder is no less than 10% and no more than 50%. In case of a non-resident shareholder, the regime is applicable provided that no withholding tax is applicable on dividends distributed by the Italian subsidiary (i.e. non-resident shareholders qualifying for the Parent - Subsidiary Directive). The option is irrevocable for three taxable periods and must be exercised by all the companies and communicated to the tax authority within the first of the three accounting periods.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, it is not.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Companies are also subject to the Regional Tax on Business Activities (IRAP) at a standard rate of 3.9% (regional authorities may decrease or increase the standard rate by up to one percentage point). IRAP is not deductible from a IRES taxable base. With effect from fiscal year 2011, Law Decree 98/2011 provided for new rates for Banks (4.65%) and Insurance Companies (5.90%).

The taxable base is equal to the net value of production and is determined in relation to the type of activity and only with respect to the business carried on in the Italian territory.

The method for determining the net value of production differs for:

- industrial and commercial companies;
- banks and financial entities;
- SIMs (so-called "*società di intermediazione mobiliare*") not trading on their own account or place securities they have underwritten;
- SIMs trading on their own account and place securities they have underwritten;
- management companies of mutual investment funds (so-called "SGR"); and
- investment companies with variable corporate capital (so-called "SICAV").

The tax is payable according to the same rules provided for IRES; please see question 4.2 above.

4.8 Are there any local taxes not dealt with in answers to other questions?

Real estate properties are subject to the municipal tax on real estate (ICI, *Imposta Comunale sugli Immobili*). The taxable base equals the sum of the estimated value for the type and the class of immovable property (as determined by the Cadastral Office) for the months of possession during the calendar year. The Municipality where the property is located sets the tax rate ranging from 0.4% to 0.7%. For industrial buildings without a cadastral value, the taxable base is the historical cost of the real estate, re-valued by certain fixed parameters.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There is no special set of rules for taxing capital gains and losses. As a matter of fact, apart from the participation exemption regime, capital gains and losses arising from the disposal of assets are included in the IRES taxable base and also, subject to certain conditions, in the IRAP taxable base. If the assets have been held for the 3 financial years preceding the year of disposal, the seller may elect to tax the gains, in equal instalments, over a period of up to 5 years (including the year of the sale).

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

There are no special tax rates provided for capital gains in Italy.

5.3 Is there a participation exemption?

Yes, according to the Italian law on participation exemption (PEX), 95% of the amount of capital gains derived from the disposal of shares and other participations by corporate entities is exempt from tax, provided that the participation has been held continuously from the first day of the 12th month prior to the disposal; for this purpose, the LIFO principle applies.

In order to qualify for the exemption, the following criteria must be met through the 3 financial years preceding the year of the disposal:

(i) the participated company must be a resident of a state or territory which is not included in the so-called black list, as provided by the Ministerial decree 21, November 2001, unless a ruling has been obtained that the holding of the shares in the black-listed company does not achieve the localisation of income in a black-listed state or territory ("*subject to tax*" test);

(ii) the participated company must perform a real business activity ("*active business*" test). The active business test does not apply for listed companies; and

(iii) the participation must have been accounted for as a fixed asset in the first Financial Statements of the holding period.

In the case of a holding company, the conditions set out under points (i) and (ii) are met if they are met by the subsidiary whose shares represent the majority of the assets of the holding.

In case of a company holding real estate assets, the capital gain is considered exempt only if the effective business consists in the building and sale of real estate and not the mere enjoyment of the properties.

5.4 Is there any special relief for reinvestment?

No, there is not.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Registration tax equal to €168 is due upon the formation of a subsidiary. The same tax is applicable to the establishment of a branch.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

An annual fee payable to the Chamber of Commerce proportional to yearly turnover is due by locally formed subsidiaries. The fee ranges from €373 to €77,500 (if the turnover exceeds €51.6m). Branches of non-resident companies are subject to a yearly fee of €110.

6.3 How would the taxable profits of a local branch be determined?

In principle, Italian branches are not treated differently from Italian resident subsidiaries.

The branch shall keep local accounting books and must draw-up its profit and loss account for tax purposes. It is subject to IRES, according to the same rules applied to Italian resident corporations (the income being calculated based on the profit attributable to the branch), and to IRAP, which applies to the value of the net production deriving from the activity carried out by the branch in the Italian territory.

Moreover, Italian tax law provides for a "limited force of attraction" of the branch, under which other items of income of the foreign company sourced from Italy (but not related to the branch) may be attributed and included in the taxable income of the Italian branch. However, this limited force of attraction should not apply if the foreign company is resident in a treaty country.

Transfer pricing documentation requirements also to Italian branches of foreign companies.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

No, it would not.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As a general rule, a branch cannot benefit from double tax treaty provisions as it is not, as such, considered as a resident within the meaning of the tax treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding taxes are levied on remittance of branch profits.

7 Overseas Profits

7.1 Does Italy tax profits earned in overseas branches?

Resident companies are subject to corporate income tax (IRES) on their worldwide income. Foreign income, including profit from foreign branches, is therefore computed in the taxable base, according to Italian rules.

The head office is required to keep separate ledgers for income and expenses of foreign permanent establishments so that their profits and losses can be determined without further processing.

The criteria of allocation of income and expenses between the head office and its permanent establishments are not regulated under Italian domestic tax law. It must be noted that, even if resident entities subject to the corporate income tax are taxed on their worldwide income (thus also including the results of foreign permanent establishments), the allocation of income to the foreign permanent establishment is relevant for the purposes of the foreign tax credit computation.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Foreign-source dividends are treated in the same manner as domestic dividends. Therefore, 95% of their amount is not included in the taxable base for corporate income tax purposes, subject to the condition that: (i) the dividends have not been fully or partially deducted in the state of source; and (ii) are not derived (i.e. directly or distributed) from a company resident in a state or territory included in the CFC black list.

The Tax Authorities clarified (circular letter no. 51 of 2010) that dividends distributed by a European subsidiary, which in theory may benefit from the Parent-Subsidiary Directive (see question 3.1), are taxable in Italy if:

- such dividends are derived (fully or partially) from black-listed countries; and
- the holding of shares in the foreign company through the EU company is aimed at avoiding the less favourable tax regime.

However, as clarified in the Circular, the presence of such abusive triangular scheme must be ascertained by using a case-by-case approach with a burden of proof on the company to give evidence of where dividends distributed to the Italian shareholder are derived from. In the absence of such evidence, dividends distributed to the Italian shareholder are deemed to be derived from black-listed countries.

7.3 Does Italy have "controlled foreign company" rules and if so when do these apply?

Italian CFC legislation provides that the profits realised by a foreign entity are deemed to be the profits realised by an Italian resident person, whether they are an individual, a corporation or another entity subject to corporate income tax, if:

- the resident person controls, directly or indirectly, also through a trustee or interposed third persons, a foreign entity; and
- the entity is not resident in a state or territory included in the list of countries or territories allowing an adequate exchange of information (the so-called "white list").

From 2010, CFC rules have been extended to include countries, which are not officially listed as black list countries. Accordingly, they now also apply to any jurisdiction in which the following two conditions are met:

- the effective taxation of the controlled foreign company is 50% lower than the Italian taxation on the same income, in the same taxable year; and
- the foreign company derives more than 50% of its proceeds from passive income or intra-group activities.

In addition to controlled companies, the CFC legislation is also applicable to "affiliated companies", i.e. where an Italian resident entity directly or indirectly holds 20% (10% in the case of listed companies) or more of the entitlement to profit rights of an entity resident or established in a state or territory which has a privileged tax regime.

These provisions do not apply if the Italian controlling entity proves that the localisation abroad does not constitute an artificial scheme aimed at achieving undue tax advantages. To this end, the Italian resident has to apply for a ruling of the Italian tax authorities. It is possible to claim the non-application of CFC rules by filing an advance ruling request, whereby adequate documentation is provided in order to prove either that (i) the non-resident entity mainly and effectively carries on a commercial or industrial activity as its principal activity in the foreign country or territory in which it is established, or that (ii) the participation in the non-resident subsidiary does not trigger the effect of locating income in a tax heaven country (in other terms, the location of the subsidiary in the low-tax country was not tax-driven).

8 Anti-avoidance

8.1 Does Italy have a general anti-avoidance rule?

Italian tax law does not contain a general anti-avoidance rule, but several specific provisions intended to counter specific tax avoidance practices.

The most important among them is art. *37-bis* of the Presidential Decree no. 600/1973, providing that the tax authorities may disregard single or connected acts, facts and transactions carried out without valid economic reasons, intended to circumvent obligations and limitations provided under tax law and to obtain tax savings or refunds otherwise undue when certain specific transactions are carried out.

Law no. 248/2006 introduced the rebuttable presumption that a non-resident entity holding a controlling interest in an Italian subsidiary shall be considered tax resident in Italy if (i) it is directly or indirectly controlled by Italian residents, or (ii) the majority of the members of its Board of Directors are resident in Italy.

Moreover, under Law no. 724/1994, certain entities (such as stock companies, limited liability companies and non-resident companies and entities) shall be deemed to be "dummy" if they do not get through the "operating test", comparing the operating revenues with an amount resulting from the application of fixed ratios to certain assets. The fiscal consequences for an entity to be considered dummy are: (i) for direct tax purposes, the duty to declare a minimum taxable base; and (ii) for VAT purposes, no right to claim the relevant refund, offsetting VAT or transferring the VAT credit surplus resulting from the VAT return (except for specific rules set forth for the VAT credit carry forward).

However, the Italian Supreme Court has ruled in various decisions that a general principle of 'abuse of law' is present in the Italian tax legislation, stemming directly from the Italian Constitution and applying to all kinds of taxes, indirect and direct. The concept of abuse of law, as defined by the ECJ and accepted by the Supreme Court, states that the tax implications of a transaction can be disregarded by the tax administration where such transaction is essentially aimed at obtaining a tax advantage.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is not a requirement to disclose the use and/or the content of an avoidance scheme.

Paolo Omodeo Salè

CBA Studio Legale e Tributario
Via Flaminia 135
00196 Roma
Italy

Tel: *+39 06 8091 3201*
Fax: *+39 06 807 7527*
Email: *paolo.omodeosale@cbalex.com*
URL: *www.cbalex.com*

Born in Rome on December 25, 1956, Paolo graduated in Economics and qualified as a Chartered Accountant and Auditor. He was a visiting scholar at Berkley University, School of Law, (California), in 1983.

Professional experience:

- 1981-1982 Second lieutenant with *Guardia di Finanza* (Finance Police) seconded at the General Headquarters.
- 1982-1985 Associate of Chiomenti Law Firm.
- 1985-2003 Associate, Partner, Managing Partner of Andersen Legal.
- 2003-2005 Equity Partner of Studio Tributario e Societario, Deloitte.
- 2004-2006 : Managing Partner of Studio Legale Associato, Deloitte.
- 2006-2008: Partner at Giontella-Omodeo Salè Studio Legale e Tributario, Rome.
- Since April 2008: Partner in Camozzi Bonissoni Varrenti & Associati, now CBA Studio Legale e Tributario.

Other: Speaker in several Tax Schools and Master Programmes.
Languages: English.

Nicoletta Mazzitelli

CBA Studio Legale e Tributario
Via Flaminia 135
00196 Roma
Italy

Tel: *+39 06 8091 3201*
Fax: *+39 06 807 7527*
Email: *nicoletta.mazzitelli@cbalex.com*
URL: *www.cbalex.com*

Born in Rome, on August 4, 1962, Nicoletta holds a Degree in Economics and she is qualified as a Chartered Accountant and Auditor.

Professional experience:

- From 1988 to 2000, Nicoletta has worked as a tax consultant for Andersen Legal. During this period she spent three years at the tax department of Arthur Andersen in London where she assisted clients both on international and Italian domestic corporate tax and VAT matters. She also worked in the Transfer Pricing specialised team.
- In 1999 she was appointed as the Italian VAT Service Line leader and in this capacity she has set up an Italy-wide group of specialised VAT consultants and has assisted multinational companies operating in the telecommunication, energy and e-commerce industries.
- In January 2001, she joined CBA Studio Legale e Tributario (formerly Camozzi Bonissoni Varrenti & Associati) as tax partner and she assists Italian and multinational companies on international corporate tax and VAT issues.

Other: She is currently partner of VAT Forum, an international partnership of indirect tax specialists.
Languages: English, French.

CBA
STUDIO
LEGALE E TRIBUTARIO

CBA Studio Legale e Tributario ("CBA") is one of the largest independent Italian firms, characterised by its strong partner-led approach, personalised services to clients and our partners' commitment to excellence.

CBA is a full service law firm with particular emphasis on corporate law, tax, private equity and real estate. Other areas of practice for which the firm is publicly recognised are energy, construction and infrastructures, trusts and estates, non-profit organisations and sports. CBA has currently 45 partners and over 180 professionals, with offices in Milan, Rome, Padua and Munich.

Japan

Nagashima Ohno & Tsunematsu

Yuko Miyazaki

1 General: Treaties

1.1 How many income tax treaties are currently in force in Japan?

As of September 1, 2011, there are 48 income tax treaties (applicable to 59 contracting states) currently in force in Japan. In addition, a tax treaty with Kuwait was signed on February 17, 2010 and a tax treaty with Hong Kong was signed on November 9, 2010, but neither of them have yet entered into force as of September 1, 2011. Also, new tax treaties were signed with Switzerland on May 21, 2010 (the "New Japan/Switzerland Treaty") and with the Netherlands (the "New Japan/Netherlands Treaty") on August 25, 2010 but neither of them have yet entered into force as of September 1, 2011. In addition, Japan has entered into tax information exchange agreements with several low tax countries and jurisdictions.

1.2 Do they generally follow the OECD or another model?

Most of the income tax treaties currently in force in Japan generally follow the OECD Model Treaty with certain deviations. After the new modernised tax treaty with the United States entered into force on March 30, 2004 (the "Japan/US Treaty"), the Japanese government is understood to have been considering the Japan/US Treaty as the new model for Japan's future treaties, particularly for treaties with developed countries. The Japan/US Treaty includes some noteworthy modernised provisions (such as, for example, a fairly comprehensive limitation on benefit clause and an exemption from source country taxation with respect to dividends paid by certain qualified subsidiaries to controlling parents), not found in the OECD Model Treaty. Following the Japan/US Treaty, similarly modernised tax treaties entered into force with the UK on October 12, 2006 (the "Japan/UK Treaty"), with France on December 1, 2007 (the "Japan/France Treaty"), and with Australia on December 3, 2008 (the "Japan/Australia Treaty"). The New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty are similar modernised tax treaties. In some of Japan's income tax treaties with developing countries, Japan agreed to include a tax-sparing credit clause. However, it is anticipated that Japan would generally take the approach of limiting the application of such a clause only to the necessary minimum in terms of the scope of income and the time period.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

If treaties are ratified by the Diet and promulgated in Japan, such treaties take effect domestically in Japan, in accordance with those treaties, without being incorporated into domestic law. However, it is generally understood that whether or not treaties are self-executing without any domestic execution law depends on the contents of the particular clause in those treaties. In Japan, matters necessary to implement tax treaties are provided for in the Act on Special Provisions of the Income Tax Act, the Corporation Tax Act and the Local Tax Act, in order to implement tax treaties and its related laws and regulations.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The Japan/US Treaty is the first income tax treaty executed by Japan in which a fairly comprehensive limitation on benefits clause of general application is included, and has been followed, with certain variations, by the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty; and so are the New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty.

The limitation on benefits clause included in the Japan/US Treaty provides that a resident of a contracting state that derives income from the other contracting state shall be entitled to the benefits accorded to residents of the contracting state only if such resident satisfies any one of certain objective tests, which are the "qualified person" test, the "active trade or business" test, and the "competent authority's determination" test. The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of one of the tests is likely to have a real business purpose for the structure which it has adopted; or has a sufficiently strong nexus to the contracting state to warrant obtaining the benefits; and that this business purpose or connection is sufficient to justify the conclusion that obtaining the treaty benefits under the Japan/US Treaty is not the principal purpose of establishing or maintaining residence in the contracting state.

The Japan/US Treaty, the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty (as well as the New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty) also include a series of anti-conduit clauses, which provide that a resident of a contracting state shall not be considered to be the beneficial owner of dividends, interest, royalties or other income in certain "back-to-back" arrangements so that, if such arrangement exists, contemplated treaty benefits are denied.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

It is a well-established constitutional principle in Japan that no treaty is overridden by any rule of domestic law (whether existing at the time the treaty takes effect or enacted subsequently).

2 Transaction Taxes

2.1 Are there any documentary taxes in Japan?

Japan has Stamp Tax, which is imposed on certain categories of documents that are exhaustively listed in the Stamp Tax Act, including, for example, real estate sales agreements, land leasehold agreements, loan agreements, transportation agreements, merger agreements and promissory notes.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

We have value-added tax, named Consumption Tax and Local Consumption Tax. The aggregate tax rate of Consumption Tax and Local Consumption Tax is at present 5%.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Taxable transactions, for the purposes of Consumption Tax and Local Consumption Tax, are defined to mean those transactions conducted by a business enterprise (regardless of whether it is a legal person, i.e. a company, or natural person, i.e. an individual; and, in the case where such business enterprise is a non-resident company or a non-resident individual, regardless further of whether or not such business enterprise has any permanent establishment in Japan) to transfer or lease goods or other assets or to provide services, for consideration, within Japan. However, certain specified categories of transactions, such as, for example, transfers and leases (other than for certain temporary purposes) of land, housing leases (other than for certain temporary purposes), transfers of securities, extension of interest-bearing loans, provision of insurance, deposit-taking and certain other specified categories of financial services, provision of certain specified scope of medical, social welfare or educational services, are excluded from taxable transactions. With respect to imported goods, they are subject to Consumption Tax and Local Consumption Tax when they are released from a bonded area, except that certain specified categories of imported goods, such as, for example, securities, stamps, exchange checks, equipment for disabled persons and textbooks, are excluded from taxable imported goods. Export transactions are generally exempt from Consumption Tax and Local Consumption Tax.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Consumption Tax and Local Consumption Tax charged on taxable transactions and incurred by a business enterprise is generally recoverable in full, by way of tax credit or refund, with certain exceptions; for example: (i) if a taxpayer's ratio of the revenue from taxable transactions over the total revenue from transactions within Japan is less than 95% (which is typically the case for, for example, certain financial institutions); or (ii) effective from any fiscal year starting on or after April 1, 2012, if a taxpayer's revenue from taxable transactions in the relevant fiscal year exceeds 500 million Yen, such taxpayer's recovery of Consumption Tax and Local Consumption Tax would generally be limited.

2.5 Are there any other transaction taxes?

There are some transaction taxes in Japan, including, but not limited to, Registration and Licence Tax, Real Property Acquisition Tax and Automobile Acquisition Tax.

2.6 Are there any other indirect taxes of which we should be aware?

There are various indirect taxes in Japan such as Liquor Tax, Tobacco Tax and Gasoline Tax. Depending on the business involved, these taxes may or may not be relevant.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Under the Japanese domestic tax law, generally a non-resident shareholder (either a non-resident company or a non-resident individual) of a Japanese company is subject to Japanese withholding tax with respect to dividends it receives from such Japanese company at the rate of 20%; provided, however, that, if the Japanese company paying the dividends to a non-resident shareholder is a listed company, this withholding tax rate is reduced to (i) 7% until December 31, 2013, and (ii) 15% thereafter, except for the dividends received by a non-resident individual shareholder holding 3% (or 5% if the record date for such dividends is on or before September 30, 2011) or more of the total issued shares of such listed Japanese company.

Most of the income tax treaties currently in force in Japan generally provide that the reduced treaty rate at the source country shall be 15% for portfolio investors and 10% or 5% for parent and other controlling shareholders. It may be worth noting that: (i) under the Japan/US Treaty and the Japan/UK Treaty, there is an exemption from source country taxation with respect to dividends paid by a company in either state to a shareholder who is a qualified resident (to be determined subject to the relevant limitation on benefit clause) of the other contracting state, if such shareholder is either a corporate shareholder holding 50% or more (or more than 50% in case of the Japan/US Treaty) of the voting shares of the issuer company (subject to certain additional requirements) or a pension fund; and (ii) under the Japan/France Treaty and the Japan/Australia Treaty there is a similar, but not the same, exemption from source country taxation with respect to dividends paid by a company in either state to a corporate shareholder with certain ownership percentage who is a qualified resident of the other contracting state. There is an exemption from source country taxation with respect to dividends similar to the one mentioned in (i) above in the New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty as well.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Under Japanese domestic tax law, royalties relating to patents, know-how or copyright used for any Japanese company's business carried on in Japan and paid by the Japanese company to a non-resident licensor (either a non-resident company or a non-resident individual) is subject to Japanese withholding tax at the rate of 20%. If such non-resident licensor is a non-resident company who has a branch office within Japan, such non-resident company licensor may be exempt from the said withholding tax as long as such non-resident company licensor satisfies certain requirements, including in particular the requirement that such royalties be subject to the Corporation Tax in Japan.

Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for royalties generally be reduced to 10%. It is worth noting that the Japan/US Treaty, the Japan/UK Treaty and the Japan/France Treaty provide that no source-country taxation shall be made by either state with respect to royalties, subject to comprehensive limitation on benefits clauses, while the Japan/Australia Treaty provides that the withholding tax rate for royalties is reduced to 5%. There is a similar exemption from source country taxation with respect to royalties in the New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty as well.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Under Japanese domestic tax law, interest on corporate bonds issued by a Japanese company that is paid to a non-resident bondholder (either a non-resident company or a non-resident individual) is generally subject to Japanese withholding tax at the rate of 15%. Also under Japanese domestic tax law, with respect to certain specified scope of discount corporate bonds issued by a Japanese company (except for certain qualified short-term discount bonds), such Japanese company will be required to withhold, at the time of the issuance of the discount corporate bonds, 18% or 16%, as the case may be, of the amount equivalent to the difference between the face value and the issue price thereof (original issue discount). The amount so withheld will be deemed to be, and treated as, the Income Tax imposed on, and collected from, the bondholder (including a non-resident bondholder) who receives the original issue discount upon redemption.

There are some important exceptions to the foregoing rule. Firstly, so long as corporate bonds are issued outside Japan on or after April 1, 1998 and interest thereon is payable outside Japan, a non-resident bondholder may be entitled to claim an exemption from Japanese withholding tax on both interest and original issue discount, subject to certain procedural requirements; provided, however, that this exemption does not apply for interest or original issue discount received by certain specified scope of parties related to the issuer (including parties that have more than 50% shareholding relationship). Also, with respect to book-entry corporate bonds to which the Act on Transfer of Bonds and Shares, etc. apply and a book-entry of which is made by a certain depository companies, a non-resident bondholder may be entitled to claim an exemption from Japanese withholding tax on both interest on and original issue discount from book-entry corporate bonds (except for bonds whose interest is linked to profits of the issuer or its related party) issued in the Japanese market before March 31, 2013, subject to certain procedural requirements; provided, however, that this exemption does not apply for interest or original issue discount received by certain specified scope of parties related to the issuer.

Interest on bank deposits and other similar deposits deposited by a non-resident depositor (either a non-resident company or a non-resident individual) with any office of a bank or other institution in Japan is generally subject to Japanese withholding tax at the rate of 15%, under Japanese domestic tax law.

Interest on loans extended by a non-resident lender (either a non-resident company or a non-resident individual) to a Japanese company conducting business carried on in Japan and in relation to such business is generally subject to Japanese withholding tax at the rate of 20% under the Japanese domestic tax law. If such non-resident lender is a non-resident company who has a branch office within Japan, such non-resident company lender may be exempt from the said withholding tax as long as the non-resident company lender satisfies certain requirements, including in particular the requirement that interest on such loans is subject to the Corporation Tax in Japan.

As an exception to the foregoing, if a non-resident company makes a deposit or extends a loan to any of the financial institutions designated under the Foreign Exchange and Foreign Trade Law of Japan who book such deposit or loan as a special account for offshore banking on or after April 1, 1998, such non-resident company would be exempt from Japanese withholding tax with respect to interest to be paid on such deposit or loan.

Most of the income tax treaties currently in force in Japan provide that the withholding tax rate for interest (regardless of whether it is interest on bonds, deposits or loans) is reduced generally to 10%. It is worth noting that under the Japan/US Treaty, the Japan/UK Treaty, the Japan/France Treaty and the Japan/Australia Treaty, certain specified categories of financial or other qualified institutions which are residents of the US, the UK, France or Australia, as the case may be, which qualify for treaty benefits thereunder, may be exempt from source country taxation in Japan with respect to interest, subject to certain requirements. There is a similar exemption from source country taxation with respect to interest in the New Japan/Switzerland Treaty and the New Japan/Netherlands Treaty as well.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

The payor of interest may be denied a deduction of the interest which it paid to a non-resident recipient for its own income tax purposes in Japan, due to the application of the "thin capitalisation" rules under Japanese domestic tax law. Even in such case, the treaty relief (i.e. the application of the reduced treaty rate under the applicable income tax treaty) available to the non-resident recipient of such interest would nevertheless not be restricted.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not applicable in Japan. Please see the answer to question 3.4.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Under the "thin capitalisation" rules in Japan, debt advanced by a third party and guaranteed by a parent company would generally be treated as related party debt, subject to "thin capitalisation" rules.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are generally no other restrictions on deductibility of interest payments by a local company to a non-resident other than the "thin capitalisation" rules in Japan, except that interest payments may be subject to transfer pricing rules. Please also see the answer to question 3.8 below.

3.8 Does Japan have transfer pricing rules?

Yes. Japanese transfer pricing rules are applicable to both a Japanese company and a Japanese branch of a non-resident company if either of them engages in transactions with any of their "foreign-related persons" (for example, a direct or indirect 50% share ownership would render a foreign person a "foreign-related person" for the purposes of the transfer pricing rules).

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

In Japan, there are at present five different income taxes imposed on corporate profits, namely: Corporation Tax (national tax); Prefectural Inhabitant Tax per corporation tax levy (local tax); Municipal Inhabitant Tax per corporation tax levy (local tax); Enterprise Tax (local tax); and Local Special Corporation Tax (national tax). Depending on the amount of stated capital and certain other factors, the applicable rates for each taxpayer company of these income taxes may vary. While the Enterprise Tax and the Local Special Corporation Tax paid in any fiscal year are treated as a deductible expense in such fiscal year, the other three income taxes are not deductible. Taking the foregoing into consideration, the headline effective tax rate of all income taxes mentioned above would be approximately 40%. (Please also see the answer to question 5.1 below.)

4.2 When is that tax generally payable?

The taxes on corporate profits are required to be paid, in principle, within two months after the end of each fiscal year. If a company is an ordinary company whose fiscal year is longer than six months, the company is required to prepay part of the current fiscal year's tax within two months after the end of the first six months of each fiscal year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for Corporation Tax is the net taxable income for Corporation Tax purposes; such net taxable income is calculated based on the results reflected in the taxpayer company's financials, prepared in accordance with Japanese generally accepted accounting principles, which are required to be finalised by the proper legal procedure as required under the applicable corporation law, and by making the necessary adjustments to such results as required by any applicable rules provided in the Corporation Tax Act and its related laws and regulations. The tax base for each Prefectural Inhabitant Tax per corporation tax levy and Municipal Inhabitant Tax per corporation tax levy is, in principle, the amount of Corporation Tax.

With respect to Enterprise Tax, generally the tax base is the net taxable income for Enterprise Tax purposes, as determined by the relevant rules for Enterprise Tax (which is not necessarily the same as the net income for Corporation Tax purposes; for example, offshore income is excluded for Enterprise Tax purposes); provided, however, that, if a taxpayer company's capital amount is more than 100 million yen, the tax base for Enterprise Tax is determined by a combination of the net taxable income, the amount of value added as determined by the compensation paid to employees, the net interest paid, the net lease rental paid and the net profit or loss in each fiscal year, and the capital of such taxpayer company. As an exception to the foregoing, the tax base for Enterprise Tax of electric, gas and insurance businesses is determined by gross revenue. The tax base for Local Special Corporation Tax is, in principle, the amount of Enterprise Tax.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main differences 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. Entertainment expenses are generally not deductible, even though such expenses are believed to be necessary for carrying on the business; provided, however, that, if the amount of stated capital of a company is 100 million yen or less, entertainment expenses of such company are deductible subject to a certain ceiling.

4.5 Are there any tax grouping rules? Do these allow for relief in Japan for losses of overseas subsidiaries?

It is possible for a group of Japanese companies, where a Japanese parent company directly or indirectly through other Japanese companies owns 100% of other Japanese subsidiaries, to file, at the group's election and subject to an approval of the Commissioner of the National Tax Agency, a consolidated tax return. Once the election to file a consolidated tax return is approved, such election would, in principle, continuously apply to the group making such election.

If a group of companies elects to file a consolidated tax return, the parent company is required to file the consolidated tax return and pay all the consolidated tax. Each subsidiary is jointly responsible for payments of consolidated tax. The consolidated tax is calculated on the basis of the aggregate income of the parent company and all consolidated subsidiaries.

Separate from the above-mentioned consolidated tax return system, the 2010 Tax Reform has introduced special rules for intra-group transactions (the "Group Taxation Rules"), which apply to group companies in a 100% group (companies that have a direct or indirect 100% shareholding relationship), even if they do not elect to file a consolidated tax return. While a consolidated tax return can only be elected by a group of Japanese companies where a Japanese parent company directly or indirectly through other Japanese companies owns 100% of other Japanese subsidiaries, the Group Taxation Rules apply to Japanese companies wholly owned by a foreign or Japanese company or individual. The Group Taxation Rules include the following rules, among others:

(i) recognition of capital gains/losses from transfer of certain assets between Japanese companies in a 100% group is deferred until the said assets are transferred or otherwise disposed of by the transferee company;

(ii) donation between Japanese companies in a 100% group is not deductible for a donor company and donation income is not included in taxable income for a donee company;

(iii) recognition of capital gains/losses from dividends-in-kind between Japanese companies in a 100% group is deferred; and

(iv) capital gains/losses from the transfer of shares by a Japanese company to the issuer of the said shares that is in the same 100% group as the transferor company are not recognised.

In Japan, the consolidation rules or Group Taxation Rules do not allow for relief for losses of overseas subsidiaries.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Tax is generally imposed at the same rate upon all corporate profits regardless of whether such profits are distributed or retained, with the exception that a certain additional surtax may be imposed on certain types of so-called family companies' retained profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

As far as national taxes are concerned, there are no other major taxes currently in force which may have a material impact on the business operations of a company in Japan.

4.8 Are there any local taxes not dealt with in answers to other questions?

Among local taxes other than those already mentioned above, Prefectural Inhabitant Tax per capita levy, Municipal Inhabitant Tax per capita levy, Fixed Assets Tax and Automobile Tax may be of general application to business operations in general of a company in Japan.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

For purposes of income taxes imposed on a company in Japan, 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. Exceptions to the foregoing include a surtax which may be imposed on certain capital gains derived by disposition of real properties; provided, however, that such surtax is currently suspended until December 31, 2013. In the case where a tax-free qualified corporate reorganisation such as a qualified merger is undertaken, recognition of capital gains can be deferred. Also, there may be a deferral of recognition of capital gains/losses from transfer of certain assets between Japanese companies in a 100% group, as mentioned in question 4.5 above.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The surtax (as referred to in response to question 5.1 above) to be imposed on capital gains derived by the disposition of real property including, but not limited, to land located within Japan, is 5%. If certain real property such as land in Japan is disposed of within five years from its acquisition, the rate of surtax is increased to 10%. The application of these surtaxes is suspended until December 31, 2013.

5.3 Is there a participation exemption?

There is no participation exemption for taxation on capital gains. However, with respect to dividends paid to a Japanese company by its foreign subsdiary during any fiscal years starting on or after April 1, 2009, a participation exemption from Japanese income taxation is granted for the 95% portion of such dividends if the Japanese company owns at least 25% of such foreign subsidiary's issued shares or voting shares for at least six months. With the introduction of such participation exemption for dividends, the indirect foreign tax credit system (which was previously applied up to the second tier indirect subsidiaries) was abolished. The 25% threshold requirement mentioned above may be altered if a particular taxpayer is eligible for treaty benefits under an applicable tax treaty in which lower threshold is required for a treaty-based foreign tax credit eligibility (for example, 10% shareholding threshold is provided under the Japan/US Treaty).

Also, with the introduction of the above-mentioned participation exemption rule for dividends, the Japanese anti-tax haven rules or controlled foreign corporations (CFC) rules were amended to the effect that, among others, retained earnings of a Japanese company's CFC subsidiaries shall be deemed to be included in the Japanese company's taxable income subject to Japanese corporate income taxation, regardless of whether or not such retained earnings are distributed as dividends, and certain other adjustment amendments are made.

5.4 Is there any special relief for reinvestment?

Dividends received by a Japanese company from another Japanese company may be either 100% or 50% (subject to certain adjustments) deducted from the recipient company's taxable income, depending on whether or not the recipient Japanese company owns 25% or more of the total issued shares of the dividend paying Japanese company. Such dividend-received deduction is also available to a Japanese branch of a foreign corporation with respect to dividends received by such branch from any Japanese company. Capital gains from the disposition of certain qualified business assets (such as certain qualified land and buildings) may be entitled to certain roll-over relief (in whole or in part) if certain qualified reinvestment is made within a prescribed period. Also, deferral of recognition of capital gains/losses from the transfer of certain assets and dividend-in-kind between 100% group companies has been introduced by the 2010 Tax Reform, as mentioned in question 4.5. Please also see question 5.3.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

If a non-resident company forms a subsidiary (i.e. establishing a company incorporated under the laws of Japan) by making a capital contribution in cash, the formation of a subsidiary is not a taxable event. If a non-resident company forms a subsidiary by making a contribution-in-kind, such contribution-in-kind is treated as a disposition by such non-resident company of the contributed assets. Although such disposition is generally a taxable event, if the contributed assets are real properties situated within Japan or certain other similar assets or otherwise than the assets held through such non-resident company's offices outside of Japan, such contribution-in-kind may qualify for a tax-free reorganisation under Japanese tax law if certain other requirements are satisfied. If the contributed assets fall under the category of the assets situated within Japan and the subject contribution-in-kind does not qualify for a tax-free reorganisation, it is possible that the capital gains derived from such disposition are found to constitute income sourced and taxable in Japan for the non-resident company making such contribution-in-kind, in which case such non-resident company would generally be, in the absence of a relief under an applicable tax treaty, subject to Japanese corporate income taxes with respect to such capital gains.

In order to form a Japanese subsidiary, the articles of incorporation of such subsidiary must be prepared, which is subject to Stamp Tax at the rate of 40,000 yen; also, such subsidiary must be registered in the commercial register kept at the competent office of the legal affairs bureau of the Ministry of Justice. Upon filing an application for such registration, such subsidiary is generally subject to Registration and Licence Tax at the rate of seven-thousandths (7/1,000) of its stated capital amount. Any subsequent increase in the stated capital of such subsidiary is also required to be registered in a timely manner in the commercial register and is generally subject to Registration and Licence Tax at the same rate. (While a branch of a non-resident company, including any change in the stated capital of such non-resident company in its home country, is also required to be registered in the commercial register in Japan, the rate of Registration and Licence Tax imposed on the branch upon application for such registration is fixed at 90,000 yen per application for establishment of a branch and 9,000 yen per application for change in the stated capital in its home country.)

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Generally, there are no other significant taxes or fees that would be incurred by a Japanese subsidiary upon its formation but not by a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

Under the Corporation Tax Act, if a non-resident company which has its branch in Japan earns "profits derived from business carried on within Japan", such business profits constitute Japanese source income taxable in Japan. With respect to the question of how the amount of such business profits should be determined, certain specific rules are provided in the relevant regulations. Under such regulations, depending on the category of business involved (e.g. whether the business involved is manufacturing, sale and distribution, construction, shipping or air transportation, insurance, publication and broadcasting, or any other business), different factors are used to determine the scope of income to be treated as business profits sourced from Japan.

In the case where the subject non-resident company is a resident of a country with which Japan has an income tax treaty, generally such treaty includes a provision similar to Article 7(2) of the OECD Model Treaty (requiring that the arm's-length principle shall be applied in determining the amount of income attributable to the relevant permanent establishment). The question of to what extent the above-mentioned specific rules included in the Japanese domestic tax law should be interpreted as being altered by such treaty provision often gives rise to a serious issue in practice.

With respect to the detailed method of calculating taxable income, the rules applicable to a Japanese company are, in principle, also made applicable to a branch of a non-resident company, mutatis mutandis. In calculating the taxable income of a branch, only such expenses as are necessary for earning Japanese source income are treated as deductible expenses.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax or other similar tax to which a branch of a non-resident company, but not a subsidiary, is subject.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch of a company which is a resident in such treaty country can benefit from the treaty provisions to some extent. For example, while the so-called entire system is adopted for income taxation of a non-resident company who has a branch in Japan under Japanese domestic tax law, under almost all of the income tax treaties currently in force in Japan, the attributable system is adopted. With respect to the treaty relief given to passive income such as dividends, interest and royalties, because most of the income tax treaties currently in force in Japan include provisions similar to Articles 10(4), 11(4) and 12(3) of the OECD Model Treaty, a branch of a non-resident company would not be allowed to enjoy such treaty relief.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No. No Japanese withholding tax or other tax would be imposed on the remittance of funds from the Japanese branch of a foreign corporation to its head office merely because such remittance is a repatriation of profits by the branch to its head office abroad.

7 Overseas Profits

7.1 Does Japan tax profits earned in overseas branches?

Yes. A Japanese company is generally subject to Japanese income taxes with respect to its worldwide income. In other words, if a Japanese company has overseas branch(es) and earns tax profits through such overseas branch(es), such tax profits are included in the Japanese company's overall taxable income for Japanese taxation purposes.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As already mentioned in question 5.3, subject to certain shareholding threshold and holding period requirements, the 95% portion of the dividends paid to a Japanese company by its overseas subsidiary is exempt from Japanese corporation tax.

7.3 Does Japan have "controlled foreign company" rules and if so when do these apply?

As already indicated in question 5.3, Japan has its own CFC rules and if such CFC rules are applied to any particular overseas subsidiary, such CFC subsidiary's net profits (but not its net losses) of any relevant fiscal year shall be deemed to constitute the Japanese parent company's income in its fiscal year ending immediately after two months have elapsed from the end of the subsidiary's relevant fiscal year, regardless of whether or not such profits are distributed to the parent.

8 Anti-avoidance

8.1 Does Japan have a general anti-avoidance rule?

Japanese tax laws do not have a general anti-avoidance rule. It is worth noting that recently the tax authority has tended to take a more active stance in combating avoidance schemes and taxpayers so challenged have been more inclined to seek judgments by the courts. Thus, the courts are playing a more important role than ever in rule-making in light of tax avoidance.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Japanese tax laws do not have a disclosure rule that imposes a requirement to disclose avoidance schemes.

Yuko Miyazaki

Nagashima Ohno & Tsunematsu
Kioicho Building, 3-12, Kioicho, Chiyoda-ku
Tokyo 102-0094
Japan

Tel: *+81 3 3511 6117*
Fax: *+81 3 5213 2217*
Email: *yuko_miyazaki@noandt.com*
URL: *www.noandt.com*

Yuko Miyazaki is a partner of Nagashima Ohno & Tsunematsu and her primary areas of practice are taxation, with a particular emphasis on international taxation, and general corporate law. She graduated from the University of Tokyo (LL.B.) and Harvard Law School (LL.M.).
Since she was admitted to the bar in Japan in 1979, she has been with Nagashima, Ohno & Tsunematsu (and its predecessor firm, Nagashima & Ohno), except for a two-year period from 1984 to 1986 during which she worked for the Legal Department of the World Bank in Washington, D.C. as Counsel.
She is a member of the International Fiscal Association and was a visiting professor of the University of Tokyo Law School from April 2004 through March 2007, teaching taxation of financial transactions/products and international taxation.

NAGASHIMA OHNO & TSUNEMATSU

Nagashima Ohno & Tsunematsu is widely known as a leading law firm in Japan, and a foremost provider of international and commercial legal services, including advice (strategic and legal), negotiation and documentation in a broad range of business law-related areas covering, among others, general corporate, M&A, capital markets and various other financing transactions, financial regulations, antitrust law, intellectual property laws, telecommunications, broadcasting, internet and multimedia law, labour law, taxation and dispute resolution. We represent domestic and foreign companies and organisations involved in every major industry sector and in every legal service area in Japan. The tax practice of Nagashima Ohno & Tsunematsu is renowned for its broad coverage of a variety of tax-related matters, ranging from tax planning for various commercial transactions to tax disputes and tax litigation cases arising from differences in opinion with the tax authority.

At Nagashima Ohno & Tsunematsu, the Tax Practice Group gathers together some of the most well-regarded practitioners in Japan, and we have a deep pool of talented professionals, provigin our clients with legal services of the highest quality. As testament to our efforts, many foreign tax publications have recognised our tax practice as having an unparalleled reputation, surpassing all other law firms in Japan.

Korea

Seung-Soon Lim

Yoon & Yang LLC

Tae-Hwan Oh

1 General: Treaties

1.1 How many income tax treaties are currently in force in Korea?

Beginning with the execution of the tax treaty with Japan in 1970, as of August 2011, Korea has executed double taxation treaties and anti-tax avoidance treaties on individual income tax, corporate tax, and other taxes with 77 countries, including the US, Germany, the UK, and Thailand.

1.2 Do they generally follow the OECD or another model?

Korea accepts the OECD standard model treaty as its tax model treaty, but if necessary depending on the counterpart countries, allows exceptions from the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Tax treaties are executed through such procedures as negotiation, signing, ratification, and exchange of the ratification instrument. In the case of ratification of a tax treaty, an instrument of ratification in a certain form should be prepared and exchanged in order to prove the ratification. Generally, treaties take effect on the date of exchange of such ratification instrument unless there are special provisions thereon. However, as for Korea, tax treaties specifically prescribe the effective date and the date of implementation in the provision for "entry into force".

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

(1) Adoption of Beneficiary Ownership Concept

In order to prevent residents of third countries from taking advantage of the tax treaties, tax treaties provide for the concept of beneficial ownership. That is, tax treaties provide that the limited tax rates in treaties apply only when the beneficial owner(s) of interests, dividends, and royalties are residents of the other contracting state.

(2) Exchange of Information

Tax treaties provide that necessary information should be exchanged between tax authorities of the contracting states for the purpose of preventing tax evasion and tax avoidance.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

If any provisions of tax treaties are different from domestic law, treaties should be applicable preferentially to the domestic law in order to keep the promise with the other contracting country. However, under the Korean Constitution, treaties have the same effects as those of domestic law, and it should be deemed that the rules of *lex posterior derogat priori* and *lex specialis derogat generali* apply in such cases.

2 Transaction Taxes

2.1 Are there any documentary taxes in Korea?

In Korea, anyone who prepares a contract to create, transfer, or change rights to properties or any other documents proving such is required to pay stamp tax on such documents at the time of preparation of such documents according to the Stamp Tax Act.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes, any enterprises which supply products or services subject to imposition of VAT are required to report and pay VAT on their supplies of products or services, regardless of whether they are registered enterprises, or whether VAT has been collected at the time of supplying such products or services.

The VAT rate is 10/100 with respect to both general tax payers and simplified tax payers.

In addition, pursuant to the principle of taxation in the consuming country which is accepted as a common practice in international trades, there is a zero-tax-rate system.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Supply of goods or services is one of the types of taxable transactions, and subject to imposition of VAT. In this context, "goods" refers to any tangible or intangible objects with economic values and "services" refers to labour or any other acts with economic values other than goods. However, provision of collaterals, transfer of business, and payment of tax in kind pursuant to the applicable law are not deemed as supply of goods or services.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input tax is deducted from the output tax during the taxable period, to which the date of supply of the goods or services subject to such input tax belongs. Businesses can recover any amount of input tax indicated on the tax invoice only if they received the invoice at the time of purchasing goods or services.

However, the amount of the following input tax will not be deducted from output tax: input tax on the expenses not directly relating to business; input tax relating to the purchase and maintenance of small cars for non-business purposes; or input tax relating to entertainment expenses.

2.5 Are there any other transaction taxes?

Securities Transaction Tax:

Transfer duty on the transfer on sale of shares is generally payable at the rate of up to 0.5%, which is called securities transaction tax. This tax shall generally be paid by the seller and applies even where the transfer is a share exchange between foreign companies. This tax should be generally assessed on transfer price. However, in cases where transfer price is not ascertainable, the value may be assessed in accordance with the Individual Income Tax Act.

2.6 Are there any other indirect taxes of which we should be aware?

Customs duties, a kind of national tax, are imposed on the products which are imported through the customs line from a foreign country into the Korean territory. Generally luxury items are subject to high rates of tax and raw material items are subject to low rates of tax.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

In the case of payment of dividends to non-residents, located in the countries which have no tax treaties with Korea, resident companies should deduct 20/100 of the payment as the withholding tax pursuant to the Corporate Tax Act.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In the case of payment of royalties to non-residents, located in the countries which have no tax treaties with Korea, local companies should deduct 20/100 of the payment as a withholding tax, pursuant to the Corporate Tax Act.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In the case of payment of interests to non-residents located in the countries which have no tax treaties with Korea, local companies should deduct 20/100 (14/100 in the case of interests on bonds) of the payment as a withholding tax, pursuant to the Corporate Tax Act.

Meanwhile, according to the Restriction of Special Taxation Act, if the payment falls under the interests on the foreign-currency-denominated bonds issued by local businesses or the interests on debts in foreign currencies, which are borrowed from foreign financial institutions and should be repaid in foreign currencies, collection of withholding tax in Korea is exempted regardless of execution of tax treaties.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Korea has adopted a taxation system for thin capitalisation under the Adjustment of International Taxes Act, established in the late 1995, and effective since January 1, 1997.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

According to the Adjustment of International Taxes Act, if the average amount of interest-bearing debts extended by foreign controlling shareholders exceeds three times (six times in the case of financial businesses) the amount of equity held by the same shareholders in the relevant local company, any interests on such excessive amount are not considered as an expense under the tax law.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, even if a local company has a loan extended by a third party other than its foreign controlling shareholder, if (i) there is a prior agreement between the local company and the foreign controlling shareholder, and (ii) the terms of the loan is actually determined by the local company and its foreign controlling shareholder, such loan is considered as a loan directly borrowed from the foreign controlling shareholder and subject to the taxation system for thin capitalisation.

In addition, any borrowings extended to a local company from a third-party financial institution under the foreign controlling shareholder's guarantee are also considered as loans subject to the taxation system for thin capitalisation.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Under the Corporate Tax Act, a local company, which has acquired and retained any assets recognised as not directly related to its business or has made any provisional payments to a specially related person not in connection with the company's business, may not include any interests paid on loans in its business expenses.

3.8 Does Korea have transfer pricing rules?

Under the Adjustment of International Taxes Act, in international transactions, of which one of the parties is a foreign specially related person, if the price of such transaction exceeds or falls short of a normal price, tax authorities may determine or correct the tax base or tax amount with respect to its resident, based on the normal price.

In addition, in order to remove any potential causes of conflicts between tax payers and tax authorities and provide foreseeability of taxation, there is the Advance Pricing Agreement (APA) system in place.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The corporate tax rate in Korea is currently 22%, but it will be changed to 20% from 2012.

4.2 When is that tax generally payable?

Companies should pay corporate tax on their income that they gain in a certain business year within 3 months from the closing date of the business year, but companies may pay the corporate tax in instalments with respect to (i) any amount exceeding KRW 10,000,000 if the tax amount payable exceeds KRW 10,000,000 and the total amount of tax payable is no more than KRW 20,000,000, or (ii) 50% of the tax amount payable if the amount is KRW 20,000,000 or more, within 1 month (2 months for small companies) from the expiration of the period for payment as mentioned above.

However, for companies whose business year is 6 months or longer, the period of 6 months is prescribed as the period for interim payment. Such companies should pay, within 2 months after the expiration of such period for interim payment, the tax amount corresponding to 6 months among the total corporate tax paid in the previous business year or the tax amount calculated based on its income generated in the 6 months of the relevant business year (if the tax amount payable exceeds KRW 10,000,000, payment in instalments as mentioned above is available). The corporate tax paid as interim payment is deducted from the calculation of the final amount of corporate tax for the relevant business year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The corporate tax base is calculated by applying certain adjustments to the profits assessed pursuant to the corporate accounting rules.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The matters subject to adjustment include the difference in taxable period between the Corporate Tax Act and corporate accounting; the difference in evaluation method of assets and debts; and, the expense items, which are classified into expenses in business accounting but cannot be recognised as deductibles for policy purposes (i.e. any amount of entertainment expenses exceeding the statutory limit, penalties, etc.).

However, new provisions were introduced to the Corporate Tax Act to alleviate the problems that may occur to companies that adopted International Financial Reporting Standards with respect to increase in tax liability or the burden to make tax adjustments.

4.5 Are there any tax grouping rules? Do these allow for relief in Korea for losses of overseas subsidiaries?

Korea enacted its first consolidated tax payment system on December 26, 2008 and implemented it on January 1, 2010. According to the system, a parent company and its wholly owned subsidiary fall under a tax group for consolidated tax payment and constitute a single unit for imposition of corporate tax, and any deficits of the subsidiary can be deducted, in principle, from the amount of consolidated income.

However, since the companies eligible for such consolidated tax system are limited to the companies which have their head offices or principal offices in Korea, such system is not applicable to overseas subsidiaries, and accordingly, the deficits of overseas subsidiaries are not recognised as deductibles in the calculation of corporate tax.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

The Corporate Tax Act of Korea neither distinguishes the distributed profits and retained profits nor applies different tax rates to them.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

There are education tax, which is reported and paid by financial and insurance companies at the rate of 0.5% of their profits; farming and fishing villages special tax, which is reported and paid by the companies receiving tax exemptions or deductions, at the rate of 20% of the deducted or exempted amount of tax; and, composite real property tax, which is levied on the companies which have excessive real properties.

Such education tax and composite real property tax are deducted from the taxable income for the calculation of corporate tax.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are such local taxes as follows: acquisition tax, which is reported and paid at the rate of 2% of the acquisition price at the time of acquisition of certain assets such as real properties and automobiles; registration tax, which is reported and paid at the time of registration of acquisition, transfer, change, or deletion of property right and other rights on public registry; local income tax, which is reported and paid at the rate of 10% of the levied amount of corporate tax; and property tax, which is paid by any person owning land, buildings, houses, ships, and aircrafts.

Among such local taxes, those relating to acquisition of assets (acquisition tax and registration tax, which is paid upon registration of acquisition of ownership of property right) constitute the acquisition cost for the assets, and other local taxes are deductible from the taxable income for corporate tax.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

In taxation, gains and losses from the transfer of assets are included in the profits of the relevant business year like the gains and losses from the normal business.

However, as for the gains from transfer of properties, which are recognised as owned for a speculative purpose not in direct connection with the business such as houses and land for non-business purposes, companies are required to pay a certain amount of tax at a certain rate, separately from the corporate tax on the profits for the relevant business year, as mentioned above.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

As for the profits from transfer of general assets, they are included in business profits just like other kinds of business profits and are subject to 22% of tax rate.

However, if the company transfers houses or land held for non-business purposes, any gains from such transfer, unlike the above business profits, are subject to the tax liability to pay an additional amount calculated by applying a 10% tax rate (30% after January 1, 2013) to the gains from the transfer.

5.3 Is there a participation exemption?

Regarding the dividends that a company satisfying the requirements as a holding company under applicable laws receives from its subsidiary, depending on its percentage of shareholding in the subsidiary, 100% [if the shareholding ratio is 80% (40% in the case of listed companies)] or 80% [if the shareholding rate is 40% - 80% (20% - 40% in the case of listed companies)] of dividends are excluded from taxable income. Regarding the dividends that a company other than a holding company receives from its subsidiary, depending on its shareholding percentage, 100% (if the shareholding rate is 100%), 50% [if the shareholding rate is no less than 50% (30% in the case of listed companies)], or 30% of dividends are excluded from taxable income. However, these provisions are applicable only to the dividends from Korean subsidiaries (which have their headquarters or principal offices in Korea), not to those from foreign subsidiaries.

However, regarding the dividends received from foreign subsidiaries, indirect foreign tax credits equivalent to foreign corporate tax paid by foreign subsidiaries are granted on the amount of dividends from foreign subsidiaries (which are limited to the companies, of which no less than 20% of shares have been held by the parent company for 6 months or longer as of the reference date for dividend allocation) in order to prevent double taxation. In such a case, if the indirect foreign tax credits are permitted under the tax treaty between the foreign subsidiary's resident country and Korea, the entire amount of foreign corporate tax, as calculated by statutory formula, is granted as tax credit, but even if indirect foreign tax credits are not allowed under the tax treaty, tax credits are granted under the Korean tax law on 50% of the foreign corporate tax.

5.4 Is there any special relief for reinvestment?

In the case of replacement investment of fixed assets for business purposes, the amount calculated by applying a certain rate to the value of the relevant fixed asset for business is deductible. However, stocks are not included in such fixed assets for business purposes.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

In establishing a corporation, 0.48% of the capital as registered at the time of incorporation should be reported and paid as the registration tax.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Subsidiaries, which fall under Korean companies, are liable to pay corporate tax to Korean tax authority with respect to their worldwide income, but branches, which fall under foreign companies, are liable to pay corporate tax only on the income generated in Korea, among the entire income attributed to them.

6.3 How would the taxable profits of a local branch be determined?

If a foreign company has a fixed place of business in Korea, among the profits generated in Korea excluding capital gains, only the profits, which are deemed attributable to such fixed place of business based on the actual relevance to it, constitute taxable income of such place of business.

In calculating the profits attributable to such fixed place of business, if the place of business is assumed as an entity conducting business independently from its head office, the profits expected to be earned by such place of business are deemed attributable to it.

Meanwhile, in determining the profits of the fixed place of business, overhead expenses, including operation expense and general maintenance expense incurred for the purpose of such fixed place of business, wherever they are incurred, if reasonably allotted, are deductible from the taxable income.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

In the event that there is a provision in the tax treaty between Korea and the foreign country where the foreign corporation is located (currently, there are explicit provisions for branch tax in the tax treaties between Korea and Canada, France, Australia, Indonesia, Philippines, Brazil, Kazakhstan, Morocco, and Thailand), a foreign company's fixed place of business in Korea should pay, in addition to the corporate tax, the tax calculated by applying the lower of 22% and the rate of the relevant tax treaty applicable to the profits of the relevant place of business in Korea after subtracting the corporate tax, etc. paid by the place of business and the recognized amount of replacement investment [shareholders' equity as of the end of the relevant business year (assets - liabilities) after subtracting shareholders' equity as of the commencement date of the same business year] and the amount not recognised as a deficit under the taxation system for thin capitalisation (in the case of the Philippines, the amount actually transferred).

However, in accordance with the principles of reciprocity, in cases where a foreign country in which a foreign company is located does not impose branch profits tax on Korean companies' place of business in that foreign country, Korea does not impose a branch profits tax on that foreign company's place of business in Korea.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Since foreign companies' branches in Korea are not Korean companies or residents, tax benefits granted to Korean companies or residents under tax treaties are not applicable to them.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Please see question 6.4.

7 Overseas Profits

7.1 Does Korea tax profits earned in overseas branches?

For local companies or residents, both domestic and foreign source incomes are incomes subject to taxation. However, for foreign companies or non-residents, only domestic source income is subject to taxation.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends that a local company receives from a non-resident company are considered as income subject to taxation. However, in cases where a local company has 10% or more voting shares of the non-resident company and has been holding those shares since six months before the record date, of the amount of corporate tax paid by the non-resident company corresponding to that dividend income, a certain percentage, 100% if there are provisions under tax treaties or up to 50% if there are no specific provisions, is recognised as a tax credit for foreign taxes paid.

7.3 Does Korea have "controlled foreign company" rules and if so when do these apply?

In cases where residents either directly or indirectly own 20% or more of shares of a foreign company that has its headquarter or main offices in a country or region in which a company's tax liability is imposed at 15% or less of the actual income ("Special Foreign Company") and the Special Foreign Company has a special relationship with a resident, the amount of retained earnings of that Special Foreign Company at the end of each fiscal year that is to be returned to the resident will be deemed as being distributed to the resident, and therefore, corporate tax is imposed on it by including it in the taxable income of the resident.

However, the forgoing regulation is not applicable if the Special Foreign Company (i) is operating a business that is not a legal type of business such as wholesale business, financial business, insurance business, etc., (ii) has a fixed facility necessary for the operation of the business in the relevant area such as an office, store, factory, etc., and (iii) is actually running a business using those facilities.

8 Anti-avoidance

8.1 Does Korea have a general anti-avoidance rule?

The notes to the 2003 OECD Standard Model Treaty recommend its member nations to apply rigorous taxation to the abuse of tax treaties by strictly applying the principle of real taxation so that double taxation treaties executed between countries for the promotion of international investment and trade would not facilitate tax avoidance or tax evasion. In addition, the current position of courts is that even if tax treaties do not include such phrases, the principle of real taxation and other regulatory systems against tax avoidance and tax evasion under the nation's tax law are generally applicable to the interpretation and application of tax treaties.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no disclosure rule.

Seung-Soon Lim

Yoon & Yang LLC
23rd Fl., Asem Tower, 159-1
Samsung-dong, Gangnam-gu
Seoul
Korea

Tel: *+82 2 6003 7124*
Fax: *+82 2 6003 7017*
Email: *sslim@hwawoo.com*
URL: *www.hwawoo.com*

Seung Soon Lim, a managing partner of Yoon & Yang LLC, is currently widely known as one of the most prominent lawyers in the tax area in Korea by various media. His nickname is Mr. Tax. Mr. Lim dealt with abundant tax cases as a research judge on tax in the Supreme Court, a professor (of tax law) in the Judicial Research & Training Institute, a presiding judge in the Administrative Court, and he also handled many important tax cases as a lawyer. In addition, his book entitled "*Tax Law*," is widely read in the academic society and by those dealing with practical affairs. Currently, he is serving as a commissioner in various tax-related commissions and gives lectures regarding tax at various educational and training programmes for attorneys and judges, graduate schools, law schools, and other institutions.

Tae-Hwan Oh

Yoon & Yang LLC
23rd Fl., Asem Tower, 159-1
Samsung-dong, Gangnam-gu
Seoul
Korea

Tel: *+82 2 6003 7597*
Fax: *+82 2 6003 7017*
Email: *thoh@hwawoo.com*
URL: *www.hwawoo.com*

Tae-Hwan Oh is one of the leading practitioners in the field of tax law in Korea. After serving as a Judge at various levels of courts, he has been a partner at Yoon & Yang LLC in the tax team since 2007. His specialty is in consulting and litigation related to taxation and administrative law. He accumulated a vast wealth of knowledge and experience especially by serving as a Judge at the Seoul Administrative Court, where he conducted hearings and adjudicated numerous tax cases involving corporate tax law, value added tax law, income tax law, special tax treatment control law, etc.
In Yoon & Yang LLC, as the team leader of the tax team, Mr. Oh provides comprehensive legal services primarily related to areas of tax law involving corporation transactions, such as international taxation, tax controversy, tax advice, etc.

YOON & YANG LLC
법무법인(유) 화우

Yoon & Yang LLC is a leading law firm in Korea, which provides the best service across the entire areas of legal practice including corporate law and international transactions and litigation based on its best expertise of more than 220 attorneys, accountants, tax accountants, and other professionals. In order to provide specialised legal services, Yoon & Yang LLC has organised specialised teams with specialised attorneys for each practice area, thereby systematically sorting out professional knowledge and know-how, and the firm also provides a comprehensive one-stop legal service as optimised for customers through mutual cooperation between such specialised teams. Especially the tax team, which consists of Korean attorneys, certified public accountants specialised in international taxation, tax accountants, advisors who are former high ranking officials of the National Tax Service, and many other tax professionals, provide the best advice regarding general tax matters in Korea and to foreign companies, which wish to do business with Korean counterparts.

Kosovo

Alketa Uruçi

Boga & Associates

Andi Pacani

1 General: Treaties

1.1 How many income tax treaties are currently in force in Kosovo?

Kosovo has concluded only one tax treaty. It was entered into with the Republic of Albania and has been in force since 2006.

1.2 Do they generally follow the OECD or another model?

The treaty follows the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Tax treaties must be ratified by Parliament. A treaty ratified by Parliament becomes a part of the Kosovo legal system after publication in the Official Gazette and prevails over any law which differs from the treaty's provisions.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The treaty does not incorporate anti-treaty shopping rules.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The treaty prevails over domestic law regardless of whether the domestic legislation existed previously or is introduced subsequently to it.

2 Transaction Taxes

2.1 Are there any documentary taxes in Kosovo?

No, there are no documentary taxes in Kosovo.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Kosovo has introduced VAT in 2001. Currently, the VAT rate is 16%; exports are zero rated. A new Law "On VAT", which is in line with the EU Directive on VAT, entered into force on 1 July 2010. The turnover threshold for registration purposes is set to EUR 50,000.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The following activities are VAT-exempted:

- insurance and reinsurance transactions;
- financial services;
- the supply of postage stamps, fiscal stamps and other similar stamps;
- betting, lotteries and other forms of gambling;
- the supply of land or land on which a building or house stands;
- the supply of houses, apartments or other accommodation used for residential purpose; and
- the leasing or letting of immovable property.

Other exemptions are provided on importation, exportation and services related to international transport of goods and passengers.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Generally, taxpayers registered for VAT are entitled to recover the input VAT, provided that the VAT is charged in relation with their taxable activity. When taxpayers make both taxable and exempted supplies, VAT may be reclaimed partially.

VAT cannot be reclaimed on certain recreation expenses and representation costs and it is limited on car expenses not used only for business purposes.

2.5 Are there any other transaction taxes?

Excise tax apply to a limited number of goods such as coffee, tobacco, alcoholic drinks, soft drinks, derivatives of petroleum and motor vehicles, mainly for the transport of passengers.

2.6 Are there any other indirect taxes of which we should be aware?

Except for excise and customs duties, there are no other indirect taxes.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

No, there is no withholding tax on dividends distributed from a Kosovo resident company.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Yes. There is a 10% withholding tax on royalties paid by a Kosovo company to a non-resident.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Yes. There is a 10% withholding tax on interest paid by a Kosovo company to a non-resident.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

No, there are no "thin capitalisation" or similar rules.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

No, there is no any provision on this regard.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

As indicated in question 3.4, there are no "thin capitalisation" rules in place.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No, there are not.

3.8 Does Kosovo have transfer pricing rules?

Corporate Income Tax Law provides that the prices between related parties should be fixed at open market value. Such value should be determined under the uncontrolled price method, and when this is not possible, the resale price method or the cost-plus method. Additional rules are provided for by an administrative instruction.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Kosovo Corporate Income Tax Law provides for a flat rate of 10%.

4.2 When is that tax generally payable?

The tax is payable on quarterly advance payments and final settlement is made on or before 31 March of the following year upon submission of financial statements.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The taxable base is calculated starting from the profit shown in the financial statements, adjusted in accordance with the limitation provided in Corporate Income Law.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The Corporate Income Law provides a list of expenses that are non-deductible for tax purposes, consisting of:

- fines and penalties;
- income tax paid or accrued for the current or previous tax period and any interest or late penalty incurred for late payment of it;
- any loss from the sale or exchange of property between related persons;
- pension contributions above the maximum amount allowed by the Kosovo Pension Law;
- bad debts that do not meet the specified conditions;
- contributions made for humanitarian, health, education, religious, scientific, cultural, environmental protection and sports purposes, which exceed five per cent (5%) of taxable income (before the deduction of such expenses);
- representation costs (these include publicity, advertising, entertainment and representation), which exceed two per cent (2%) of total gross income; and
- accrued expense for which the withholding tax should be paid, unless such expense is paid on or before 31 March of the subsequent tax period.

4.5 Are there any tax grouping rules? Do these allow for relief in Kosovo for losses of overseas subsidiaries?

No, there are no tax-grouping rules.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, there is no difference in this regard.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Yes, there are property taxes in Kosovo. All persons that own, use or occupy immovable property are subject to tax on real estate. The annual tax rates vary between 0.05% and 1% of the market value of the real estate, depending on the location.

4.8 Are there any local taxes not dealt with in answers to other questions?

No, there are not.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Yes, Corporate Income Law indicates the rules applicable to capital gain. As a general rule, capital gains and losses are treated as ordinary income/losses from economic activity. Capital gains are not recognised for fixed assets which are depreciated in a pool and purchased prior to 01.01.2010.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains are taxed at the same rate as business profit.

5.3 Is there a participation exemption?

No, there is not any exemption.

5.4 Is there any special relief for reinvestment?

No, there is no relief for reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes payable upon formation of subsidiaries.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no such taxes or fees.

6.3 How would the taxable profits of a local branch be determined?

Branches are taxed only on the taxable income from a Kosovo source of income. The taxable income is determined in the same manner as for resident companies.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There are no such branch profit taxes. Taxable income of branches is subject to Corporate Income Tax at the same rate of 10%.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Branches have the same treatment under the local legislation.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, there is no withholding tax or other tax in regard of remittance of profit by the branch.

7 Overseas Profits

7.1 Does Kosovo tax profits earned in overseas branches?

Foreign-sourced income is taxable in Kosovo. However, tax credit is allowable for the amount of income tax paid overseas for the income derived abroad.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

No, dividends distributed by a non-resident to a local company are exempted income.

7.3 Does Kosovo have "controlled foreign company" rules and if so when do these apply?

No, there are no "controlled foreign company" rules.

8 Anti-avoidance

8.1 Does Kosovo have a general anti-avoidance rule?

Tax Procedure Law provides for the right of tax authorities to disregard and re-characterise a transaction or element of the transaction that does not have a substantial economic effect, where the form of the transaction does not reflect its economic substance and was entered into as part of a scheme to avoid a tax liability.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there are no requirements to disclose avoidance schemes.

Alketa Uruçi

Boga & Associates
Deshmoret e 4 Shkurtit Str.
P.O. Box 8264, Tirana
Albania

Tel: *+355 4 22 510 50*
Fax: *+355 4 22 510 55*
Email: *auruci@bogalaw.com*
URL: *www.bogalaw.com*

Since 1999, Alketa has focused her practice on tax and customs laws in all industries and sectors in Albania and Kosovo. With her double major studies background in Law and Economics, Alketa has acquired solid understanding and experience in tax legislation and its impact and interaction with other legal framework, such as labour and employment, commercial companies law, real estate and construction.

Her practice areas encompass corporate tax, VAT, national taxes, local taxes, personal income tax, excise tax and customs duties. Alketa advices and manages tax assignments in all industries and sectors such as aviation, banking and financial institutions, cement, consumer goods, construction and real estate, telecommunications, etc.

Alketa is active as tax litigator in all levels of Albanian courts, where she represents the clients during judiciary claims against the tax assessments and tax authorities.

Andi Pacani

Boga & Associates
Deshmoret e 4 Shkurtit Str.
P.O. Box 8264, Tirana
Albania

Tel: *+355 4 22 510 50*
Fax: *+355 4 22 510 55*
Email: *apacani@bogalaw.com*
URL: *www.bogalaw.com*

Andi has developed solid experience in accounting, tax and regulatory framework, with a very good experience in the application of accounting regulations (national and international standards), corporate tax law and other fiscal laws, by being involved in assignments providing any tax and accounting assistance to clients seeking to operate and engage in business activities in Albania and Kosovo.

Andi graduated from the University of Tirana, Faculty of Economy in Business Administration, in 1999. In 2005, Andi obtained a licence as an Approved Accountant.

BOGA & ASSOCIATES

LEGAL • TAX • ACCOUNTING

Boga & Associates, established in 1994, has emerged as one of the premiere law firms in Albania, earning a reputation for providing the highest quality in legal, tax and accounting services to its clients. Boga & Associates also operates in Kosovo (Pristina) offering full range of services.

The firm provides services to a broad spectrum of regional and local organisations, including private and public companies, partnerships and government agencies, as well as not for profit organisations. With its diverse capabilities and experience, the firm services leading clients in most major industries, banks and financial institutions, companies engaged in insurance, construction, energy and utilities, entertainment and media, mining, oil and gas, professional services, real estate, technology, telecommunications, tourism, transport, infrastructure and consumer goods.

Lithuania

Laimonas Marcinkevičius

Juridicon Law Firm

Ingrida Steponavičienė

1 General: Treaties

1.1 How many income tax treaties are currently in force in Lithuania?

Lithuania currently has forty-seven treaties on the avoidance of double taxation of income and capital in force.

1.2 Do they generally follow the OECD or another model?

The treaties follow the Lithuanian Model Tax Treaty that is based both on OECD and United Nations Model Tax Conventions, taking into consideration the remarks of OECD experts.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

These treaties are applied directly and do not have to be incorporated into domestic laws. The treaties come into force after they have been signed and ratified by the Lithuanian Parliament. The treaties themselves may also indicate a later moment of coming into force.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Lithuanian treaties on avoidance of double taxation usually do not incorporate special anti-treaty shopping rules, with minor exceptions (e.g. the treaties with the USA, UK, etc.). Nevertheless, most of them contain beneficial ownership requirements in the articles regulating taxation of dividends, interest and royalties and an arm's length requirement applicable to the transactions between related parties.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

International treaties have supremacy over domestic laws in Lithuania. As the treaty comes into force, it overrides the domestic laws of the same field, unless it is stated otherwise in the treaty itself or if the national law provides a more favourable regime.

2 Transaction Taxes

2.1 Are there any documentary taxes in Lithuania?

Stamp duties and State fees of exactly established amounts are applied only for the precisely defined formal services of State institutions, e.g. review of the application, issue of the document, etc.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Lithuania has value added tax which is harmonised with the EU acquis. The standard VAT rate currently is equal to 21%.

During the transitional period until 31 December 2011, some reduced VAT rates are applied, namely:

- partly or wholly compensated pharmaceuticals are taxed with 5% VAT;
- heat energy for heating of the residential premises and hot water supplied to these premises are taxed with 9% VAT; and
- hotel type and special accommodation services, provided according to the legal acts regulating tourism activities, are taxed with 9% VAT.

The amendment of the Law on VAT prolonging this transitional period is currently being considered in the Parliament.

Books and non-periodic publications are taxed with a reduced 9% VAT rate.

0% rate VAT is charged mainly on goods exported from the EU and certain related services of transportation and insurance, as well as on the certain supply of goods to another EU Member State; 0% VAT is also charged in a few other instances prescribed by law.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In general, VAT is charged on every supply of goods or services, when the supply is effected by a taxable person in the performance of his economic activities, if the supply is for consideration and effected within the territory of Lithuania. Still, certain supplies of goods and services (such as of a healthcare, social, education, culture and sport nature; certain mail services, radio, television, insurance, financial services, rent or sale of some real property, betting, gambling and lottery services, special marks, etc.), as well as some intra-community acquisitions, stay exempt from VAT.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Under the Law on VAT of the Republic of Lithuania (the **Law on VAT**), input/import VAT may be entered for deduction if the goods or services purchased are used for the taxable supply. With some exceptions, input/import VAT that is directly or proportionally attributed to the supply exempted from VAT cannot accordingly (in whole or proportionally) be deducted. Under the Law on VAT, in some cases input/import VAT on the acquisition of entertainment and representation goods and services, motor vehicles, passenger transport services and also VAT paid on behalf of another person cannot be deducted, or its deduction is limited.

In general, VAT paid in Lithuania is recoverable; still, a few circumstances exist which should be noted. According to the laws, the difference between input and output VAT will firstly be included to cover the tax arrears of the same taxpayer, the overdue State loans to the taxpayer or the overdue loans, warranted by the State. The remaining part of excess of VAT may be returned only to the taxpayer who has paid into the budget and funds all the taxes, default interest, penalties and interest for overdue tax. Moreover, the VAT will be refunded only if there are no open investigations regarding criminal activities of the taxpayer in respect of fulfilment of his VAT obligations.

The Law restricts the maximum recoverable VAT sum to the sum of conditional or calculated VAT on taxable amounts of particular categories goods and services prescribed by the Law on VAT, such as goods and services in respect of which the 0% VAT rate was applied, acquired capital assets, etc.

As regards a foreign person's right to recover VAT, under the Law on VAT, a taxable foreign person that: (i) is established in another EU Member State; (ii) is established in a third country and registered as a VAT-payer in an EU Member State for the electronic supply of services; or (iii) is established in a third country where the VAT paid (or any equivalent tax) is refundable to taxable persons of Lithuania, has a right to recover the VAT paid in Lithuania. With some exceptions, the foreign taxable person may apply for recovery of VAT only when he had no subdivision or place of residence and did not engage in commercial activity in Lithuania, which is subject to VAT, during the period in which he paid the VAT he is asking to be refunded.

With respect to the foreign taxable persons, the laws also establish the shortest period for which the VAT may be recovered, the minimal recoverable sum and the term (quite short) during which the request for VAT recovery may be submitted.

From 1 January 2010 a taxable person registered in another EU Member State and seeking to recover the Lithuanian VAT must submit the request to the Tax Administrator of the country of his establishment.

2.5 Are there any other transaction taxes?

No, there are no other transaction taxes.

2.6 Are there any other indirect taxes of which we should be aware?

According to the EU Customs Code and related legal acts, custom duties on particular goods imported into the EU within the territory of Lithuania are levied.

Excise duties are charged on ethyl alcohol and alcoholic beverages, manufactured tobacco, energy products (fuel, oil, gas, coal, etc.) and electricity.

Environment pollution tax is levied on subjects that in the course of their economic activity emit pollution, or manufacture or import into the Lithuanian market goods and/or packing that are potential sources of pollution (tyres, accumulators, batteries, oil and air filters, oil buffers, glass, plastic, metallic and other packing). Taxpayers that implement anti-pollution or treatment of waste standards may be exempted from corresponding taxation.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

According to the Law of the Republic of Lithuania on Corporate Income Tax (the **Law on Corporate Income Tax**), dividends paid by the Lithuanian entity to the non-resident entity in general are subject to 15% withholding tax on corporate income.

Still dividends paid by the Lithuanian entity to a foreign entity that incessantly for at least 12 months controls not less than 10% of voting shares/member shares in the Lithuanian entity shall not be subject to taxation, except for cases where the foreign entity receiving the dividends is registered or otherwise organised in target ("tax haven") territories.

These provisions shall also be applicable when the treaty on avoidance of double taxation provides a less favourable regime. In case the treaty on avoidance of double taxation provides a more favourable regime, provisions of this treaty should be followed.

Dividends paid to the natural person, who is treated as a non-resident in Lithuania for taxation purposes, are taxable by tax on personal income at the rate of 20%.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In general, under the Law on Corporate Income Tax, the royalties (for use or transfer of copyright and related rights, rights to use franchise, industrial ownership – patents, trade marks, models, know-how) paid by a Lithuanian company to a non-resident company having no permanent establishment in Lithuania are subject to a **10%** withholding tax (without any deductions).

Since 1 July 2011, the royalties, paid by a Lithuanian company to a related EU company (the beneficial owner of royalties), both corresponding to the criteria established by the Law on Corporate Income Tax, are exempt from withholding tax in Lithuania.

The Lithuanian company, while paying a royalty to a foreign natural person that is not engaging in any related commercial activity in Lithuania, must deduct 15% tax on personal income.

However, the applicability of the Lithuanian tax rate on royalties may be mitigated by the Lithuanian treaties on the avoidance of double taxation in force.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In general, interest paid by a Lithuanian company to non-residents (both natural and legal persons) is taxable at the same general rates as indicated in question 3.2.

However, the following interest paid by a local company to a non-resident is tax-exempt in Lithuania:

- interest paid to a foreign legal person that is registered or otherwise organised within a Member State of the European

Economic Area or within a State with which Lithuania has a treaty on the avoidance of double taxation in force, and received it not through the foreign person's permanent establishment in Lithuania;

- interest on securities issued by the Government and interest accrued and paid on deposits and interest on subordinated loans which meet the criteria set down by the legal acts of the Bank of Lithuania, under condition that these interests are received not through the foreign person's permanent establishment in Lithuania;
- with minor exceptions - interest received by a natural person on the loans granted, if the repayment of the loans commences not earlier than 366 days after the date of the granting of the loan, and interest received by the natural person on securities, if the redemption of those securities commences not earlier than 366 days after the date of the issue of those securities; and
- interest received by a natural person on securities of the Governments and political or geographic administrative subdivisions of the Member States of the European Economic Area, as well as interest on deposits held in banking and other credit institutions, established in the Member States of the European Economic Area.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Firstly, Lithuanian thin capitalisation rules apply only to the extent to which the ratio between the capital borrowed from the controlling creditor and the fixed capital of the Lithuanian entity-debtor exceeds 4:1. The interest for the part of the loan exceeding the above-mentioned ratio cannot be deducted from the taxable income of the entity-debtor, unless the debtor proves that the same loan could be provided/received on the same conditions between unrelated persons.

For the purposes of the application of thin capitalisation rules, the controlling creditor shall be held to be any Lithuanian or foreign legal or natural person: (i) directly or indirectly possessing more than 50% of the Lithuanian debtor's capital; or (ii) possessing at least 10% of the debtor's capital and at the same time together with related persons possessing more than 50% of the debtor's capital. Any member of a group of entities (a group consisting of a parent entity and one or more taxable subsidiaries, in each of which the parent entity holds more than 25% capital) as well as the creditor's spouse, fiancé, cohabitating partner and relatives up to first grade, shall also be held to be controlling creditors.

While applying thin capitalisation rules, the borrowed capital covers loans granted and convertible bonds issued by the controlling creditor, loans granted by third persons but guaranteed by the controlling creditor, and even loans guaranteed by third persons to whom at the same time the controlling creditor issued the guarantee.

The fixed capital for "thin capitalisation" purposes means the equity capital of the debtor, excluding the debtor's financial result (profit/loss) of the current financial year.

The above-mentioned rules are not applicable against the financial institutions providing financial rent or financial leasing services.

Secondly, the interest or rent fee that depends on debtor's turnover, income, profit and so on, and interest that may be converted into the creditor's right to the debtor's capital, cannot be deducted from the taxable income of the debtor.

With regard to interest paid by a Lithuanian entity or permanent establishment to foreign entities registered or otherwise organised in target ("tax haven") territories, also see question 4.3.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

As indicated in question 3.4, thin capitalisation rules shall not be applied to the borrowed capital if the debt and fixed capital ratio of 4:1 is not exceeded; and even when exceeded, if the arm's length principle in respect to the amount and interest of the borrowed capital is followed.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

See question 3.4.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

In case a natural person provided a loan to a local company, of which he is the owner/member or to a local company in which he works, and the interest paid out by this company exceeds the real market price, the relief from the tax on personal income on this interest (see question 3.3) shall not be applied even in case the other conditions are met.

3.8 Does Lithuania have transfer pricing rules?

Where the conditions created or prescribed by mutual transactions or economic operations between associated persons (both resident and non-resident) are different from the similar ones created or prescribed between non-associated persons, the tax administrator may: re-evaluate the transactions according to their market value in similar conditions; reassess the taxable income and consequently the payable tax on income; and impose fines and penalties for the delayed payments, if any.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Currently profits of Lithuanian entities and permanent establishments of foreign entities in general are taxed at the 15% rate. Profits of small entities satisfying the requirements prescribed by the law are taxable by 5% tax on corporate profits.

With some exceptions (see questions 3.1-3.3 above), profits sourced in Lithuania and received by foreign entities other than through their permanent establishments in Lithuania are currently levied by a 10% (e.g., for interest, royalties, compensations for violation of copyrights or related rights) or 15% (e.g., for transfer or lease of immovable property located in Lithuania, distributable profits, including dividends, annual bonuses for the members of supervisory or management board) tax on corporate profits.

4.2 When is that tax generally payable?

The taxation period is usually the calendar year or another twelve-month period requested by the entity. If the income during the previous year exceeds LTL 1,000,000.00, the tax on corporate profit for the next year must be payable in advance in quarterly instalments, the first three of which must be paid before the end of the current quarter, and the fourth instalment before the 25th day of the last month of the quarter.

The newly-incorporated entities are released from the obligation to pay tax on corporate profit in advance for the first year after incorporation.

The annual declaration must be submitted before the first day of the sixth month of the next tax year. The tax must completely be paid (taking into consideration that it may need to be paid in quarterly advance payments) before the first day of the tenth month of the next tax year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base of a Lithuanian entity is all income earned in Lithuania and foreign countries, and, according to the provisions of the Law on Corporate Income Tax, the positive income of its controlled foreign entity or part of such income, as well as the income or a part of such income of the relevant European Economic Interest Grouping.

The tax base of a foreign entity covers: (i) income received from activities carried on through a permanent establishment situated in Lithuania, as well as income earned in foreign countries and attributed to the said permanent establishment if such income relates to the activities of a foreign entity in Lithuania; and (ii) income sourced in Lithuania and received in Lithuania otherwise than through a permanent establishment here (most kinds of interest, distributed profits, royalties, payments for use of related rights, industrial property, know-how, franchise, compensations for violation of copyright and related rights, income from performer or sport activities, income from transfer or lease of immovable property in Lithuania and annual bonuses for the members of a supervisory or management board).

Sponsorship received that was used for purposes other than specified in the Law of the Republic of Lithuania on Charity and Sponsorship, as well as sponsorship received in cash from a single provider during the tax period exceeding the amount of 250 minimum living standards (currently LTL 32,500.00), will also constitute the tax base both of national or foreign entities and shall be taxed at the 15% rate.

When calculating the taxable profits of a Lithuanian entity, non-taxable income, allowable deductions and deductions of limited amounts shall be deducted from income. The taxable income of permanent establishment shall be calculated by deducting from the income earned the non-taxable income, deductions of limited amounts and deductions relating to the income earned by a foreign entity through a permanent establishment. The taxable profits, earned by a foreign entity other than through a permanent establishment, shall include all of its income sourced in Lithuania without any deductions.

Sums for deduction must be supported by legally valid documents containing all the mandatory requisites of accounting documents or if executed by the foreign persons - such documents must allow the identification of the content of the economic operation.

In addition, payments made by a Lithuanian entity or permanent establishment to foreign entities registered or otherwise organised in target ("tax haven") territories shall be treated as non-allowable deductions, unless the Lithuanian entity or permanent establishment supplies evidence to the tax administrator that such payments are related to the usual activities of both parties, that the receiving foreign entity controls the assets needed to perform such usual activities, and that there exists a link between the payments and the economically grounded operation.

It should also be noted that from 1 January 2009, the taxable profit of the entity may be reduced by deducting expenses, incurred during 2009-2013 for acquisition of long-term property, used by the entity in the investment project. The taxable profit of the entity may be reduced by 50% at the maximum per one taxation year. The part of expenses not deducted during the first year may be used to reduce the taxable profit of the entity during four succeeding taxation years.

Financial accountability of Lithuanian entities must be conducted following the Business Accounting Standards, approved by the Institute of Accounting of the Republic of Lithuania, or the International Accounting Standards, as defined in Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards. The taxable income of the entities must be calculated according to the Law on Corporate Income Tax. As the provisions of these legal Acts differ in various aspects (e.g. different principles for the establishment of property acquisition price, etc.), the profit calculated for financial accountability purposes may differ from what is calculated for the corporate income tax purposes.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

See question 4.3.

4.5 Are there any tax grouping rules? Do these allow for relief in Lithuania for losses of overseas subsidiaries?

In general, each Lithuanian entity or permanent establishment of a foreign entity in Lithuania is treated as a separate taxpayer. However, income and losses of foreign permanent establishments of a Lithuanian entity must be included while calculating taxable corporate income of the Lithuanian entity. Depending on the treaties on the avoidance of double taxation, the income earned through the permanent establishments abroad and taxed there may be either released from the Lithuanian tax on corporate income, or there may be a possibility to deduct proportionally the tax paid abroad from the one payable in Lithuania.

Secondly, as indicated in question 4.3, the positive income of the controlled foreign entity shall, proportionally to its shares which are owned by the Lithuanian entity, be included in the taxable profits of the Lithuanian entity if:

- on the last day of the tax period, the Lithuanian entity holds directly or indirectly over 50% of the shares (interests, member shares) or other rights/pre-emptive rights to a part of distributable profits in the controlled entity; or
- on the last day of the tax period the controlling person, together with related persons, holds over 50% of the shares (interests, member shares) or other rights/pre-emptive rights to a part of distributable profits in the controlled entity, and at the same time holds himself at least 10% of the shares (interests, member shares) or other rights to distributable profits or pre-emptive rights to the acquisition thereof; and
- the controlled foreign entity: (i) is organised in a country which is listed in the special list ("white list") approved by the Ministry of Finance of Lithuania, but acquires special tax exemptions according to the laws of the country of registration (e.g., the holding company registered in the Grand Duchy of Luxembourg, the Trieste Free Zone Financial and Insurance Centre in Italy, Limited Liability Company in the USA, etc.); (ii) is not registered or otherwise organised both in the "white list" and in the "black list" ("tax haven") countries but is the payer of corporate income tax which amounts to less than 75% of the Lithuanian one; or

(iii) is registered or otherwise organised in target ("tax haven") territory.

The above-indicated rule shall not be applicable in cases where the income of a controlled foreign entity comprises only those payments made by the controlled entity which are treated as non-allowable deductions, or when the income of a controlled foreign entity comprises less than 5% of the income of the controlling entity.

Thirdly, the income of a European Economic Interest Grouping shall, according to the requirements of the laws and in the proportions laid down in the memorandum of association of the grouping (in the absence of any such provision - in equal shares), also constitute a part of the Lithuanian entity's taxable profits.

Finally, from 1 January 2010, Lithuanian tax laws under specific conditions allow transfer of all or a part of losses within the group of legal entities, including the cross-border transfers.

According to the Law on Corporate Income, only the losses of one entity calculated for 2010 or subsequent taxation periods may be transferred in order to decrease the taxable profits earned by the other entity during corresponding taxation periods.

Additionally, the cross-border transfer of losses is possible only when the following conditions are met:

- the losses are transferred between the members of a group of entities, consisting of a parent entity and one or more taxable subsidiaries;
- the parent entity directly or indirectly holds not less than 2/3 of shares (interests, member shares) or other rights to the distributable profit of every subsidiary participating in the transfer of losses;
- the entities are the members of the same group incessantly for a period not shorter than two years; or they are the members of the said group for the shorter term from their registration, and shall incessantly stay in the group for the period not shorter than two years from their registration; and
- in case the foreign entity is transferring the losses to the Lithuanian entity, that foreign entity:
  - i) is the resident of the EU Member State for taxation purposes, has the organisation from indicated in the Annex to the Directive 90/434/EB and is the payer of the tax indicated in Point c Article 3 of the said Directive;
  - ii) the foreign entity cannot transfer his losses to his subsequent taxation year according to the tax laws of the country of his registration; and
  - iii) the losses of the foreign entity being transferred are calculated (recalculated) according to the provisions of the Law on Corporate Income Tax of Lithuania.

It should also be noted that the entity cannot transfer its losses in case it has tax arrears or in case that because of the tax exemptions it is released from the tax on corporate income during that particular taxation year.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

In general, both distributed and retained profits are taxed at the same rate, with the exemption of special relief for reinvestment executed during 2009-2013 (see question 5.4 below).

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Tax on immovable property is levied on immovable property located in the territory of the Republic of Lithuania and belonging to the legal person by the right of ownership, as well as on immovable property (or a part of it) belonging to or acquired by a natural person but being transferred to the legal person for the use for an indefinite period or for a period exceeding one month. The tax amounts to 0.3-1% (depending on the decision of the municipality where the property is located) of the taxing value of the property per year.

Private land (excluding public road and forest land, land owned by diplomatic or consular representatives) owners are charged 1.5% tax on the land per year, calculated from the cost of the land.

According to the Law of the Republic of Lithuania on Lottery and Gaming Tax, legal persons operating lotteries and gaming must pay lottery and gaming tax in the following amounts: 5% of the total face value of the tickets distributed in a lottery; in respect of bingo, totalisator and betting - 15% of the total amount of gamers' stakes after deduction of the amount of gainings actually paid out; and in the case of machine gaming and table games, a fixed amount for each gaming device per calendar month, amounting to LTL 300.00-6,000.00.

4.8 Are there any local taxes not dealt with in answers to other questions?

In addition to the above-mentioned taxes, Lithuanian laws prescribes State natural resources tax, petroleum and gas resources tax, overstock and production tax in the sector of sugar production, tax on additional quota for white sugar production, deductions from income under the Law of the Republic of Lithuania on Forestry, tax on use of the state property by trust, inheritance tax, contributions to the Guarantee Fund, State social insurance contributions, compulsory health insurance contributions, fees for the registration of industrial property objects, stamp duties, State-imposed fees and charges, and consular fees.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains constitute a part of the taxable income of a taxable entity and in general are taxed at the ordinary tax rate. Expenses incurred for the acquisition of the property transferred are in general deductible.

The participation exemption on capital gains tax still exists. The income from the increase in the value of assets, resulting from transfer of shares, received by a Lithuanian or foreign entity through its permanent establishment, is exempt from tax on profit in Lithuania, in case:

- the shares of an entity, registered or otherwise organised in a Member State of the European Economic Area or in a State with which a treaty for the avoidance of double taxation has been concluded and brought into effect and which is a payer of corporate income tax or an equivalent tax, are sold;
- the entity that transfers the shares held more than 25% of voting shares in the entity being transferred for an uninterrupted period of at least two years; or the entity that transfers the shares held more than 25% of voting shares in the entity being transferred for an uninterrupted period of at least three years in case the shares were previously transferred during special tax exempt reorganisation or transfer indicated in Law on Corporate Income; and
- the shares are not being acquired by the issuer of the shares itself.

The Law on Corporate Income Tax establishes special rules for the recognition and taxation of income from the increase in the value of assets in certain cases where entities are reorganised, liquidated or transferred, where a European company or a European cooperative society with a registered office in Lithuania transfers its registered office to another EU Member State.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

See question 5.1.

5.3 Is there a participation exemption?

For participation exemption regarding corporate income tax on received dividends, see question 3.1; on exemption regarding capital gains, see question 5.1.

5.4 Is there any special relief for reinvestment?

From 1 January 2009 the taxable profit of the entity may be reduced by deducting expenses, incurred during 2009-2013 for acquisition of long-term property, used by the entity in the investment project. The conditions, under which the project shall be held as investment project, are determined by the Law on Corporate Income Tax.

The taxable profit of the entity may be reduced by 50% at the maximum per one taxation year. The part of expenses not deducted during the first year may be used to reduce the taxable profit of the entity during four succeeding taxation years.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No taxes are imposed, except for State and notary fees.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no other such significant taxes.

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch cover all the income attributable to the activities of the branch and sourced both in Lithuania and in foreign countries, after allowable deduction of the expenses incurred for the purposes of the branch.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Income earned by the foreign company through the branch registered in Lithuania shall be subject to Lithuanian corporate income tax at the standard rate of 15%.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

No, usually a branch would not benefit from tax treaty provisions.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Remittance of profits by the branch is not subject to any withholding or other tax (except bank fees).

7 Overseas Profits

7.1 Does Lithuania tax profits earned in overseas branches?

In general, the tax base of a Lithuanian entity is all income earned in Lithuania and in foreign countries, including income earned in overseas branches of a Lithuanian entity. However, according to the Law on Corporate Income Tax, income from activities carried out through permanent establishments of Lithuanian entities in a state of the European Economic Area is not attributable to the tax base of the Lithuanian entities, whereas income from activities carried out through these permanent establishments is subject to corporate income tax or equivalent tax in this State. Moreover, depending on the particular treaty on the avoidance of double taxation, the income earned through the permanent establishment abroad and taxed there may be either released from the Lithuanian tax on corporate income, or there may be a possibility to deduct proportionally the tax paid abroad from the one payable in Lithuania.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

According to the Law on Corporate Income Tax, dividends received by a Lithuanian entity from the non-resident entity in general are subject to 15% corporate income tax.

Still dividends received by a Lithuanian entity from another foreign entity which is registered or otherwise organised in a State of the European Economic Area and whose profit is subject to corporate income tax or an equivalent tax shall not be subject to taxation. Also, dividends received by a Lithuanian entity from other foreign entity in which the Lithuanian entity incessantly for at least 12 months controls not less than 10% of voting shares/member shares shall not be subject to taxation, provided that the dividends are received from a foreign entity whose profit is subject to corporate income tax or an equivalent tax and which is not registered or otherwise organised in target territories.

These provisions shall also be applicable when the treaty on avoidance of double taxation provides a less favourable regime. In case the treaty on avoidance of double taxation provides a more favourable regime, provisions of this treaty should be followed.

7.3 Does Lithuania have "controlled foreign company" rules and if so when do these apply?

According to the Law on Corporate Income Tax, the positive income of the controlled foreign entity shall be included into the taxable profits of the controlling Lithuanian entity. Conditions for applying "controlled foreign company" rules are described in question 4.5.

8 Anti-avoidance

8.1 Does Lithuania have a general anti-avoidance rule?

Starting from 2002, the issue of preventing tax avoidance is resolved by a combination of general and specific anti-avoidance rules established in Lithuanian tax laws.

The main principle and general rule established in the Law on Tax Administration indicates that in respect of taxes, the content of the activities carried on by the participants of legal relations shall take precedence over their form. It means that where a taxpayer's transaction, economic operation or any combination is concluded with a view to gaining a tax benefit (i.e. to defer the deadline for the payment of tax, to reduce or fully avoid the payable amount of tax, to increase the tax overpayment/difference to be refunded/credited or to shorten the time limit for refunding the tax overpayment/difference), the tax administrator shall apply the **content-over-form principle** for the purpose of calculating the tax. In this case, the tax administrator shall not take into account the formal expression of the taxpayer's activity and shall recreate the distorted or hidden circumstances associated with taxation, as provided for in tax laws, and calculate the tax pursuant to the relevant provisions of the said tax laws.

Complementing the above said principle, particular tax laws establish the specific anti-avoidance rules, such as the right of the tax administrator to **re-evaluate the transactions between associated persons** (see question 3.8), "**thin capitalisation**" rules relating to: the interest paid to controlling persons (see question 3.4); treating payments made to foreign entities in target ("**tax haven**") territories as non-allowable deductions (see question 4.3); allowing the cross-border use of losses on strict conditions (see question 4.5); the obligation to include into the taxable profits the positive income of the controlled foreign entity (see questions 4.3, 4.5, 7.3); not allowing to decrease the taxable profits by losses of financial activities, etc.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no such general requirement to disclose tax avoidance schemes. However, during the tax inspection the tax administrator may require to disclose the economic purpose of transactions the company has performed. In case the tax administrator considers, that the company's transactions were performed with a view to gaining a tax benefit, but not to economic purpose, it will apply the content-over-form principle (see question 8.1).

Furthermore, anti-money laundering rules are also applicable to business transactions. According to these rules the banks, insurance undertakings, close-ended investment companies, trusts, company service providers, auditors, notaries, bailiffs and some other service providers having established that their customer performs a suspicious transaction or monetary operation, must suspend that operation or transaction and report about it to the competent institution (in most cases – to the Financial Crime Investigation Service).

Laimonas Marcinkevičius

Juridicon Law Firm
Totoriu St. 5-7
LT-01121 Vilnius
Lithuania

Tel: +370 5 269 1101
Fax: +370 5 269 1010
Email: laimonas.marcinkevicius@juridicon.com
URL: www.juridicon.lt

Laimonas Marcinkevičius is a Managing Partner at Juridicon Law Firm (full name: Law Firm Marcinkevičius, Čaikovski & Partners Juridicon), and an advocate (Attorney at Law). Laimonas Marcinkevicius established his own law firm in 1996 and became an attorney at law in 2003. He is a member of the International Bar Association, an associate member of the American Bar Association, Risk and Insurance Management Society and a member of Lithuanian Project Management Association.
Laimonas Marcinkevicius graduated from the Faculty of Law of Vilnius University in 1998, where he obtained professional qualifications of a qualified lawyer. In 2006 he obtained Practice Diploma in International Joint Ventures (College of Law of England and Wales). Laimonas Marcinkevicius has been a LLD candidate since 2005 and is a lecturer at Mykolo Romerio University, Faculty of Law.
His main practice areas include: foreign investment; international taxation; mergers and acquisitions; and litigation.
Mr Marcinkevičius' working languages are English, Russian and Lithuanian.

Ingrida Steponavičienė

Juridicon Law Firm
Totoriu St. 5-7
LT-01121 Vilnius
Lithuania

Tel: +370 5 269 1101
Fax: +370 5 269 1010
Email: ingrida.steponaviciene@juridicon.com
URL: www.juridicon.lt

Ingrida Steponavičienė is a Partner at Juridicon Law Firm (full name: Law Firm Marcinkevičius, Čaikovski & Partners JURIDICON), an advocate (Attorney at Law) and a tax expert. Mrs Steponaviciene obtained her Master's of Law degree in Vilnius University in 2002. She has been a lawyer in Juridicon since 2001, was recognised as an advocate (Attorney at Law) in 2007 and started her practice as an advocate in 2008.
Her main practice areas include: foreign investment, tax law, mergers and acquisitions, company law and labour law.
Mrs Steponavičienė's working languages are Lithuanian (native), English and Russian.

Juridicon Law Firm is an independent law firm, highly specialised in corporate and commercial law as well as tax and trust services.

The firm's mission is to provide qualified, creative and result-oriented services to businesses and to provide reliable, high quality and efficient solutions at a reasonable price, and generally serve as a primary resource and partner in all aspects of clients' business growth and development.

Each of Juridicon lawyers is an excellent expert in his/her field of practice. The areas of our practice include: tax planning and tax litigation, contracts and litigation, corporate counselling and litigation, as well as company formation services.

Juridicon was recommended by specialised publications such as European Legal Experts, Tax Directors Handbook and The Legal 500. In 2009 Juridicon was selected by "*Ziniu ekonomikos forumas*" ("Economy of Knowledge Forum") as one of fourteen most innovative firms in Lithuania, and was the only law firm among them.

To implement the firm's mission a significant contribution is also made by the approach to service delivery chosen by Juridicon - the Legal Project Management Concept and HelpDesk for Juridicon customers.

Juridicon Law Firm is a member of Warwick Legal Network, an international association of independent law firms that provides a high-quality legal service to clients on an international scale and currently comprises selected law firms in 25 European countries.

Chapter 29

Luxembourg


Pierre Elvinger


Dirk Richter

Elvinger, Hoss & Prussen

1 General: Treaties

1.1 How many income tax treaties are currently in force in Luxembourg?

Luxembourg has agreed to 76 income tax treaties. Currently, 64 of these income tax treaties are in force. In total, 36 treaties apply to Luxembourg corporate undertakings of collective investment (SICAV/SICAF) (see also question 1.4 for South Korea).

1.2 Do they generally follow the OECD or another model?

Almost all income tax treaties entered into by Luxembourg follow the OECD Model Convention on Income and Capital, except the income tax treaties with Germany and France that had come into force before the first OECD Model Convention (and despite further renegotiations with both treaty partners). Deviations from the OECD model treaty often relate to a few particulars but seldom to the entire treaty, e.g. the taxation of capital gains under the income tax treaty with South Korea or more typically the limitation-on-benefits provisions in the Luxembourg-US income tax treaty. 22 income tax treaties agreed by Luxembourg contain a provision compliant with article 26, paragraph 5 of the OECD model, relating to the exchange of information upon request in matters that previously had been covered by banking secrecy. Luxembourg is not grey or black-listed by the OECD in this respect. Similarly, some tax treaties include some of the provisions proposed by the UN Model Convention. See also question 1.4.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Tax treaties are to be incorporated into domestic law. The following procedure applies:

The legislator gives its consent by adopting a consenting law *(loi d'adaptation*) that authorises the Grand Duke to ratify the tax treaty. The tax treaty enters into force once the ratification instruments have been exchanged and after publication of such ratification in the official gazette, following which the tax treaty is incorporated into domestic law. Typically, a tax treaty contains specific language as to its entry into force, which thus, given the above ratification and publication process, may be retroactive. Such retroactivity is valid when provided for by the consenting law and provided that it improves the position of the tax payer ("*in meius*").

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The income tax treaties concluded by Luxembourg do not systematically contain anti-treaty shopping rules, except for the limitation-on-benefits provisions contained in the income tax treaty concluded with the USA, Hong Kong, Singapore and Trinidad and Tobago.

Also, more recently negotiated treaties make broader reference to the concept of "beneficial ownership" and in the context of dividend distributions that the distributing company must not only be "a Company of the other Contracting State" but "a Company who is a tax resident of the other Contracting State", which depending on the context may be considered as a more restrictive language.

A large number of treaties concluded by Luxembourg include specific limitation on benefits provisions that deny treaty protection to companies subject to the Law of July 31, 1929 or any similar law enacted by Luxembourg, such as e.g. the Private Wealth Investments Companies (*Société de Gestion de Patrimoine Familial* "SPF"). Now that companies subject to the Law of July 31, 1929 no longer exist, the question of how such limitation on benefits clause must be interpreted, as well as what should be considered as a "similar law". In this context, a recent dispute has arisen as to the interpretation of this provision under the double tax treaty between Luxembourg and South Korea and whether, contrary to past practice, South Korea would be entitled to exclude Luxembourg SICAV from the benefits of this treaty under the limitation on benefits clause by arguing that the Luxembourg legislation on investment funds should be considered as such "similar law(s)".

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Under the general principle of Luxembourg public law, (tax) treaties are to be considered a *"lex specialis*", prevailing over domestic law. Thus, once a tax treaty is applicable and a conflict between domestic law and treaty law arises, the tax treaty provisions will apply.

2 Transaction Taxes

2.1 Are there any documentary taxes in Luxembourg?

Ad valorem registration duties are levied on a number of transactions in Luxembourg, which either must be registered (e.g. notary deeds and documents used in the framework of judicial proceedings in front of a court must be registered by law) or are voluntarily registered.

An *ad valorem* 6% registration duty, assessed on the highest of the purchase price or the fair market value, is levied on the transfer of land and buildings, even if such a transfer is not embodied in a written document. The registration duties may be increased by municipal transfer taxes. In addition, a transcription tax of 1% applies. As an example, transfers of land and buildings, other than residential property, located in the city of Luxembourg, are subject to 10% tax. Transfers of shares in Luxembourg tax-transparent entities holding Luxembourg *situs* real estate trigger tax in the same proportion as if the Luxembourg real estate was owned and sold directly by the investors in the transparent entity.

A 0.24% registration duty, assessed on the amount of the claim, is due on the registration of an obligation to pay, evidenced by a document in writing, provided that the obligation to pay is not embodied in a security and provided that the obligation to pay does not represent the price of a transfer of movable or immovable goods which would not have been registered. The registration of such a document is therefore relatively exceptional, except if the claim is secured by a mortgage on Luxembourg real estate.

A 0.6% registration duty, assessed on the total amount of the lease payments, is due on the registration of lease agreements embodied in a written document. However, if the lease agreement is subject to VAT, no *ad valorem* registration duties will be due on the registration of the lease agreement.

All transactions relating to a securitisation operation involving a Luxembourg securitisation vehicle incorporated under the Law of March 22, 2004 are exempt from registration, except if the transaction involves a transfer of rights on land and buildings located in Luxembourg or on planes and boats registered in Luxembourg.

Mortgages are subject to a special mortgage tax at 0.05% of the value of the property.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Luxembourg implemented the EU value-added tax system in its legislation by a law of February 12, 1979.

The standard VAT rate applying to supplies of goods or services is 15%. However, specific transactions may be subject to reduced rates of 12%, 6% or 3%.

Three annexes to the Luxembourg VAT Code define the goods and services which are subject to the standard rate or the reduced rates. The annexes cover a defined area and must be interpreted in a strict sense.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

VAT is in principle charged on all supplies of goods and services carried out (or deemed carried out) in Luxembourg, for consideration and by a person carrying out an economic activity.

The rules governing the place of supply and the VAT exemptions generally follow the provisions of the Council Directive 2006/112/EC of November 28, 2006 and are refined by ECJ case law. Typical VAT exemptions relate to transactions relating to medical, social or educational care and cultural services, financial transactions, insurance and reinsurance and connected services, as well as management services rendered to regulated undertakings for collective investment and pension funds subject to the supervision of the CSSF or of the Commissariat aux assurances, SICARs and to Luxembourg securitisation vehicles subject to the law of March 22, 2004.

The supply and the renting of immovable assets are in principle exempt from VAT. However, VAT payers may opt for the application of the VAT to such transactions, provided the immovable asset is entirely or mainly used for activities which allow the deduction of input VAT. Rental agreements which are subject to the VAT pursuant to an option for VAT are not subject to proportional registration duties and are registered at the fix rate of EUR 12. Supplies of buildings to which the VAT is applied pursuant to an option for VAT are however cumulatively subject to VAT and to proportional registration duties.

The transfer of a totality of assets or part thereof (provided it can be considered as a going concern), for example in the framework of a merger, falls outside the scope of the Luxembourg VAT.

Intracommunity supplies to taxable persons and exports are zero-rated.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Generally, all the VAT paid on goods and services by a Luxembourg taxable person in relation to his business is recoverable.

If a taxable person carries out transactions which are subject to VAT (i.e. subject to VAT or zero-rated) and transactions that are exempt from VAT, it will have a limited right to deduct upstream VAT. This right will, in principle, be calculated on the basis of a *pro rata* rule, unless a segregation of the business activities in a VAT-able and a VAT-exempt business sector is possible, in which case only the input VAT related to the VAT-able business sector will be recovered in full.

No recovery is available for VAT paid for goods or services used to deliver VAT-exempt transactions, except for VAT on goods and services used to deliver banking, financial and insurance transactions, provided that the recipients of such transactions are established outside the EU or that these transactions are directly linked to goods which are to be exported outside the EU.

Certain persons that are not considered to be carrying out an economic activity, since they do not undertake transactions which fall within the scope of VAT (typically, passive holding companies), may also carry out certain transactions which are subject to VAT (e.g. reinvoicing of expenses or renting (part of) a building). These VAT payers, called partial VAT payers, might have a partial right to deduct input VAT.

2.5 Are there any other transaction taxes?

A fixed registration fee of EUR 75 applies. The fee is due exclusively in the cases mentioned by law, i.e. upon incorporation or subsequent capital increase (or allocation to share premium) and migration of foreign entities to Luxembourg.

The abolition of the capital duty implies that the same registration duties apply in the case of a contribution of real estate to a company. In the case where real estate is contributed exclusively in consideration for shares of the company, a reduced rate of 0.6% transcription tax and 0.5% transfer tax applies. The transfer of real estate in the frame of business combinations is however tax exempt.

Mortgage Register: Changes in ownership of real property are subject to an additional 1% tax levied on the higher of the sales price or the market value.

2.6 Are there any other indirect taxes of which we should be aware?

There are Custom and Excise duties for certain goods, depending on the international commitments taken by Luxembourg.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

A 15% (for hidden dividends the tax rate is 17.65%) withholding tax applies to dividends paid by a Luxembourg resident undertaking with a collective character, unless such rate can be reduced by applicable tax treaties or under the domestic dividend withholding tax exemption regime, based on the EU Directive 90/435 of July 23, 1990, as amended.

Under the domestic dividend withholding tax exemption regime, dividends paid by a Luxembourg resident undertaking with a collective character to a shareholder who holds (or commits to hold) a shareholding for at least 12 months that represents at least 10% of the share capital of the dividend distributing entity (or shares with an acquisition price of at least EUR 1.2m), are exempt from Luxembourg withholding tax if the dividend recipient is: any foreign undertaking with a collective character that is a tax resident in a country that has concluded a tax treaty with Luxembourg and that is subject to taxation comparable to Luxembourg corporate income tax (at a rate of least 10.5%); or an undertaking with a collective character enumerated in the exhibit to article 2 of EU Directive 90/435 of July 23, 1990, as amended:

- a foreign (non-EU) corporation that has migrated to Luxembourg and that has become a fully taxable Luxembourg resident corporation;
- a corporation or a cooperative society, which is a resident in a Member State of the European Economic Area (i.e. Norway, Iceland, Liechtenstein) and that is subject to taxation comparable to Luxembourg corporate income tax;
- a corporation resident in Switzerland subject to corporate income tax without benefiting from an exemption; and
- a Luxembourg permanent establishment of one of the above-mentioned categories.

Distribution of liquidation proceeds (or advance payments thereon) is not subject to dividend withholding tax. When properly structured, the same may hold true for distributions upon a partial liquidation of the Luxembourg company.

Distribution made by entities subject to a special tax regime such as SPFs, SICAV, SICAR and securitisation vehicles set up under the Law of March 22, 2004 are, in principle, not subject to withholding tax on payment of proceeds to an investor (but see EU Savings Directive 3.3).

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Regardless of the tax status of the recipient, Luxembourg has not levied any withholding tax on royalties since January 1, 2004. Luxembourg has introduced a special tax regime for intellectual or industrial property rights acquired after December 31, 2007, or created by oneself, which provides for tax exemption of 80% of the income from IP rights, including the realised capital gain upon sale of the IP.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Arm's-length, fixed or floating rate interest payments are not subject to Luxembourg withholding tax. Profit-sharing interest paid on certain debt instruments may be subject, under certain conditions, to a 15% withholding tax, unless a lower tax treaty rate applies, or an exemption would be available.

With the introduction of the EU Savings Directive on taxation of savings income in the form of interest as of July 1, 2005, a withholding tax may be levied on interest paid by a Luxembourg paying agent, or secured for the benefit of, EU residents or residents of certain EU-dependent or associated territories individuals or "residual entities", unless such beneficial owner opts for an exchange of information procedure. The rate has been increased to 20% as of July 1, 2008, and will, in principle, be increased to 35% as of July 1, 2011 onwards.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Luxembourg tax law does not contain debt-to-equity ratio provisions. However, administrative practice requires compliance with an 85:15 debt-to-equity ratio when the debt financing is granted or guaranteed (see also question 3.5) by a shareholder. This, however, does not apply to back-to-back financing.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The Luxembourg authorities would generally consider 12 months' EURIBOR plus 200 basis points, as being an at arm's length interest rate for loans and within the limits of the 85:15 debt-to-equity ratio, as referred to under question 3.4 above. In case the debt financing would exceed the above 85:15 debt-to-equity ratio, the interest on such debt would nevertheless not be regarded as excessive if through modification of the applicable interest rate total interest expense stays in line with the above ratio.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Debt advanced by a third party but guaranteed by a parent company (other than pledging the shares of the Luxembourg debtor to the creditor) is treated as a shareholder loan and consequently the 85:15 debt-to-equity ratio will be applied.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No, there are not. However, regardless of whether the recipient is a resident or a non-resident, Luxembourg tax law re-characterises profit-participating interest payments on certain debt instruments into non-deductible distributions that may trigger withholding tax in the same way as dividend payments (see under question 3.1).

3.8 Does Luxembourg have transfer pricing rules?

Inter-company pricing between affiliated companies must be on an arm's-length basis to be accepted for Luxembourg tax purposes.

The Luxembourg tax authorities have however issued a Tax

Circular on 28 January 2011 that provides guidance on the tax treatment of companies conducting intra-group financing activities (and sets out certain substance and documentation requirements for those companies). This Tax Circular refers to the OECD transfer pricing guidelines.

It is therefore recommended to support transactions with affiliated companies by written transfer pricing agreements, which include comprehensive reference to current market conditions, and to hold adequate justifications for the transfer prices applied on each transaction with affiliated companies. In practice, the Luxembourg tax authorities accept justification and documentation suggested by the OECD transfer pricing guidelines, as referred to in the above Tax Circular.

Documentation is to be prepared at the moment the transactions are passed. Transfer pricing documentation does not need to be filed with the tax returns. It only needs to be remitted to the tax authorities upon their request.

There are no specific limitations on transfer pricing adjustments either. General statutes of limitation apply.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The Luxembourg profit tax system consists of a national corporate income tax ("*impôt sur le revenu des collectivités*" or "IRC"), at a rate of 21%, and the municipal business tax ("*impôt commercial communal*" or "ICC"), at a rate of 6.75% (for companies established in Luxembourg-city). In addition, there is a 5% surcharge for the employment fund calculated on the IRC. The total combined tax rate since January 1, 2011 is therefore 28.80%.

Since January 1, 2011, the IRC is set at a minimum of EUR 1,575 for collective entities whose activity is not subject to approval of a minister or a supervisor and where the sum of the financial assets (including real estate), the securities, the bank deposits, the cash in postal cheque accounts, the cheques and the cash exceed 90% of the total assets.

4.2 When is that tax generally payable?

Corporate tax returns must be filed annually no later than May 31 of the year following the close of an accounting period. An extension for filing may be obtained. Taxes become due upon the issuance of the assessment. However, upon receipt of a preliminary assessment, companies are required to make quarterly prepayments for both corporate income tax and municipal business tax (as well as net wealth tax; see question 4.7 below). The level of the preliminary assessment is based on the taxable income of the previous financial year.

The tax due according to the final assessment must be paid within one month after the date of assessment. On request, an extension for payment may be obtained. For late payment of the assessment, an interest rate of 0.6% per month on the assessed amount may become due.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Domestic companies and foreign companies resident in Luxembourg (including Luxembourg branches of foreign companies) are liable to corporation taxes on their worldwide profits, unless a tax treaty applies. Tax is payable on profits realised minus tax-deductible expenses and losses, which may be carried forward indefinitely.

For the determination of the taxable profit, in principle the commercial accounts are followed, subject to adjustments imposed by tax law (see question 4.4 below).

Pursuant to the bill of law deposited on July 30, 2010, fully taxable undertakings having financial assets for more than 90% of their balance sheet would be subject to a minimum flat corporate income tax of EUR 1,500 (unless corporate tax as determined under general taxation principles exceed this amount).

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Differences between profits shown in commercial accounts and taxable profits are mainly due to:

- exempt commercially realised profits (e.g., dividend/capital gains exemption);
- add-back expenses (e.g., interest expenses on assets generating tax-exempt income or directors' fees, which are not for the day-to-day running of the company);
- corrections to the tax result from transactions not executed at-arm's-length; and/or
- the applications of different valuation rules in accounting and in tax (e.g. tax roll-over regimes) to different depreciation rules under tax and accounting rules.

Adjustments are generally made in the tax returns. In specific cases, a separate tax balance sheet may be drawn.

4.5 Are there any tax grouping rules? Do these allow for relief in Luxembourg for losses of overseas subsidiaries?

Luxembourg tax law knows the concept of fiscal unity, i.e. consolidation, which applies if the following conditions are met:

- the parent company has held, directly or indirectly, a participation of 95% or more in the share capital of a subsidiary, as from the beginning of the accounting period during which the application for the consolidation regime has been made;
- the subsidiary is a capital company resident in Luxembourg and fully subject to corporate income tax;
- the consolidating parent company is a capital company resident in Luxembourg and fully subject to corporate income tax, or a branch of a non-resident company which is subject in its jurisdiction of establishment to an income tax which is comparable to Luxembourg income tax; and
- the consolidation is requested for aT least five accounting years.

Subject to prior authorisation by the Minister of Finance, the tax consolidation regime may be granted to subsidiaries held for less than 95%, but at least 75%, provided that the relevant participation is of particular interest to the national economy of Luxembourg.

The consolidation for municipal business tax is granted upon election if the conditions of the income tax consolidation regime are met.

Each member of the fiscal group reports its own taxable result and files tax returns as if it were an independent tax payer. Thereafter, the parent company establishes the group tax return by adding up all individual results of the different group companies.

Under Luxembourg tax grouping rules, no relief is granted for losses of overseas subsidiaries. The parent company may, however, book in its accounts depreciation on the participation.

To some extent a tax consolidation also exists for net wealth tax (see question 4.7 below).

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, it is not.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Luxembourg companies are subject to annual net wealth tax, which is levied at a rate of 0.5% on the company's worldwide net worth on January 1. Non-residents unprotected under a tax treaty are subject to net wealth tax on their Luxembourg assets. Shareholdings eligible for the dividend exemption regime are excluded from the taxable base (see question 5.3). Liabilities financing tax exempt assets are not deductible. For companies that solely invest in equity stakes for which they benefit from the parent-subsidiary exemption, the annual net wealth tax liability may be limited to the legal minimum of EUR 63 (S.A. or SCA), or EUR 25 (S.à r.l.). The net wealth tax may be reduced within the limit of the Luxembourg corporate income tax due, provided certain conditions are met (among others, an allocation to a non-distributable reserve established for 5 years).

SPFs, undertakings of collective investment, SICAR and securitisation vehicles set up under the Law of March 22, 2004 are exempt from net wealth tax.

4.8 Are there any local taxes not dealt with in answers to other questions?

Real property tax levied by the municipalities on real estate located in their areas, ranging from 0.7%-1% multiplied by municipal factors, among others.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains and losses are included in the taxable basis for corporate income tax.

Capital gains exemption is available if a fully taxable Luxembourg resident undertaking with a collective character (or a Luxembourg branch of certain qualifying foreign entities), upon disposal of an interest in an undertaking with a collective character mentioned in the Exhibit to Art. 2 to the Parent/Subsidiary Directive (including Luxembourg) or of a capital company that is subject to an effective rate of taxation of at least 10.50% in its home country, has held (or commits to hold) for an uninterrupted period of at least 12 months at least 10% of the paid up share capital (or shares with an acquisition price of at least EUR 6 million). Capital gains exemption, in principle, also applies to participations held through tax-transparent entities.

In case of a capital gain, expense recapture rules exist. This mechanism is globally tax neutral.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No, it is not.

5.3 Is there a participation exemption?

Dividend exemption is available if a fully taxable Luxembourg resident undertaking with a collective character (or a Luxembourg branch of certain qualifying foreign entities), has held (or commits to hold), for an uninterrupted period of at least 12 months, at least 10% of the paid up share capital (or shares with an acquisition price of at least EUR 1.2 million) of an undertaking with a collective character, mentioned in the Exhibit to Art. 2 to the Parent/Subsidiary Directive (including Luxembourg) or of a capital company that is subject to an effective rate of taxation of at least 10.50% in its home country. Dividend exemption, in principle, also applies to participations held through tax transparent entities.

If the above conditions are not met, dividends from a Luxembourg taxable capital company, from an EU resident company falling within the scope of the EU Parent/Subsidiary Directive or from a capital company resident in a tax treaty country and that is subject to an effective rate of taxation of at least 10.50% in its home country, are exempt for 50%.

As a principle, expenses in relation with tax-exempt dividend income are not tax deductible, up to the amount of such tax-exempt income.

5.4 Is there any special relief for reinvestment?

When a capital asset in the form of a building or an asset that cannot be depreciated is disposed of, the taxpayer may elect to defer the tax liability generated by such disposal by means of roll-over relief. To qualify for the relief, the alienated capital asset must have been entered into the balance sheet of the company for at least 5 years and the company must envisage the reinvestment of the sales price in certain qualifying assets. Further, the deferred gain must be booked into a non-distributable reserve in the company's balance sheet for the year in which the alienation took place.

Tax roll-over relief under conditions may also exist for:

- conversion of debt into shares;
- conversion into another undertaking with a collective character;
- merger/de-merger of an undertaking with a collective character, mentioned in the Exhibit to Art. 2 to the Parent / Subsidiary Directive (including Luxembourg) or of certain other foreign entities; and
- qualifying share for share exchange of an undertaking with a collective character, mentioned in the Exhibit to Art. 2 to the Parent / Subsidiary Directive (including Luxembourg) or of certain other foreign entities.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

See question 2.5.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are not.

6.3 How would the taxable profits of a local branch be determined?

In principle, Luxembourg applies the direct method. This means that Luxembourg branches of foreign corporations are taxed in the same way as resident companies. Taxable profits are generally calculated by reference to the income and deductions attributable to the local branch's business activities, determined under the assumption that the branch acts like an enterprise independent of its head office. However, transactions between the head office and branch are generally disregarded (except for banking activities). All Luxembourg income so allocated to and derived by a branch in Luxembourg (including dividends, patents, royalties, and interest attributable to the branch), is taxable in Luxembourg.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

No, it would not.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As a general rule, branches are not considered to be a Luxembourg resident in the sense of domestic law or treaty law and can therefore not benefit from the provisions of the tax treaties entered into by Luxembourg.

However, under ECJ case law and, in certain cases, following non-discrimination provisions referred to in tax treaties concluded between Luxembourg and the residence country of the head office, Luxembourg branches may be required to extend benefits under a tax treaty with third countries when the Luxembourg branch derives income from such third countries.

In addition, Luxembourg branches of non-resident companies may, by virtue of domestic law, qualify for tax credits for foreign taxes, and for the exemption of capital gains or dividends (See under questions 5.1 and 5.3).

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, it would not.

7 Overseas Profits

7.1 Does Luxembourg tax profits earned in overseas branches?

The Luxembourg tax system taxes resident collective undertakings and permanent establishments of foreign collective undertakings on a worldwide basis. Therefore, subject to potential impact of applicable double tax treaties, the profits of overseas branches are included in the taxable basis for Luxembourg tax purposes.

Since, however, under applicable double tax treaties, Luxembourg applies in principle the exemption method for overseas branch profits, such profits are in principle tax-exempt in Luxembourg.

In the absence of an applicable double tax treaty, overseas branch profits are subject to IRC. Foreign profit taxes paid may be credited against the IRC.

Since the ICC is a territorial tax limited to profits derived from a business carried on in Luxembourg, profits of overseas branches are not subject to it.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

See under question 5.3 above.

7.3 Does Luxembourg have "controlled foreign company" rules and if so when do these apply?

Luxembourg does not have controlled foreign company legislation, except for the very specific form of foreign family foundations.

8 Anti-avoidance

8.1 Does Luxembourg have a general anti-avoidance rule?

The general tax law contains anti-avoidance provisions that permit the Luxembourg tax authorities to challenge sham transactions and tax-avoidance schemes (so-called "abuse of law"-doctrine) in the field of direct taxes. The "abuse of law"-doctrine does not apply in the field of capital duty and transfer taxes. It is unclear whether these anti-avoidance provisions also cover the field of VAT.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is no requirement to make special disclosure of avoidance schemes.

Pierre Elvinger

Elvinger, Hoss & Prussen
2, place Winston Churchill B.P 425
L-2014
Luxembourg

Tel: +352 44 66 44 2112
Fax: +352 44 22 55
Email: PierreElvinger@EHP.LU
URL: www.ehp.lu

Pierre Elvinger is "*maître en droit*". He became a member of the Luxembourg Bar in 1991 and joined Elvinger Hoss and Prussen the same year. He studied tax law with the "*Institut für Steuerrecht*" of the "Cologne University". His activities concentrate on litigation, tax law and employment law.
He is fluent in English, French, German and Luxembourgish.

Dirk Richter

Elvinger, Hoss & Prussen
2, place Winston Churchill B.P.425
L-2014
Luxembourg

Tel: +352 44 66 44 2440
Fax: +352 44 22 55
Email: DirkRichter@EHP.LU
URL: www.ehp.lu

Dirk Richter concentrates on tax matters with a focus on corporate and international taxation for institutional and corporate investors as well as transactional advice for regulated and unregulated private equity and real estate clients.
He is a member of the "International Bar Association", the "International Fiscal Association" and the "Luxembourg Association of Fiscal Law" and has co-authored the national report to the 2008 Brussels Congress on non-discrimination at the crossroads of international taxation.
He is fluent in English, French and German and speaks Japanese.

ELVINGER, HOSS & PRUSSEN
AVOCATS À LA COUR

Elvinger, Hoss & Prussen was founded in 1964 by lawyers committed to excellence and creativity in the provision of legal services. The founders of the firm were among the first to foresee the role that Luxembourg was about to play as a leading European financial centre.

For decades, the partners of the firm have played an instrumental role in the construction of the legal and regulatory environment which is crucial to the success of the Luxembourg financial sector. In this context, the firm pioneered instruments and legal structures before they were recognised by law and regulations and used on a daily basis in financial transactions. Today the firm advises on high-profile local and international transactions and has an impressive client base.

Over the years the firm has grown with the financial centre and earned the reputation of being one of the most prestigious and highly respected law firms in Luxembourg.

Macedonia

Debarliev, Dameski & Kelesoska Attorneys at Law

Dragan Dameski

1 General: Treaties

1.1 How many income tax treaties are currently in force in Macedonia?

The Republic of Macedonia has been a part of the Former Yugoslavia since 1991, when it announced its independency. After this time, the Republic of Macedonia took onboard some of tax treaties entered into by the Former Yugoslavia and signed a number of new tax treaties. Currently, the Republic of Macedonia has tax treaties with 38 countries.

1.2 Do they generally follow the OECD or another model?

The treaties are based on and generally follow the OECD model convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. The tax treaties must be ratified by the Macedonian Parliament and announced in the official Gazette in order to be legally effected.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Generally, treaties do not incorporate specific limitation of benefits provisions.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In the Republic of Macedonia, all domestic laws and rules must comply with general principals of international law and treaties, to which the Republic of Macedonia is part of or has a tendency to join.

2 Transaction Taxes

2.1 Are there any documentary taxes in Republic of Macedonia?

There are no documentary taxes in the Republic of Macedonia.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The Republic of Macedonia has adopted a Value Added Tax system, which is in line with the EU directive for VAT. Currently, two rates apply in the Republic of Macedonia. A Standard rate of 18% and a preferential rate of 5% applies to items which are specifically enumerated in the Value Added Tax Act.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In general, all transactions are charged with VAT.

The only exemptions from the Macedonian Value Added Tax Act include the following:

- banks and financial services;
- supply of residential building and apartments that are part-used for housing purposes, except the first supply, which must made within five years after the construction;
- supply of postal stamps;
- insurance and re-insurance services are not entitled to deduct input VAT;
- games of chance and lotteries;
- supply by institutions in the field of culture (botanical gardens, zoos, animals parks, etc.);
- services by broadcasting and television stations, except commercial activities;
- health services provided by hospitals, clinics, health centres, medical and chemical laboratories for diagnostics;
- services and supply of goods by institutions for social welfare and protection, including services to homes for hospitalisation, care and treatment to old people;
- international transportation of passengers; and
- activities in technological industrial Development Zones.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Taxpayers who are registered for VAT, according to the law, are entitled to recover the paid VAT. However, it may be noted that not all businesses are required by law to register for VAT. Businesses with an annual turnover of under 2,000,000.00 MKD are not obligated to register for VAT, and they are not entitled to tax credit deduction.

The taxpayer shall not be entitled to tax credit deduction for:

- Purchase or importation of goods or performed services used for supply tax.

- Purchase, production and importation of bicycles, motors vehicles with less than 4 wheels, etc.
- Expenditures for presentation of the enterprise or its owner.
- Supply or import of regulators, audio and video devices, carpets and artistic items for the purpose of furnishing a business premises.
- Costs for transportation of people.
- Costs for accommodation in hotels or similar facilities or for catering.

2.5 Are there any other transaction taxes?

Only if VAT is not applicable, the transfer of real property is subject to a real estate transaction tax. The tax rate of this transfer tax is between 2% and 4%.

2.6 Are there any other indirect taxes of which we should be aware?

In the Republic of Macedonia, indirect taxes are VAT, excise tax and custom tax.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Yes, withholding tax is imposed on such dividends at a tax rate of 10% from the paid dividends.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Withholding is imposed on royalties, as well at a tax rate of 10% from the paid royalty.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

If the interest that is being paid by the resident origins from a loan given from the non-resident and the two subjects are connected parties, then a tax at a tax rate of 10% shall be applied on the difference between the paid higher interest and the interest on that kind of loan in case the two subjects were not connected parties, i.e. bank market interest.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Yes. If the non-resident owns a share of at least 25% of the basic capital of the resident, and the loan given from the non-resident is at least three times the amount of that share, then the interest paid from the resident to the non-resident shall be subject to taxation.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The limit for a "safe harbour" is the minimum size of the share of the resident (25% margin) and the minimum amount of the loan (three times the size of the share of the resident).

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, the thin capitalisation rules are extended if the loan is given from a third party, and the non-resident guarantees it.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

If the interest that is being paid to the non-resident is an income of the local company, then there will be withholding tax at a tax rate of 10% imposed.

If the interest that is being paid from the resident to the non-resident is simple interest, and the two subjects are connected parties, then a tax at a tax rate of 10% shall be imposed on the interest.

3.8 Does Republic of Macedonia have transfer pricing rules?

Yes, there are transfer pricing rules incorporated in the profit tax law.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

In the Republic of Macedonia, as from 1 January 2008, a tax rate of 10% applies to all companies. This tax is paid by all resident companies that achieve profit in Macedonia and abroad, as well as by the non-residents that achieve profit from its activities in Macedonia. The tax rate is proportional.

Tax payers which are located in a technological industrial development zone are relieved of paying profit tax for 10 years from the beginning of their activity.

4.2 When is that tax generally payable?

The tax is calculated and payable on an annual basis.

The tax application must be submitted by 28 February of the current year for the activity of the company in the previous year. After that, the ascertained profit tax is calculated and is payable in 12 equal monthly instalments, within 15 days of each month.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The basics for taxation are the disallowed expenses and the less shown income of the company. The gross profit ascertained with commercial accounts, adjusted with the disallowed deductions and the less shown income, is a basis for taxation if that profit is distributed in the form of dividends.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

As stated in question 4.3, the adjustments in the commercial accounts for taxation are the disallowed expenses and the less shown income of the company. The main adjustments (differences) are: the expenses that are not related to the company's activity and are not consequences of its activity; the interest paid on loans that are not used for funding the company's activity or are used for buying luxuries; and the permanent write-off of uncollected debt. There are other adjustments provided in the law, however their significance is minor.

4.5 Are there any tax grouping rules? Do these allow for relief in Republic of Macedonia for losses of overseas subsidiaries?

In the Republic of Macedonia there are no tax grouping rules.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Profit tax of 10% shall be imposed upon distribution of the profit. In case there is retained profit, profit tax shall not be imposed until that profit is distributed.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Companies resident in the Republic of Macedonia are subject to taxation with property taxes, in case they own and/or sell immovable assets in Macedonia.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are additional taxes that might be imposed. Those are communal tax and administrative tax. Some of them are set by the local municipalities and the rate depends on the company business and/or size as to whether they are insignificant.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

When it comes to capital gains and losses for corporations (business profits), the rules for taxing capital gains and losses are set in Profit Tax Law.

There is a special set of rules for taxing capital gains and losses, referring to natural persons, as a part of the Income Tax Law.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

According to Income Tax Law, the tax rate imposed upon capital gains, referring to natural persons, is the same as the rate imposed upon business profits for corporations, according to Profit Tax Law, i.e. a 10% rate.

The difference is in the base for implementing the rate; for natural persons it is 70% of the gain; while for the corporations, it is 100% of the gain.

5.3 Is there a participation exemption?

No participation exemption.

5.4 Is there any special relief for reinvestment?

There is a relief of profit tax payment for reinvested profits from the current year.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no capital duties (taxes) when establishing a subsidiary in Macedonia.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Currently, in the Republic of Macedonia, no such taxes or fees apply.

6.3 How would the taxable profits of a local branch be determined?

The profits of a branch are subject to corporate income tax, as with all other residents in Macedonia.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

The taxable income of a branch is computed according to the same rules and rates as they are applicable to any other resident taxpayer in Macedonia.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Since the branch is considered as a resident for tax payment, it cannot benefit from tax treaty provisions.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Withholding tax shall apply as prescribed in question 3.1 above.

7 Overseas Profits

7.1 Does Republic of Macedonia tax profits earned in overseas branches?

The Republic of Macedonia won't tax profit earned in overseas branches until that profit is distributed in the form of a dividend to the resident of Macedonia.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

According to the regulation of the Republic of Macedonia, if a resident receives dividends from non-residents, that income is subject to taxation reduced for the amount of profit tax paid for such dividends in the country where the non-resident is located. This reduction is allowed for dividends paid by the non-resident, calculated at tax rate of 10%.

However, the resident must submit evidence about the paid tax in the country where the non-resident is located.

7.3 Does Republic of Macedonia have "controlled foreign company" rules and if so when do these apply?

The Republic of Macedonia does not have controlled foreign company rules.

8 Anti-avoidance

8.1 Does Macedonia have a general anti-avoidance rule?

There are no specific anti-avoidance rules but there are some provisions and measures implemented in Macedonian laws that achieve results in this direction. For example, the provisions of the Law of VAT have regard to related entities that might/have to be registered as one tax payer for VAT purposes. Also, there are some regulations introduced by the ministry of finance which contain provisions that regulate cases that have appeared as practical problems of tax evasion. For example, according to the Instruction book for the Law of VAT, if the invoice issued by the tax payer is fictitious then the taxpayer does not have the right of deduction of the previously paid VAT and he is obligated to pay the calculated VAT enunciated in the invoice. Sometimes these kinds of bylaws produce a legal inequality because the taxpayers are not fully informed about their provisions and are faced with penalties because of it.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

In general there are no special requirements for the disclosure of avoidance schemes.

Dragan Dameski

Debarliev, Dameski & Kelesoska Attorneys at Law
Street Albert Ajnastajn no. 4/1
Skopje
Republic of Macedonia

Tel: *+389 23 136 530; +389 23 215 471*
Fax: *+389 23 215 470*
Email: *Dameski@ddklaw.com.mk*
URL: *www.ddklaw.com.mk*

Dragan Dameski is one of the founders of Debarliev Dameski & Kelesoska Attorneys at Law. He is the head of the corporate department of the company. Electronic communications, competition, electronic commerce, corporate law, direct foreign investments and energetics are his most valued areas of expertise.
Dragan Dameski graduated at Iustinianus Primus Faculty of Law in Skopje, Republic of Macedonia in 1999. He first started working at Spirkovski Law Office Skopje, and later established Debarliev Dameski & Kelesoska Attorneys at Law, along with Partners Emilija Kelesoska Soljakovska and Ivan Debarliev.
In 2003 Dragan Dameski was admitted to the Macedonian BAR Association, and since 2005 he has been a member of the Management Board of the Association of Mediators of Macedonia. He is also a member of the International Advocates Union (UIA) and the International Bar Association (IBA).
Dragan speak English, Serbian, Croatian and has good French.

DDK
DEBARLIEV, DAMESKI & KELESOSKA
attorneys at law

Accepting the premises that no one can be equally versed in all fields of law, DEBARLIEV, DAMESKI & KELESOSKA Attorneys at Law has been created as a company committed to be the leading business law firm in Macedonia.

Debarliev, Dameski & Kelesoska Attorneys at Law is also the first law company established in the territory of R. Macedonia, distinguishing itself on the market with a clear business and corporate law orientation, complemented with an excellent network of legal experts covering the complete territory of R. Macedonia.

The quality of Debarliev, Dameski & Kelesoska Attorney at Law rests mainly upon the quality of its attorneys, their accessibility and efficiency. DDK's attorneys at law share outstanding academic backgrounds, as well as strong commitment to legal perfection.

The partners of DDK have more than fifteen years' law practice experience and have exceed clients' expectation by providing sophisticated and efficiently managed legal services.

DDK offers excellent legal services to clients involved in all the biggest M&A, energy projects in Macedonia, and has been engaged as counsel in numerous successful PPP projects, privatisations, capital markets transactions, banking, joint ventures etc.

Chapter 31

Malta

Walter Cutajar

Avanzia Taxand Limited

Mary Anne Inguanez

1 General: Treaties

1.1 How many income tax treaties are currently in force in Malta?

Malta has an extensive treaty network with nearly 60 income tax treaties in force and over 10 treaties that are in the pipeline awaiting signature, ratification or both. Malta's tax treaties are mainly with European countries, although it also has treaties with countries in America, Africa, Middle East, the Gulf and Asia. Moreover, as a member of the European Union, dividends, interest and royalties may also benefit from the EU Parent Subsidiary Directive or the Interest and Royalties Directive.

Apart from treaty relief, Malta also gives double taxation relief through legislative provisions, in the form of unilateral relief or a Flat Rate Foreign Tax Credit (FRFTC) on foreign source income and capital gains. Unilateral relief provides relief from double taxation on a unilateral basis where the tax is charged in a country with which Malta does not have a double tax treaty. It may also be claimed in respect of underlying tax. The overseas tax is allowed as a credit against the Malta tax up to a level which does not exceed the total tax charge in Malta. The FRFTC is available to entities in receipt of income or capital gains from overseas and are therefore allocated, for income tax purposes, to the Foreign Income Account (FIA). A certificate from an auditor stating that the income stands to be allocated to the FIA is sufficient to claim FRFTC and no proof is necessary as to any foreign taxes suffered.

The FRFTC is calculated at 25% of the amount of the net overseas income or gain received by the Maltese company before any allowable expenses. The income plus the credit less allowable expenses is subject to income tax at the standard rate of 35%, with relief for the deemed credit up to a maximum of 85% of the Malta Tax payable. Upon a distribution of profits, the shareholders are entitled to tax credits and tax refunds and this results in an effective tax rate of 6.25% or less.

1.2 Do they generally follow the OECD or another model?

Malta's double tax treaties are mainly based on the OECD model convention. Some of the treaties contain a tax-sparing provision which makes the treaty even more attractive. In all tax treaties, the dividends article caters for Malta's full imputation system of taxation.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

A treaty needs to be incorporated into domestic law. Treaties are given force of law by means of publication in the Government Gazette as a legal notice under the Income Tax Act. A treaty will enter into force and have effect from the dates determined by the treaty.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Few treaties have an article on Limitation of Benefits (LOB), although protocols often exclude persons who are entitled to a special tax regime such as offshore companies, Freeport companies and shipping companies registered under the Merchant Shipping Act. Most of these companies are now defunct.

The tax treaty with the United States of America contains a detailed LOB clause.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The Income Tax Act provides that once a tax treaty enters into force, this shall have effect in relation to income tax notwithstanding anything in the Act or any other enactment. Therefore, should there be a conflict between a treaty provision and domestic law, it is the treaty which prevails.

Needless to say, if the treaty provision is less attractive than the normal provisions contained in the Income Tax Act then the latter prevails. A classic example is withholding taxes since Malta does not impose any withholding tax on dividends, interest and royalties.

The only limitation is that treaties made after 1 October 1968 do not apply with respect to income tax upon the chargeable income of any person engaged in the production of petroleum produced in Malta.

2 Transaction Taxes

2.1 Are there any documentary taxes in Malta?

Malta levies a stamp duty, which is known as a 'duty on documents and transfers'. This is payable on transfers of immovable property situated in Malta, certain marketable securities, insurance contracts and certain other transactions.

Duty on the acquisition of immovable property is levied at 5% (with some exemptions in instances where the property is being bought as the individual's sole ordinary residence). Stamp duty on share transfers is 2%, but transfers of shares in Collective Investment Schemes (funds) and companies which have more than 50% of shares owned or controlled by non-resident persons are exempt from duty.

No duty is chargeable on the transfer of securities which are affected through a local bank or through a person holding a licence under the Investment Services Act. Hence transfers of listed securities, which have to be transferred through a licensed person, are consequently exempt from duty. Certain exemptions from stamp duty are also provided on certain share transfers made upon a restructuring of shareholding that occurs through mergers, demergers, amalgamation and reorganisation within a group of companies.

There is no succession duty or inheritance tax in Malta, except that duty is levied on transfers '*causa mortis*' of immovable property or securities in Maltese companies (provided they do not fall within the exemptions referred to above).

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

VAT was introduced in Malta in 1995 and is the principal form of indirect taxation in Malta. The VAT legislation incorporates most of the provisions contained in the EU Directives, although Malta has negotiated some special arrangements. The standard rate of VAT is 18% and applies to any supply of goods and services which is not exempt or subject to the reduced rate of 5% or 7%.

The reduced rate of 5% applies to supply of electricity, confectionery, medical accessories, printed matter, items for the use of the disabled and works of art, whereas the reduced rate of 7% applies to accommodation which is licensed under the Malta Travel and Tourism Services Act.

Goods and services may also be 'exempt with credit' or 'exempt without credit'. 'Exempt with credit' is similar to having a zero VAT rate and applies on exports, pharmaceutical goods and food. Exempt without credit applies to immovable property, insurance, banking, broadcasting and education.

Where supplies are either taxable or 'exempt with credit', input VAT is fully recoverable (unless specifically blocked), but where supplies are 'exempt without credit', VAT is neither charged nor recoverable by the supplier.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Malta applied the EU Sixth Directive but also negotiated certain special arrangements. Exclusions from VAT are also provided for. A derogation obtained during accession negotiations (and subsequently confirmed by the EU) enables Malta to have exemption with credit status on food, pharmaceutical products, inland passenger transport, international passenger transport and domestic inter-island sea passenger transport. The supply of water by public authorities and the supply of buildings and building land are also exempt without credit.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input tax is only recoverable by a taxable person (a person who is required to be registered for VAT). Input tax is attributed in accordance with the nature and the tax status of the supply intended to be made by the business. Input tax on supplies wholly used to make taxable supplies is deductible in full. Input tax wholly used to make exempt or non-business supplies is not deductible. Where a person makes both taxable and exempt without credit supplies and incurs expenditure that is not directly attributable to either, the VAT on the expenditure must be apportioned between the supplies (under the partial attribution provisions).

Small undertakings with a turnover below the established threshold may opt for an exempt without credit status. Such entities or individuals will not recover input VAT.

Input tax on tobacco and tobacco products, alcoholic beverages, works of art, motor vehicles, entertainment and some other items is not recoverable.

2.5 Are there any other transaction taxes?

Customs duties are still levied on certain imports from non-EU countries. Excise duties are levied on particular classes of goods such as alcohol and tobacco.

Malta has an ecological tax known as 'Eco Tax', which levies tax on products and materials which are potentially harmful to the environment, such as batteries, refrigerators, air conditioners and plastic bottles. Applicable rates vary according to the particular product or material.

2.6 Are there any other indirect taxes of which we should be aware?

There are no further taxes applicable to businesses and corporate entities.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

There is no withholding tax on dividends, irrespective of the shareholder's country of residence. Malta has a full imputation system of taxation on dividend distribution out of profits allocated to the Foreign Income Account, the Maltese taxed Account and the Immovable Property Account. Any tax paid by the company is credited in full to the shareholder upon a distribution of such profits.

The income tax rate applicable to companies is 35% and the highest personal tax rate is also 35%. If a shareholder is not subject to tax or qualifies for a lower rate of tax than the 35% already paid by the company, then he is entitled to a tax refund equivalent to the excess tax paid by the company. This system avoids any double taxation of distributed corporate profits.

Moreover, the income tax system utilises five different tax accounts, namely the Maltese Taxed Account (MTA), the Foreign Income Account (FIA), the Final Tax Account (FTA), the Immovable Property Account (IPA) and the Untaxed Account (UA). A distribution from the MTA or the FIA entitles shareholders to claim a tax refund equivalent to 6/7 or 5/7 of the tax paid by the distributing company (depending on the type of income). A distribution from the FIA entitles the shareholder to claim a tax refund equivalent to 100% of the tax paid by the company or else to 2/3 of the tax paid. As a result of these tax refunds, the overall effective tax rate may be reduced drastically and in some cases any tax leakage may also be eliminated completely.

Distributions to a non-resident person from the FTA, IPA and UA are not subject to any withholding tax and no tax refunds may be claimed in respect of such dividend distributions.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties arising in Malta and accruing to a non-resident person are exempt from any tax in Malta, provided such royalties are not related to a permanent establishment which the said person may have in Malta.

Malta does not impose any withholding tax, irrespective of the recipient's tax status and the country of residence.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest arising in Malta and accruing to a non-resident person is exempt from any tax in Malta, provided such interest is not related to a permanent establishment which the said person may have in Malta.

Malta does not impose any withholding tax, irrespective of the recipient's tax status and the country of residence.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Malta does not have any thin capitalisation rules but the Income Tax Act contains a general anti-avoidance provision. By virtue of this anti-avoidance provision, the tax authorities may disregard any scheme which reduces the tax payable.

However, a taxpayer may apply for an Advance Revenue Ruling (ARR) on the tax treatment of any transaction which concerns any financial instrument or other security and on any transaction which involves international business.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There are no statutory safe harbour rules. The principle for related party transactions should be the arm's length principle. However, a taxpayer may apply for an Advance Revenue Ruling and thus have certainty on the tax treatment of a transaction. ARRs are valid for five years and renewable for a further five-year period and are still valid for a two-year period if there is a change in the legislation which affects the ruling.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

As already mentioned above, Malta does not have any thin capitalisation rules. However, a scheme which reduces the tax payable may fall foul of the anti-avoidance provision and thus be ignored for income tax purposes.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Malta does not impose any restrictions or limitations on the interest payments made by a local company to a non-resident. The Income Tax Act exempts from tax interest received by non-residents, provided there is no permanent establishment in Malta.

3.8 Does Malta have transfer pricing rules?

Malta does not have any transfer pricing rules.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Companies are subject to income tax at a standard rate of 35%. A company in receipt of foreign source income may claim the FRFTC (see question 1.1) so that the tax payable is reduced to 18.75%.

Companies engaged in petroleum produced in Malta are subject to a tax rate of 50%.

4.2 When is that tax generally payable?

Companies whose sources of income are Malta-sourced are subject to a system of provisional tax payments whereby income tax in respect of the current year is paid in three instalments, with the tax charge calculated on the chargeable income of the year preceding the previous year. Any shortfall of provisional tax payments which result in a tax liability for the year is to be paid by the tax return date. The tax return date for a company whose financial year end is a calendar year is 30th September of the following year. The provisional tax instalments of a company, whose financial year end is 31st December, become due on 30th April, 31st August and 21st December.

Companies which operate the FIA and whose sources of income are foreign source are not subject to any provisional tax payments. Payment of the company's income tax may be made within 18 months from the end of the financial year end and not by the tax return date.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base follows the commercial or statutory accounts subject to certain adjustments. Certain items of expenditure which reduce the accounting profits may not be allowable or deductible for tax purposes and are therefore added back in order to calculate the chargeable income. This applies to provisions and unrealised expenses.

On the other hand, tax legislation may provide for certain deductions which are not claimed as expenses in the commercial accounts. This may apply in cases of inflated allowances in excess of the actual expenditure incurred (for example, R&D allowances).

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The general rule is that expenses which are incurred in the production of the income are allowable for income tax purposes, whilst expenses which are of a private nature, of a capital nature, recoverable from any insurance or of a voluntary nature are not allowed for income tax purposes.

4.5 Are there any tax grouping rules? Do these allow for relief in Malta for losses of overseas subsidiaries?

Malta's income tax laws do not require consolidated accounts for tax purposes. However, groups of companies may still benefit from 'group relief', which enables a member company to surrender tax losses to another group member. The losses surrendered by a group company may be set off against the tax profits or chargeable income of the claimant company. The surrendered losses may be carried forward by the claimant company and these are available for set off against future profits. The surrendering and claimant company must have identical accounting periods, have satisfied the definition of a group during the last financial year, and must be a tax resident in Malta. Hence, relief for losses incurred by overseas subsidiaries is not possible under our law.

The 'group relief' provisions contain specific anti-abuse provisions to restrict the surrendering of losses made by companies performing work related to immovable property.

Companies are considered to be members of the same group if more than 50% of the capital is owned directly or indirectly by the same company. The 50% test applies to share capital, voting rights, profits available for distribution and distribution on a winding up.

A much wider definition of a group of companies applies for capital gains tax purposes. In this case, companies of which more than 50% are owned and controlled by the same shareholders qualify as a group for capital gains tax purposes. Assets may be transferred within a group without any capital gains tax.

No group concept exists in the VAT legislation.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No. Subject to double taxation relief which reduces the Malta tax, chargeable income is subject to income tax at the rate of 35%, irrespective of whether it is distributed or not.

Profits which are distributed are brought to charge in the shareholder's hands at the grossed up amount and full credit is given for the tax already paid by the company. Under Malta's full imputation system of taxation (which ensures a full credit of the income tax paid by the company), it may be said that profits which are distributed by a company are not subject to any income tax at all at the level of the distributing company.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

There are no other national taxes payable by companies. Certain capital gains are brought to charge with trading income. Capital gains arising on transfers of immovable property or other specific assets such as securities, patents, trademarks, trade-names and business goodwill are brought to charge as part of the taxpayer's chargeable income.

Transfers of certain immovable property may be subject to a property transfer tax equivalent to 12% of the transfer value instead of taxing the actual capital gain (see question 5.2 below).

4.8 Are there any local taxes not dealt with in answers to other questions?

There are no other local taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains which are chargeable to tax in Malta are those gains or profits realised from immovable property, securities (excluding preference shares having a fixed rate of return), business goodwill, copyright, patents, trademarks, trade-names and the transfer of the beneficial interest in a trust.

There are specific rules on how to calculate or determine the capital gain on immovable property and securities, including securities in companies which own immovable property. The rules also contain formulae and inflation-linked adjustments, which mean that the effective tax rate can be less than the standard rate of 35%.

A capital gain is brought to charge as part of the chargeable income but a capital loss cannot be set off against other income for the year of assessment but shall be carried forward and set off against capital gains in respect of subsequent years of assessment until the full loss is absorbed.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains are taxed at the same rate applicable to other chargeable income, which is 35%. However, a special regime exists with respect to the transfer of immovable property situated in Malta. Transfers of immovable property (which had previously not been acquired through inheritance) are taxed at 12% of transfer value. The tax is collected by the notary upon the deed of transfer and the property tax is full and final. Under certain circumstances, the vendor has the option to opt out of this 12% final withholding tax, in which case 7% provisional tax (calculated on the transfer value) is payable upon the deed and the eventual capital gains calculated at the self-assessment stage are subject to tax at 35%. The capital gain is arrived at by deducting the cost of acquisition from the selling price but there are various rules on how to calculate the cost of acquisition and the inflation element, etc.

The capital gain arising upon the sale of immovable property which was derived through an inheritance is also paid on the transfer deed but at 12% upon the gain (selling price less the value which was declared upon the inheritance).

Individuals transferring their sole ordinary residence are exempt from tax upon capital gains, provided the property has been owned and occupied for at least three years and is transferred within one year from vacating the premises. There are other exemptions such as donations and group transfers.

5.3 Is there a participation exemption?

Yes, companies that derive dividend income or capital gains from a 'participating holding' may opt for the 'participation exemption'. Alternatively, the Maltese company may elect to be subject to tax and pay income tax on dividend received and capital gains arising from a participation holding and then upon a distribution of profits, the shareholder is entitled to claim a full refund of the company income tax.

A shareholding in a company qualifies as a 'participating holding' (and therefore for the participation exemption) if the Maltese company holds equity shares in a company or a qualifying body of persons and it:

- has at least 10% of the equity shares in another company;
- is an equity shareholder in a company and is entitled to purchase the balance of the equity shares of the other company, or it has the right of first refusal to purchase such shares;
- is an equity shareholder in a company and is entitled to either sit on the Board or appoint a person on the Board of that subsidiary as a director;

- is an equity shareholder which invests in a company a minimum of €1.17 million (or the equivalent in a foreign currency) and such investment is held for a minimum uninterrupted period of 183 days; or
- holds the shares in a company for the furtherance of its own business and the holding is not held as trading stock for the purpose of a trade.

Furthermore, the 'target company' must either satisfy any one of the following 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;

or else it must satisfy both of the following 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 which is not less than 5%.

5.4 Is there any special relief for reinvestment?

Where an asset (which is subject to capital gains and is used in a business for a period of at least three years) is transferred and replaced within one year by an asset used solely for a similar purpose in the business, any capital gains realised on the transfer is not subject to tax but the cost of acquisition of the new asset is reduced by the said gain. When eventually the asset is disposed of without replacement, the overall gain shall take into account the transfer price and the cost of acquisition, reduced as aforesaid.

Furthermore, where an asset is transferred from one company to another and such companies are deemed to be a group of companies, it shall be deemed that no loss or gain has arisen from the transfer. This is also applicable where the two companies are controlled and beneficially owned directly or indirectly to the extent of more than 50% by the same shareholders.

The Income Tax Act contains anti-abuse measures in relation to the above two tax deferral provisions to ensure that companies benefiting from the above do not transfer the asset to third parties.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary. Only a registration fee (ranging from €245 up to €2,250) is payable to the Registry of Companies.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

A Maltese subsidiary / company is subject to tax on a worldwide basis, subject to the tax credits and refunds which may apply upon a distribution of profits. However, a branch of a foreign company, known as an 'overseas company', is only subject to tax on income attributable to the branch. The income computation follows that adopted for domestic companies. The branch is allowed to deduct a proportion of the expenses associated with the head office management. In practice, there are minor differences between having a branch and a locally registered subsidiary.

6.3 How would the taxable profits of a local branch be determined?

A branch is subject to income tax in Malta as if it was a wholly independent entity. The tax authorities follow the OECD principles.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax in Malta.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch of a foreign company or an overseas company may benefit from Malta's network of tax treaties, provided it is a tax resident in terms of the treaty provisions. The tax legislation does not contain specific provisions applicable to branches and these are treated as a permanent establishment subject to income tax on income attributable to the branch.

Apart from tax treaty provisions, an overseas company may also benefit from unilateral relief.

There are no big differences between the tax treatment of branches and subsidiary companies, except that the determination of chargeable income of a Malta branch may be more subjective and therefore it may be advisable to seek advance revenue ruling or confirmation from the tax authorities.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, Malta does not impose any withholding taxes. Profits may be remitted without any tax implications.

7 Overseas Profits

7.1 Does Malta tax profits earned in overseas branches?

Yes, profits earned in an overseas branch (of a Maltese company) are subject to income tax at the standard rate of 35% subject to any double taxation relief. Such profits are allocated to the FIA. (See further details on the implications arising from a distribution from the FIA in question 3.1 above).

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

The likelihood is that such dividend income is exempt from tax under Malta's generous participation exemption regime.

7.3 Does Malta have "controlled foreign company" rules and if so when do these apply?

No, Malta does not have any CFC rules.

8 Anti-avoidance

8.1 Does Malta have a general anti-avoidance rule?

The income tax legislation contains a few general anti-avoidance provisions.

One provision provides that where any scheme which reduces the amount of tax payable by any person is artificial or fictitious or is in fact not given effect to, this shall be disregarded by the tax authorities and the person concerned is assessed accordingly.

Another provision provides that where 'a series of transactions' is effected with the sole or main purpose of reducing the amount of tax payable by a person under the 'investment income provisions', then such person would be assessable as if the said 'investment income provisions' did not apply. (The investment income provisions provide for a final tax of 15% on certain investment income.)

A similar anti-avoidance provision (applicable to the investment income provisions) applies to the Flat Rate Foreign Tax Credit.

Another anti-avoidance provision relates to group relief. If a company is a member of a group of companies and arrangements are in existence, the sole or main purpose of which is to reduce any company's tax liability, then that company shall be treated as not being a member of that group of companies for any year preceding a year of assessment in which the said arrangements are in existence. There are also other specific anti-abuse provisions related to group relief.

Another provision provides that when an asset is transferred from one company to another company within a group and the transfer is exempted from tax as the two companies form part of a group, the transfer will be subject to property tax at the rate of 12% if the companies cease to be a group before the lapse of five years.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is no requirement to make special disclosure of avoidance schemes.

Walter Cutajar

Avanzia Taxand Limited
Leicester Court Suite 2, Edgar Bernard Street
Gzira GZR1702
Malta

Tel: +356 2730 0045
Fax: +356 2730 0049
Email: walter.cutajar@avanzia.com.mt
URL: www.avanzia.com.mt

Walter Cutajar is Managing Director of Avanzia Taxand.
With over 20 years experience in local and international tax, Walter maintains a reputation of adopting a commercial approach to his advice. Working with predominantly multi-national companies, he has provided structuring and transactional consultation on the complete range of corporate tax activities, including mergers and acquisitions, company reorganisations and cross-border restructurings.
Walter currently advises a number of multi-national companies and sits on the board of directors of a number of companies including finance companies, captives and investment vehicles.
Aside from his wealth of experience in international tax matters, including tax planning, treaty interpretation and advice, he also has a great deal of knowledge on corporate matters, company law, management, and administration. He specialises in treaty planning, holding companies, intellectual property, and treasury and finance operations.
During his time as a Big 4 partner, he was responsible for the firm's tax department and was a regular participant in international tax conferences and events. He continues to give various lectures and presentations, and is the author of various taxation articles. For a number of years he was an examiner in taxation with the UK's Association of Chartered Certified Accountants.
Walter holds a first degree in Accounting and a post-graduate qualification in International Tax Law. He is a fellow of the Malta Institute of Accountants, a member of the Institute of Financial Accountants in the UK, a member of the Malta Institute of Taxation, a member of the Institute of Financial Services Practitioners, a member of the International Fiscal Association, and was involved in various councils and committees in the fields of taxation and financial services.

Mary Anne Inguanez

Avanzia Taxand Limited
Leicester Court Suite 2, Edgar Bernard Street
Gzira GZR1702
Malta

Tel: +356 2730 0045
Fax: +356 2730 0049
Email: maryanne.inguanez@avanzia.com.mt
URL: www.avanzia.com.mt

Mary Anne Inguanez is a Director of Avanzia Taxand.
She holds a first degree in Accounting from the University of Malta and a Diploma in Taxation awarded by the Malta Institute of Taxation. She is also a member of the Malta Institute of Accountants, a member of the Malta Institute of Taxation and a member of the Institute of Financial Services Practitioners.
Mary Anne worked for some time in the tax department of one of the Big 4 audit firms before moving to Avanzia Taxand in 2005. She has considerable experience in a number of areas, including corporate tax, personal tax, employment issues, capital gains tax, indirect taxation and liquidations.
She is a tax consultant, advising a number of multi-national companies, financial institutions, funds and high-net worth individuals in her areas of expertise, and is often involved in cross-border financing transactions and reorganisations.
Aside from her experience in local and international tax matters, she assists clients in tax negotiations and in obtaining advance revenue rulings and tax confirmations from the tax authorities.

Avanzia
Taxand

Avanzia Taxand is ranked as a Tier Two Firm in Euromoney's Corporate Tax Handbook. In 2009 Avanzia Taxand was named 'Malta Tax Firm of the Year' by the International Tax Review and in 2011 Avanzia Taxand were chosen as the winner of the Corporate Intl Magazine 2011 Global Award for 'Tax Law Firm of the Year in Malta'.

Avanzia Taxand is the Maltese member firm of Taxand which is the first global network of independent tax advisors. We work closely with over 300 tax partners in nearly 50 countries and more than 2,000 tax advisors serving the global marketplace.

We employ tax professionals, financial advisors and lawyers who, together as a team, offer a comprehensive and integrated range of tax, legal and financial advisory services. Our areas of expertise include corporate tax and international tax, restructuring, mergers and acquisitions, corporate law.

Our broad range of services are focused on our areas of expertise although we also provide corporate tax compliance, company formations, management and administration, indirect taxation, transaction tax, advance revenue rulings, tax litigation, liquidations and redomiciliations.

Our international tax experts and lawyers give advice on holding companies and financing structures, banking and insurance, intellectual property and royalty planning, collective investment schemes, professional investor funds, trusts etc.

Our approach, as professional tax advisors, is innovative and creative. We constantly look ahead, not only to make sure that clients are in compliance with legislation and to identify any potential problems, but also to help clients take full advantage of new opportunities. We seek to partner with our clients to develop an action plan that addresses challenges and opportunities in a rapidly changing global economy. Our professionals will help you build that plan and implement it.

Nigeria

Abimbola Akeredolu

Banwo & Ighodalo

Dipo Okuribido

1 General: Treaties

1.1 How many income tax treaties are currently in force in Nigeria?

Nigeria presently has thirteen tax treaties in force with the following countries – the United Kingdom, France, Belgium, Pakistan, Romania, Canada, Czech Republic, Slovak Republic, The Netherlands, the Philippines, South Africa, China and Italy (with respect to air transport).

1.2 Do they generally follow the OECD or another model?

Generally, Nigerian Double Taxation Treaties follow the United Nations model, with a few differences adopted from the OECD model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes, treaties have to be incorporated into domestic law before they take effect. However, by virtue of provisions in the Companies Income Tax Act Cap C21 LFN 2004 (as amended by the Companies Income Tax (Amendment) Act No. 11 of 2007) ("CITA") (Section 45) and the Personal Income Tax Act Cap P8 LFN 2004 (Section 38), all that is required to incorporate an income tax treaty into domestic law is an order by the Minister of Finance (published in the Federal Government Gazette), declaring that arrangements have been made between Nigeria and the relevant country regarding relief from double taxation.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Yes. Most treaties include specific simple limitations of benefits provisions to the effect that reliefs will not apply (particularly with regard to interest, dividends and royalties) where the arrangement giving rise to the income was created mainly for the purpose of taking advantage of the treaty and not for *bona fide* commercial reasons.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

As indicated in question 1.3, treaties only come into force upon incorporation into domestic law. Following such incorporation, tax treaties (like any other domestic law), supersede all prior enactments but remain subject to any laws which may subsequently be enacted in respect of issues covered by the treaty.

2 Transaction Taxes

2.1 Are there any documentary taxes in Nigeria?

Yes. By virtue of the Stamp Duties Act, Cap S8 LFN 2004, certain categories of instruments (including virtually all forms of agreements and security documentation) are required to be stamped at either *ad valorem* rates of up to 1.5% or nominal rates, within forty days of first execution in Nigeria or within thirty days of receipt in Nigeria (in cases where the document is executed outside Nigeria).

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Yes. A federal Value Added Tax is imposed by virtue of the Value Added Tax Act Cap V1 LFN 2004 (as amended by the Value Added Tax (Amendment) Act No. 12 of 2007), at the rate of 5% of the value of supplies of taxable goods and services in all parts of the country. In addition, in Lagos State, pursuant to the Sales Tax Law Cap 175 Laws of Lagos State and the Sales Tax Schedule (Amendment) Order 2000 of Lagos State, a sales tax at the rate of 5% is also imposed on the sale of goods and services.

Both the Value Added Tax Act and the Sales Tax Law are currently the subject of litigation in which the validity of the taxes are being challenged, however, Value Added Tax continues to be collected by the Federal Inland Revenue Service.

Apart from the foregoing there is also a tax imposed in Lagos, at the rate of 5% of the total bill issued for the use or possession of the right to use of a hotel, hotel facility or events centre, as well as the purchase of consumable goods or services in any restaurant whether or not located within a hotel in Lagos. This tax is chargeable pursuant to the Hotel Occupancy and Restaurant Consumption Law of 2009.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The supply of the following goods are exempt from VAT: (i) all medical and pharmaceutical products; (ii) basic food items; (iii) books and educational materials, (iv) baby products; (v) fertiliser, locally produced agricultural and veterinary medicine, farming machinery and farming transportation equipment; (vi) all exports; (vii) plant and machinery imported for use in the export processing zone or free trade zone (provided that 100% production of such company is for export, otherwise tax shall accrue proportionately on the profits of the company); (viii) plants, machinery and equipment purchased for the utilisation of gas in downstream petroleum operations; and (ix) tractors, plough and agricultural equipment and implements purchased for agricultural purposes.

The supply of the following services are exempt from VAT: (i) medical services; (ii) services rendered by Community Banks, People's Bank and Mortgage Institutions; (iii) plays and performances conducted by educational institutions as part of learning; and (iv) all exported services.

The supply of the following goods and services are zero-rated: (i) non-oil exports; (ii) goods and services purchased by diplomats; and (iii) goods purchased for use in humanitarian donor funded projects.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Recoverable VAT is limited to the tax on goods purchased for resale, imported into the country to be resold, or on goods which form the stock-in-trade used for the direct production of any new product on which the output tax is charged. VAT on any overheads, services and general administration of a business, as well as capital items, are not recoverable.

2.5 Are there any other transaction taxes?

Transfer taxes which vary depending on the location of the property are payable in respect of the transfer of real property. Also, under the Nigerian Oil and Gas Industry Content Development Act 2010, the sum of 1% of every contract awarded to any operator or contractor or other entity involved in any project in the upstream segment of the Nigerian oil and gas industry is to be paid to the Nigerian Content Development Fund. (This obligation was recently imposed and it is not yet clear whether it is being enforced.)

2.6 Are there any other indirect taxes of which we should be aware?

Pursuant to the Customs, Excise Tariff, etc. (Consolidation) Act, customs and excise duties are imposed on a range of imports and manufactured goods, with reference to rates in a harmonised commodity and coding system, which is reviewed from time to time.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Withholding tax is imposed under the CITA at the rate of 10% (reduced to 7.5% in respect of residents of countries which are party to double tax treaties in force in Nigeria.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Please refer to question 3.1 above.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Please refer to question 3.1 above. However, subject to the tenor of the loan, an exemption from the withholding tax may be available. Under section 11 (6) of the CITA, the following exemptions are applicable in respect of tax chargeable on interest on foreign loans:

Repayment Period including Moratorium	*Grace Period*	*Exemption allowed*
Above 7 years	Not less than 2 years	100%
5-7 years	Not less than 18 months	70%
2-4 years	Not less than 12 months	40%
Below 2 years	Nil	Nil

Note that to qualify for the exemptions, the moratorium must be applicable to both interest and principal payments.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

There are no thin capitalisation rules in Nigeria.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not applicable in Nigeria.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not applicable in Nigeria.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

This is not applicable in Nigeria.

3.8 Does Nigeria have transfer pricing rules?

No. Revenue authorities are however empowered to disregard dispositions (including trusts, agreements and arrangements) and transactions which, in their opinion, are artificial/fictitious transactions, and to make requisite adjustments.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The basic corporate income tax rate is 30%. Nigerian companies are however subject to a further obligation to pay an additional 2% of their assessable income as "education tax".

Companies engaged in petroleum exploration and production are subject to a separate, special tax regime, with tax rates of either 85% or 50%, depending on the nature and or location of their oil and gas interests.

4.2 When is that tax generally payable?

Within six months after the company's accounting year end date.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base is profits pursuant to audited (commercial) accounts subject to adjustments.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

This is not applicable in Nigeria.

4.5 Are there any tax grouping rules? Do these allow for relief in Nigeria for losses of overseas subsidiaries?

This is not applicable in Nigeria.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No. Tax is imposed on the entire profit of the company for the relevant accounting year.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Apart from the Education Tax referred to in question 4.1, certain categories of companies (telecommunications companies, cyber companies and internet service providers, pension managers and pension-related companies, and banks, insurance companies and other financial institutions with a turnover of at least N100million) are also required to pay an information technology levy of 1% of their profit before tax.

Also, oil producing company operating, onshore and offshore, in the Niger-Delta Area and gas processing companies are required to contribute 3% of their total annual budgets to the Niger Delta Development Commission.

4.8 Are there any local taxes not dealt with in answers to other questions?

Yes. In addition to federal taxes, there are other state and local government tax regimes that might apply to a domestic or foreign corporation engaged in a trade or business in any State or locality. The kinds of taxes and the rates also vary from State to State and local government to local government but do not include any income, profit or capital gains taxes as these are reserved for the federal government.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains are taxed under the Capital Gains Tax Act Cap C1 LFN 2004.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The rate of capital gains tax is 10%.

5.3 Is there a participation exemption?

Gains accruing to a person from the disposal of stocks and shares are exempt from Capital Gains Tax. Gains accruing to holders of unit trusts are also exempt provided the proceeds are re-invested.

5.4 Is there any special relief for reinvestment?

Yes, provided that the assets disposed and the assets acquired are used solely for the same trade, belong to the same class of assets and fall within a specified class of assets (including buildings, permanent and semi-permanent structures, land, ships, aircrafts and goodwill), and that the new assets are acquired within a period of 12 months from the date of the disposal of the old assets. Also, the acquisition must be for the purpose of the use of the asset in trade and not wholly or partly for realising a gain.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Stamp duties at the rate of 0.75% and Corporate Affairs Commission filing fees at the rate of 1% (or 2% in the case of a public company).

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Under Nigerian law, a company is not permitted to carry on business without incorporating a subsidiary in Nigeria, save for where it is granted exemption under Section 56 of the Companies and Allied Matters Act Cap C20 LFN 2004 ("CAMA").

6.3 How would the taxable profits of a local branch be determined?

As indicated in question 6.2, a local branch will be required to be incorporated in Nigeria. Upon incorporation it will be treated as a Nigerian resident company and will be taxed on its global income to the extent that its income or profit accrues in, derives from, is brought into, or is received in Nigeria.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

As stated above, the tax treatment will be the same as for any other Nigerian resident company.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As previously stated, a branch will be a Nigerian resident company. Consequently, it will be entitled to all the benefits and reliefs available to Nigerian companies, including the benefits of any subsisting tax treaties.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Withholding tax at the rate of 10% (but reducible to 7.5% if a treaty is applicable) will be imposed on dividends, interest, and royalties remitted by the local branch/company.

7 Overseas Profits

7.1 Does Nigeria tax profits earned in overseas branches?

Yes. Nigerian companies are subject to tax on their worldwide income.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

No, provided that such profits are repatriated to Nigeria through Government-approved channels (i.e. the Central Bank of Nigeria, any bank or other corporate body appointed by the Minister as an authorised dealer in foreign exchange).

7.3 Does Nigeria have "controlled foreign company" rules and if so when do these apply?

Nigeria does not have "controlled foreign company" rules.

8 Anti-avoidance

8.1 Does Nigeria have a general anti-avoidance rule?

Nigeria does not have 'general anti-avoidance' rules.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no requirement to make 'special disclosure of avoidance' schemes.

Abimbola Akeredolu

Banwo & Ighodalo
98 Awolowo Road, South-West Ikoyi
Lagos
Nigeria

Tel: +234 1 461 5203-4
Fax: +234 1 461 5205
Email: aakeredolu@banwo-ighodalo.com
URL: www.banwo-ighodalo.com

Abimbola is a target driven and goal-oriented lawyer. She joined the firm in September 2007. Abimbola's resolute commitment to the best interest of her clients in transactions and in the course of litigation and negotiation of settlements, and the inevitable attendant success is an attribute for which she is often commended. She is quite renowned for her vast experience in Commercial and Tax Litigation and Arbitration. Her multilingual skills (English, French, Italian, and German) make her a lawyer with a difference.

Dipo Okuribido

Banwo & Ighodalo
98 Awolowo Road, South-West Ikoyi
Lagos
Nigeria

Tel: +234 1 270 2657-8
Fax: +234 1 461 5205
Email: dokuribido@banwo-ighodalo.com
URL: www.banwo-ighodalo.com

Dipo is an ardent researcher, relentless in pursuing and exploring legal knowledge as an antidote for practical problems. A real Mr. Fix-it, he blends sharp intellectual curiosity with a hands-on approach to tackling legal issues. Since joining the firm in 2007, Dipo has been an integral part of the firm's tax advisory practice and an active member of the Energy and Natural Resources practice group. He is a member of the Association of International Petroleum Negotiators and an Associate of the Chartered Institute of Taxation of Nigeria, and has authored several articles on contemporary tax issues.

Banwo & Ighodalo

Banwo & Ighodalo ("B & I") was established on February 1, 1991, with a determination on the part of its founding partners to build a first class law firm. From our clients' feedback, we are acclaimed to be very innovative and outstanding in the provision of efficient, timely and cost-effective legal solutions to matters brought to us. We are constantly ranked as one of the top five Nigerian law firms in Corporate Finance & Restructuring, Project Finance, Foreign Investment & Divestment, Securities & Capital Markets, Mergers & Acquisitions; as well as Energy & Natural Resources and Intellectual Property.

98, Awolowo Road	Afri-Investment House
South-West Ikoyi	lot 2669, Aguiyi-Ironsi Street
Lagos	Maitama, Abuja
Nigeria	Nigeria

Chapter 33

Norway

Frode Talmo

Bugge, Arentz-Hansen & Rasmussen (BA-HR)

Joachim M Bjerke

1 General: Treaties

1.1 How many income tax treaties are currently in force in Norway?

Norway has an extensive network of tax treaties. The treaties currently in force cover 84 different jurisdictions. Most of the treaties are bilateral, but the treaty between the Nordic countries (Denmark, Finland, Iceland, Sweden, Norway and the Faroe Islands) is multilateral. Norway is currently in the process of negotiating treaties with *i.a.* Iran, and Georgia. In addition, a number of Norway's existing treaties are under renegotiation, such as the treaties with the USA, Egypt, Italy, Cyprus, Malaysia, Malta, Germany, Latvia, the Netherlands and South Africa.

Norway also has entered into tax treaties with a limited scope, e.g. treaties regarding profits from shipping, aviation and land transportation. Further, Norway has a network of exchange of information treaties.

1.2 Do they generally follow the OECD or another model?

Tax treaties entered into by Norway are, with some modifications and exceptions, mainly based on The Model Tax Convention of the OECD. Treaties with developing countries include elements also from The United Nations Model Convention on the Avoidance of Double Taxation between developed and developing countries.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Norway follows a dualistic system where treaties are not considered to be part of Norwegian domestic law without incorporation. However, a specific Act from 1949 automatically pre-incorporates into Norwegian law all tax treaties entered into by the Norwegian Government. The tax treaties are therefore considered ranking equally to Norwegian domestic law, with the same formal status, once the tax treaty enters into force. Consent to put the treaty into force has to be given by the Norwegian Parliament ("*Stortinget*").

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Norway does not use any general "limitation of benefits" clauses ("l.o.b.") when negotiating tax treaties. However, such clauses are incorporated in some of Norway's tax treaties to avoid "double exemption" of tax. Examples of treaties which have different types of l.o.b. provisions are the treaties with the Nordic countries, the United Kingdom and Switzerland.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The treaties have the same status as domestic law; see question 1.3. Harmonisation of a domestic statutory provision and a treaty provision will be a matter of interpretation. Normally, the outcome of the interpretation will be that the treaty provision overrides domestic legislation, as regards legislation in force when the treaty takes effect. In principle, legislation introduced subsequently to the entry into force of a treaty would override a conflicting treaty provision. However, such conflict situations would not easily occur in practice.

It is uncertain whether the case-law-based anti-avoidance rule applies with regard to treaty provisions; see question 8.1.

2 Transaction Taxes

2.1 Are there any documentary taxes in Norway?

Documentary tax is paid at a rate of 2.5% when the title to real property, including buildings on leased property, is transferred. The tax is based on the market value of the properties and buildings. The tax is calculated when the deed, that transfers the ownership, has been registered in the property register. However, documentary tax is not levied when the title to property is transferred in connection with mergers, demergers and other transformation of companies carried out pursuant to legal rules based on continuity considerations.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Norway introduced VAT in 1970. The Norwegian VAT Act is built upon the same basic principles as those established within the EU. There are five different VAT rates:

1) the standard rate of 25% VAT which applies to any supply of goods or services which are not exempt, zero-rated or subject to a reduced rate;
2) the reduced rate of 14% that applies to food articles (however, in the 2012 National Budget it is proposed to increase the rate from 14% to 15%);
3) the reduced rate of 11.11% that applies to fishermen's supply

of fish to fish co-operatives;

4) the reduced rate of 8% that applies to television licences, cinema tickets, the supply of passenger transport services and the procurement of such services, transport services regarding the ferrying of vehicles as part of the domestic road network, accommodation services as well as the procurement of such services, and the admission to museums, amusement parks and sporting events, as well as the procurement of such services; and

5) the 0% rate that applies, *inter alia*, to books, newspapers and certain magazines, to the transfer of business, to certain vessels, aircrafts and platforms and to exports in general and also to some export-related activities.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

As a main rule, VAT is charged on any supply of goods and services. However, there are some substantial exemptions. The exemptions are mainly related to:

1) the supply of goods/services from social/cultural institutions and/or artists;
2) healthcare;
3) the sale and/or lease of real property; and
4) financial services, including insurance services/brokerage of such services.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

A person who is registered in the VAT register may recover input VAT. Input VAT is only deductible to the extent the acquisition is made for the use in an activity subject to VAT. For input VAT on an acquisition for use both in activities inside and outside the scope of VAT, the right to deduction is proportional, based on the anticipated use of the acquisition at the time of purchase.

There are some restrictions in the right to deduct input VAT, even if the acquisitions are for use in a taxable activity. The restrictions relate, *inter alia*, to catering services, hospitality, art and antiques and payment in kind of owners, employees etc.

A foreign business that conducts business/supplies subject to VAT in Norway, and has no place of establishment within the country, has to register in the Norwegian VAT Register through a VAT representative. The business will then obtain the right to deduct input VAT on acquisitions for use in the activity subject to VAT.

Input VAT borne by foreign businesses that are not registered for VAT purposes in Norway may, subject to certain conditions, be refunded through a specific scheme of application to the Norwegian local tax authorities. The conditions for such refund is that the foreign business is not obliged to register in Norway, the acquisition is for use in the business carried out abroad, the business would have been obliged to register for VAT if it had been carried out in Norway and that the input VAT would, in that case, have been deductible.

2.5 Are there any other transaction taxes?

No, there are not.

2.6 Are there any other indirect taxes of which we should be aware?

There are several indirect taxes and excise duties. Customs duties are generally payable on imported goods, and excise duties are levied on particular classes of goods, e.g. alcohol, tobacco and sugar. Excise duties are further levied on consumption of electricity in private households, disposal of waste for final destruction and on first time and re-registration of motor vehicles.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Corporate shareholders genuinely established and carrying out genuine business activities within the EEA are not liable to withholding tax on dividends paid by a company resident in Norway.

Personal shareholders resident within the EEA are as a starting point liable to withholding tax on dividends paid by a Norwegian company. The shareholder may, however, have a right to claim the tax fully or partly refunded according to the rules under the so-called Shareholders Model; see question 5.1 below.

Other non-resident shareholders are liable to tax on dividends from Norwegian companies. The ordinary withholding tax rate is 25%. However, in a number of tax treaties the tax rate has been reduced to 15% or lower.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

No, there are not.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

No, there are not.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

The general transfer-pricing rule described below in question 3.8 has been applied to deny deductibility of interest paid to a related party in thin capitalisation cases.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There is no "safe harbour" by which tax relief is assured.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The general transfer-pricing rule described below in question 3.8 may also apply to debt advanced by a third party but guaranteed by a parent company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Generally there are no such other restrictions.

However, tax relief may be denied according to the anti-avoidance doctrine if the interest payments are part of an arrangement in order to obtain a tax advantage contrary to the objectives behind the relevant tax provisions; see question 8.1.

3.8 Does Norway have transfer pricing rules?

The Norwegian Income Tax Act Section 13-1 states that if a taxpayer's income or wealth is reduced due to shared interest with another party, the tax authorities may adjust the income or wealth accordingly. The provision has been used to ensure arm's length pricing between associated companies, and also to deny deduction of interest in thin capitalisation cases. The OECD's Transfer Pricing Guidelines are taken into account when applying the arm's length principle.

Moreover, Norway has transfer pricing documentation rules. The rules consist of two main parts: 1) an obligation to submit information on intra-group transactions in the annual tax returns; and 2) an obligation to prepare specific transfer pricing documentation. The transfer pricing documentation prepared shall form basis for an assessment of whether prices and terms in transactions between companies within the same group are in accordance with the prices and terms that would have been stipulated between independent parties. Such documentation must be submitted to the tax authorities within 45 days upon requisition. Documentation prepared in accordance with the EU Code of Conduct, the "European Union Transfer Pricing Documentation", would normally also be satisfying.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The ordinary income tax rate is 28%.

4.2 When is that tax generally payable?

For joint-stock companies and similar companies that are treated as separate entities for tax purposes, tax is levied on a preceding year basis. Such companies have to pay a so-called advance tax (i.e. payment prior to the tax assessment) by an amount that as a main rule should correspond to the tax levied under the last tax assessment of the company. The advance tax is payable in two instalments, respectively on 15 February and 15 April in the year succeeding the income year.

After the announcement of the final tax assessment rolls, which normally takes place in October the year succeeding the income year, the advance tax shall be deducted in assessed tax. If the assessed tax constitutes a higher amount than the advance tax, the company will be liable to pay tax arrears. Moreover, the company will get a refund if the advance tax constitutes a higher amount than the advance tax.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In principle, there is no link between the financial accounts and the tax base of the company. This means that 1) the question as to which items constitute taxable income or deductible costs/losses, and 2) the question of timing of income and expenditure for tax purposes, are solely based on Norwegian *tax* law.

The tax base for business entities is the sum of operating profit/loss, financial revenues and net capital gains minus tax depreciation.

The main rules for timing of income and expenditure for tax purposes are as follows: (i) income is taxable in the year during which the taxpayer acquires an unconditional right to the income; and (ii) costs are deductible in the year in which the taxpayer incurs an unconditional obligation to cover a cost (i.e. irrespective of the due date). This means *inter alia* that general reserves for future obligations – which will be provided for under the annual financial accounts – may not be deducted for tax purposes.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

As mentioned under question 4.3, the tax base and the timing of income and expenditure for tax purposes, are solely based on Norwegian *tax* law. Therefore, the taxable profits of the company will normally differ from the profits shown in the commercial accounts. Some of the main differences are:

Loss on debts is as a main rule not deductible before the loss is certain. The right to deduct bad debts at an earlier stage is restricted according to a schematic rule, which applies only to claims that have emerged with respect to sales of inventory and services.

Inventory is normally valued at the cost price for tax purposes; hence no deduction is allowed before the goods are sold or destructed.

There are also detailed tax rules regarding depreciation of fixed assets. For tangible assets and goodwill, the depreciation rate varies from 30% to 2%. Tax depreciations are in general based on the declining balance method.

Specific tax deferral rules are applicable for the taxation of capital gains and losses on business assets.

4.5 Are there any tax grouping rules? Do these allow for relief in Norway for losses of overseas subsidiaries?

DIRECT TAX: Each joint-stock company is a taxable unit, and there is no joint taxation of groups of companies. However, if a parent company owns (directly or indirectly) more than 90% of another company, a loss in one company may be offset against the profits of the other company through a group contribution. Group contributions are tax deductible for the paying entity and taxable income for the receiving entity. Both the transferring and the receiving company must, as a starting point, be joint-stock companies resident in Norway for tax purposes. However, the group contribution rules will also apply if the transferring and/or the receiving unit is a Norwegian branch of a foreign company resident within the EEA. Apart from this, the Norwegian group contributions rules do not apply to losses of foreign subsidiaries.

In the 2012 National Budget, it is proposed that dividends distributed within a tax group will be fully exempted under the TEM (see question 5.3). This will also apply to dividends distributed from a company resident within the EEA. However, if the distributing company is resident in a low tax country within the EEA, the company must be genuinely established and performing genuine business activities within the EEA in order for the dividends to be comprised by the exemption. For the definition of "low tax country", see question 7.3.

Assets can on certain conditions be moved "tax free", from one Norwegian company to another, as long as the group connection remains. In addition, reorganisations, including mergers and demergers may, subject to certain conditions, be carried out based on a continuity principle, which means that the transaction is not regarded as a realisation or as a dividend subject to taxation.

VAT: It is possible for two or more companies to apply for registration as one single VAT unity (VAT group). In that case, supplies of goods and services within the group are not considered as supplies subject to VAT. The conditions for such registration are that one or more of the companies own 85% of the equity in each company being part of the group, that the companies are cooperating and that the group, seen as one, performs activities outside the group that are subject to VAT.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

For joint stock companies and similar entities, tax is not imposed at a different rate upon distributed profits. However, dividends received may be taxable for the shareholder; see question 3.1 and question 5.1.

Partnerships (general partnerships, limited partnerships, etc.) are not separate tax entities and are thus taxed on a transparency basis. However, the taxable income is calculated on a net assessment basis on partnership level, as if the partnership were a taxable entity. The net income/loss is allocated to each of the partners and taxed as net taxable income or deductible loss. As ordinary income, the net income will be taxed at a rate of 28%; see question 4.1. Whether the profit is distributed from the partnership or not will not affect this taxation. However, distributions made by the partnership to a personal partner may be subject to additional taxation; see question 5.1.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Norway levies net wealth tax at rates from 0.7% up to 1.1%. Joint-stock companies are exempt from the net wealth taxation, but personal shareholders are taxable for their shareholding. The net wealth value of a non-listed share is set to the share's part of the tax value of the company (in which goodwill is not included), while a listed share is taxed at its market value.

Partnerships are transparent entities also for net wealth tax purposes; see question 4.6. The net wealth is computed at the partnership level, but is allocated to each of the partners for tax purposes.

Real estate is generally valuated considerably below market value.

Employers are obliged to pay payroll tax (employer's social contribution). The rate is up to 14.1% of the employment payroll.

Special tax regimes exist for activities within the Petroleum, Hydro Electric Power and Shipping sectors.

There is no national property tax. However, a substantial number of communities levy local property tax; see question 4.8.

4.8 Are there any local taxes not dealt with in answers to other questions?

A large majority of Norwegian communities levy local property tax, at rates varying from 0.2% to 0.7% of the assessment value. The assessment value should be estimated market value of the property. It is up to each municipality to decide whether to impose property tax or not.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

The main rule is that capital gains and losses are included in the taxpayer's ordinary income and taxed at a rate of 28%, *cf.* question 4.1. However, special rules apply to gains and losses on shares and partnership shares.

Gains/losses of *corporate shareholders/partners* may be taxed according to a *Tax Exemption Method* (TEM); see question 5.3.

When income is received by a *personal shareholder* by way of dividends or capital gains, the income will (irrespective of the size of the shareholders' ownership interest) be taxed once more (i.e. in addition to the taxation at corporate level), according to the Shareholder's Model. However, only dividends and gains exceeding a computed risk-free return on the investment are taxed at the shareholder's level. The total tax burden on income that is subject to economic double taxation is 28% (company income tax) + 20.16% (tax on the personal shareholder computed as 72% x 28%) = 48.16%.

Also, *personal partners* will be subject to an additional taxation of 28% on distributions or capital gains. The additional taxation of personal partners is called the Partner's Model, and corresponds to the Shareholder's Model applicable to personal shareholders; see above. The Shareholder's Model and the Partner's Model are meant to establish neutrality in the taxation of personal shareholders and partners.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

To the extent that gains are taxable, the applicable tax rate will be the same as for business profits (28%).

5.3 Is there a participation exemption?

As follows from the above, companies are taxable at a rate of 28% for all income, but exemptions apply under TEM. The main rule under TEM is that a company's income in the form of dividends and gains on shares are exempt from taxation, whereas corresponding losses are not deductible. However, 3% of the mentioned income is still subject to taxation at the rate of 28%, resulting in an effective taxation of 0.84%. In the 2012 National Budget it is proposed that gains will be fully exempted from taxation from the income year 2012. Furthermore, dividends paid within a tax group (see question 4.5) will be fully exempt, while 3% of dividends received by other corporate shareholders will still be subject to tax (resulting in an effective taxation of 0.84%). It is further proposed that 3% of dividends received by a Norwegian branch of a foreign enterprise shall be subject to taxation at a rate of 28%.

For share gains and losses on investments in companies genuinely established and performing genuine business activities within the EEA, TEM applies without any holding or participation requirements. For share income from non-EEA investments, TEM is only applicable if the investment is not made in a low tax country, and the investment represents an ownership interest and a voting right of 10% or more for a period of at least two years. For the definition of "low tax country", see question 7.3.

Distributions from a partnership to a corporate partner are always exempt from taxation. However, in the 2012 National Budget it is proposed that 3% of the distributions from a partnership to a corporate partner shall be subject to taxation at a rate of 28% from the income year 2012. A corporate partner is, however, as a starting point, taxable for a gain on the partnership share, but may benefit from TEM. The limitation of the scope of TEM in respect of partners is based on the same main principles as is the case in respect of corporate shareholders; see above. Under TEM, 3% of the gain is currently taxable, but in the 2012 National Budget it is proposed that the gain will be fully exempt.

When TEM is not applicable, companies' gains on shares and partnership shares are subject to taxation at 28%, while corresponding losses will be deductible.

5.4 Is there any special relief for reinvestment?

There are no special reliefs for reinvestments. However, as follows from question 5.3, companies may to a great extent receive and reinvest income from shares and partnership shares without being subject to taxation.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No taxes are imposed upon the formation of a subsidiary, neither for the shareholder nor for the company established.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no other significant taxes or fees in Norway.

6.3 How would the taxable profits of a local branch be determined?

When an enterprise carries on business through a Norwegian branch, Norway will tax the profits of the enterprise but only so much of it is attributable to the branch. In other words, the right to allocate tax to the branch does not extend to profits that the enterprise may derive in Norway from other sources of income than through the branch (i.e. Norway does not apply the "force of attraction"-principle). This means that a closer assessment has to be made of each income and deduction item in order to determine whether or not it should be allocated to the branch's business activity. Tax treaty provisions supplement the domestic legislation at this point, whereas the arm's-length principle is often used, i.e. that the branch by simulation is regarded as an independent company, separated from the head office.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

The branch will be taxed for its profits in the same way as a resident company; see question 6.3.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

In cases where the company has a permanent establishment in Norway, the tax treaties seek to prevent double taxation between the country in which the company is resident, and Norway. This normally means that the credit relief method will apply, i.e. that the country where the company is resident will give credit relief for tax paid to Norway.

If the branch has additional income from a third country, there might be double taxation, where both the third country and Norway levy tax on the income. The question is then whether or not the branch can benefit from tax treaty provisions to eliminate such double taxation.

As a main rule, the tax treaties do not cover these double taxation situations. Double taxation may, however, be resolved if both Norway and the third country have entered into tax treaties with the state of which the company is a resident, i.e. seek a solution through the provisions in the treaties between the residence state, and the two other states.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No tax is imposed on repatriation of profits to the head office.

7 Overseas Profits

7.1 Does Norway tax profits earned in overseas branches?

Profits earned in overseas branches are taxed in Norway as corporate profit; see question 4.1 above. If the profits also are taxed in the country where the branch is located, double taxation is generally avoided by rendering credit relief in Norwegian tax for tax paid abroad. Credit relief may be granted even if Norway has not entered into a tax treaty with the foreign country.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by a local company from a non-resident company will as a starting point be subject to taxation at a rate of 28%. If TEM is applicable, the dividends will only be subject to an effective taxation of 0.84%; see question 5.3.

7.3 Does Norway have "controlled foreign company" rules and if so when do these apply?

Norway has "controlled foreign company" rules ("CFC-rules").

According to the CFC-rules, Norwegian shareholders will be taxed on their proportionate part of the profits of the controlled foreign company, irrespectively of whether the profit is distributed to the shareholders or not. The CFC-rules apply if the foreign company is a tax resident in a low tax country and is controlled by Norwegians. A company is considered resident in a low tax country if the tax imposed on this type of company in the foreign country is less than 2/3 of the tax levied on such companies in Norway. A company is always deemed to be Norwegian-controlled if 50% or more of the shares in the foreign company are owned by Norwegians.

However, the Norwegian shareholders will not be subject to CFC taxation if (i) Norway has entered into a tax treaty with the low tax country in question and the foreign company's income is not mainly of a passive character, or (ii) if the foreign company is genuinely established and carries out a genuine economic activity within the EEA.

8 Anti-avoidance

8.1 Does Norway have a general anti-avoidance rule?

The Norwegian Supreme Court has developed an anti-avoidance doctrine whereby a transaction may be disregarded for tax purposes, provided that:

- the major purpose of the transaction was clearly to reduce taxes; and
- the impact of respecting for tax purposes such transaction would be contrary to the objectives behind the tax provision in question.

The anti-avoidance doctrine is wide–ranging and may be applied to all types of transactions.

Furthermore, pursuant to Section 14-90 in the Norwegian Income Tax Act, if a company is party to a transaction, and it is likely that the main objective of the transaction is to utilise a general tax position (i.e. a tax position not connected to an asset or debt), the general tax position will:

- lapse if it represents a tax advantage (for instance a loss carry forward); or
- be entered as a taxable income if it represents a tax liability.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There is no requirement to make special disclosure of avoidance schemes. However, generally there is a requirement that companies give complete and accurate information to the tax authorities in their tax returns. Omission of this obligation may result in penalty tax for the company and penal liability for both the company and its advisors.

Frode Talmo

Bugge, Arentz-Hansen & Rasmussen (BA-HR)
Stranden 1, P.O. Box 1524 Vika
N-0117 Oslo
Norway

Tel: *+47 2283 0270*
Fax: *+47 2283 0795*
Email: *fta@bahr.no*
URL: *www.bahr.no*

Education: Bodø Graduate School of Business Administration (MBA 1989); Universität Mannheim (lic.rer.pol. 1991); Oslo University (Cand. jur 1995).
Experience: Partner in BA-HR from 2005. Legal adviser in the Ministry of Finance: 2003-2004. Lawyer in BAHR: 1999-2003. Deputy judge. Executive officer/adviser in the Ministry of Finance: 1995-1998.
Frode Talmo is partner of Bugge, Arentz-Hansen & Rasmussen and member of the tax group. His practise covers business and capital taxation, company law, domestic and international reorganisations, mergers and acquisitions. His is author of several articles on taxation.

Joachim M Bjerke

Bugge, Arentz-Hansen & Rasmussen (BA-HR)
Stranden 1, P.O. Box 1524 Vika
N-0117 Oslo
Norway

Tel: *+47 2283 0270*
Fax: *+47 2283 0795*
Email: *jmb@bahr.no*
URL: *www.bahr.no*

Education: Harvard Law School (International Tax Program, 1999-2000); Oslo University (Cand. jur 1996).
Experience: Partner in BA-HR since 2003. Senior Associate in BA-HR: 2000- 2002. Associate at Thommessen Krefting Greve Lund: 1997-1999.
Joachim M Bjerke is a partner of Bugge, Arentz-Hansen & Rasmussen and head of our tax group. His practise covers a wide range of areas including business and capital tax, transfer pricing, corporate law, merger & acquisitions and reorganisations. He is author and co-author of several books and articles within tax law, including a book on the Norwegian transfer pricing regulations (1997).

BA·HR

Bugge, Arentz-Hansen & Rasmussen (BA-HR) is a leading Norwegian law firm. The firm provides comprehensive legal services in domestic and international business law to Norwegian as well as foreign clients. BA-HR is organised as a true partnership based on principles of equal sharing, common values and shared ambitions. Our financial model and internal organisation enable us to offer our clients access to the firm’s combined resources and expertise. We have expertise in handling large and complex projects. Our aim is to provide efficient and focused assistance based on first class legal expertise, a practical and knowledgeable approach, relevant experience and integrity.

BA-HR has one of the leading tax departments in Norway and is recognised as a leading tax firm by all major rating firms. We assist corporate clients in taxation issues connected to mergers and acquisitions, divisions, reorganisations, stock exchange listings, transfer pricing etc. We also have extensive experience in international tax law and the special tax regimes for the shipping, petroleum and hydro-electric power industries. In addition to tax advisory, BA-HR is well known and respected for its tax litigation skills.

Poland

Ewa Opalińska

Gide Loyrette Nouel Warsaw Office

Maciej Grela

1 General: Treaties

1.1 How many income tax treaties are currently in force in Poland?

Poland has entered into income tax treaties with over 80 countries, including the Member States of the European Union, most other European countries and with several American, Asian, Australian and African countries.

1.2 Do they generally follow the OECD or another model?

Polish income tax treaties generally follow the OECD Model Convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

According to the Polish constitution, tax treaties are incorporated into Polish law once accepted by Parliament in an enactment of legislation, and then ratified by the President of Poland.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, Polish tax treaties do not contain 'limitation of benefits' clauses. However, in line with the OECD Model Convention, some treaties rely on the concept of 'beneficial ownership' to eliminate treaty shopping with regard to income from dividends, interest and royalties. However, in practice, the issue of 'beneficial ownership' is not subject to special attention by the Polish tax authorities.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

According to the hierarchy of sources of law included in the Polish constitution (being the supreme legal act), Polish tax treaties (as international agreements ratified by an enactment of legislation) override domestic tax legislation (apart from the general provisions of the Polish constitution applicable to tax matters).

2 Transaction Taxes

2.1 Are there any documentary taxes in Poland?

Polish regulations provide for stamp duty imposed on certain administrative procedures and documents.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The Polish tax system provides for VAT. The Polish VAT Act provides the following rates of VAT:

- a standard rate of 22% (starting from 2011, increased to 23%);
- a reduced rate of 7% (starting from 2011, increased to 8%);
- a "zero" rate;
- a reduced rate of 5% (starting from 2011, applicable mainly to certain food products and books); and
- a transitional reduced rate of 3% (valid until the end of 2010, applies mainly to food products).

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In general, VAT must be charged by all individuals, legal entities or other units that supply goods or services on a regular or permanent basis in Poland. Certain transactions, however, are not covered by VAT (i.e. supply of an enterprise or an organised part of an enterprise). Certain transactions are exempt from VAT with the right to a deduction ("zero" rate with the right to deduct input VAT), i.e. exports, intra-Community supplies or services and sales relating to international transportation. Certain transactions are exempt from VAT without the right to a deduction, for example the sale of real estate (excluding, for example, new buildings and building plots) unless the taxpayer opts for taxation, financial and insurance services and healthcare services. Under certain conditions, small businesses can elect to be VAT-exempt.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

As a rule, VAT payers registered for VAT purposes in Poland can deduct input VAT from the amount of output tax. Foreign entities without a business presence in Poland may reclaim the tax charged to them in a refund of VAT for foreign entities.

As a general rule, input VAT deriving from a business activity is fully deductible, though input VAT on the supply of goods and services used for exempt or non-business activities are not deductible to the extent that they serve these activities.

Moreover, the Polish VAT Act defines certain cases when input VAT is not recoverable in principle (e.g. purchase of a passenger car or fuel for such cars, purchase of hotel and gastronomic services etc.).

2.5 Are there any other transaction taxes?

Apart from VAT, Polish regulations provide for other transactional tax – a transfer tax (*podatek od czynności cywilnoprawnych*). Transfer tax is levied on a closed catalogue of civil law activities and transactions (including sale, exchange and loan contracts) and on certain operations resulting in the establishment or increase of share capital of companies and partnerships.

The rate of transfer tax differs according to the type of transaction:

- the sale (exchange) of goods and property rights connected with real estate (i.e. perpetual usufruct or ownership), loan agreements – 2%;
- increase of share capital – 0.5%; and
- sale (exchange) of other property rights – 1%.

If at least one of the transactional parties is considered to be a VAT payer with respect to this transaction, the transaction will be out of the scope of the transfer tax (this rule does not concern the transactions regarding real properties that are subject to VAT exemption).

As a rule, most restructuring transaction such as: the in-kind contribution of part of an enterprise or a qualified number of shares, as well as loans granted by shareholders to its subsidiaries, are exempt from transfer tax.

2.6 Are there any other indirect taxes of which we should be aware?

Polish tax law provides for an excise tax settled by companies selling or importing certain goods, i.e. alcoholic beverages, tobacco, mineral oil (petrol, gasoline, and other oil derivatives) and energy distributors. The tax payable is calculated on an amount per unit sold basis, or as a percentage of the price.

There is also a gambling tax, impose on certain gambling activities lotteries and random games. The activities subject to this tax are VAT-exempt.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends paid to foreign shareholders are subject to a 19% withholding tax, unless the provisions of a relevant tax treaty state otherwise, or unless the qualified shareholder from the EU (or Switzerland, Norway, Iceland or Lichtenstein) applies for exemption, as provided by the Polish CIT Act. In order to benefit from exemption or a reduced rate of withholding tax, the foreign shareholder must provide the Polish company with an eligible certificate confirming his tax residence.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid abroad are subject to 20% withholding tax, unless the relevant tax treaty states otherwise, or unless the beneficiary (being a shareholder from the EU meeting certain additional criteria) applies for a preferential rate (from July 2013 – exemption from withholding tax), as provided by the Polish CIT Act. In order to benefit from a reduced rate of withholding tax, the foreign beneficiary must provide the Polish company with an eligible certificate confirming his tax residence.

Royalties paid by Polish companies or Polish PE's to non-resident shareholders who are companies from the EU may benefit from a preferential 5% withholding tax rate if the company being the beneficiary of the royalties holds directly at least 25% of the shares in the paying company for an uninterrupted period of at least two years (this condition does not have to be met at the date of the transaction).

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest paid abroad is subject to a 20% withholding tax, unless the relevant tax treaty states otherwise, or unless the beneficiary (being a shareholder from the EU requires certain additional criteria) applies for a preferential rate (from July 2013 – exemption from withholding tax), as provided by the Polish CIT Act. In order to benefit from a reduced rate of withholding tax, the foreign beneficiary must provide the Polish company with an eligible certificate confirming his tax residence.

Interest paid by Polish companies or Polish PE's to non-residents shareholders who are companies from the EU may benefit from a preferential 5% withholding tax rate if the company being the beneficiary of the interest holds directly at least 25% of the shares in the paying company for an uninterrupted period of at least two years (this condition does not have to be met at the date of the transaction).

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Where debt finance is three times greater than the value of the company's share capital (i.e. debt / share capital ratio is greater than 3:1), thin capitalisation rules apply to interest paid to shareholders holding at least 25% of shares in capital of the company or a sister company held by the same parent company ("qualified shareholders"). As a result, interest on such loans is not recognised as a tax deductible cost in the portion in which the loan exceeds the debt / share capital ratio referred to above.

The regulations refer to both domestic and foreign loans.

Any amounts uncovered, or covered only by shareholders' debt claims on the company, are excluded when calculating the value of share capital for the purposes of a 3:1 ratio.

For thin capitalisation purposes, a "loan" is deemed to be any kind of debt claim, including debt securities and certain deposits.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

Thin capitalisation rules do not interfere with the tax relief concerning interest payments abroad, as they concern only the issue of tax deductibility of the interest paid by the Polish company.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

No, such a situation will not be subject to Polish thin capitalisation restrictions.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no other restrictions on tax relief from interest payments by a local company to a non-resident.

3.8 Does Poland have transfer pricing rules?

The Polish CIT Act provides that open market terms should be used to assess transactions ("Arm's Length Principle"), particularly transactions between associated entities and between companies and their permanent establishments in Poland.

Under CIT regulations, where the terms of a transaction between related parties differ substantially from the terms of a comparable transaction between independent entities, and where those related parties do not report any income, or report income less than could be expected in a transaction between independent entities, the tax authorities are entitled to assess the income arising from the transaction without regard to the conditions under which it was carried out.

In such cases, the tax authorities may assess the taxable transaction price using one of the following methods: (i) comparable uncontrolled price; (ii) re-sale price; (iii) reasonable margin (i.e. cost-plus); or (iv) transaction profit.

If the total value of a transaction carried out between related parties exceeds the PLN equivalent of EUR 30,000 (this concerns the performance of services or transfer of intangible assets or legal rights), the taxpayers involved should prepare relevant transfer pricing documentation. Such documentation must specify the obligations of the parties to the transaction (taking into account the assets and the risk involved), anticipated costs connected with the transaction, and the form and time of payment involved.

Transfer pricing documentation is also required for the payments made by Polish taxpayers to "tax havens" if their total transactional value exceeds annually the level of PLN equivalent of EUR 20,000.

If the documentation is not presented within seven days from a request from the tax authorities, a 50% penalty income tax rate may be applied to the underestimation of tax reassessed by the tax authority.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax is 19%.

4.2 When is that tax generally payable?

In general, advance corporate income tax payments are made monthly, before the 20th day of the following month (in certain cases it is possible to make advances quarterly). Annual income tax settlement should be made within three months from the end of the fiscal year (the entities subject to CIT may elect a fiscal year different to the calendar year).

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In general, a company's taxable base for the purpose of CIT is its net income (or, exceptionally, its gross income for example in case of dividends). Taxable net income is calculated as the difference between revenue (gross income) and tax deductible costs. A company's taxable income is calculated using data from the taxpayer's account books (adjusted in accordance with the tax law).

Tax deductible costs are defined as expenses incurred for the purpose of earning revenue or preserving/securing the source of the revenue. There is a prescribed list of expenditures and costs that are excluded from deduction by the CIT Act.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Commercial accountancy and income tax regulations determine separately the methods of calculation of the final accountancy and tax financial results. For example, tax regulations provide for different methods of depreciation of fixed and intangible assets and the settlement of foreign exchange differences, and they exclude the deductibility of certain expenditures and costs registered under accountancy regulations, etc.

4.5 Are there any tax grouping rules? Do these allow for relief in Poland for losses of overseas subsidiaries?

In general, corporate income tax regulations do not provide grouping rules (apart from settlements concerning dividends, interest and royalties). Polish regulations do not allow for relief in Poland for losses of overseas subsidiaries. It is possible to settle losses of affiliated companies gathered in the same formal tax capital group (which is considered a CIT payer), but this applies only to Polish companies.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

In general, there is no CIT rate on retained profits. Only profits to be distributed are subject to 19% CIT or a preferential tax rate.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Yes, companies are subject to other national taxes. The Polish tax system provides also for property taxes (real property tax, agricultural tax and forestry tax), being local taxes but standardised throughout Poland (local authorities have only a certain influence on the tax rates and tax relief).

The most important of these taxes is the real property tax, generally imposed on the owners of real properties (i.e. land, buildings and constructions). The taxable basis for the land and buildings is calculated according to the type, area and the method of designated use of particular real property (private use, or related with a certain type of business activity). In the case of constructions, the taxable basis is established upon their value. Local authorities are flexible in determining the taxable rates, but cannot exceed the maximum rates standardised for the whole country.

4.8 Are there any local taxes not dealt with in answers to other questions?

The Polish tax system also provides certain less important local taxes and charges, such as tax levied on certain means of transportation and charges imposed on tourists in certain areas of Poland.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There is no special tax regime for capital gains and losses. Capital gains are combined with other sources of income and taxed at the standard 19% CIT rate.

The amount of any tax loss incurred in a given tax year may be deducted from the taxable income assessed in any of the subsequent five tax years. Up to 50% of the original loss can be deducted in a single tax year, which means that a loss will take at least two years to relieve. Losses cannot be carried back.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The CIT rate is the same for capital gains and business profits.

5.3 Is there a participation exemption?

Polish CIT regulations provide participation exemption for inbound and outbound dividends in the case of EU (or Switzerland, Norway, Iceland or Lichtenstein) shareholders meeting certain additional criteria. Dividends paid by Polish companies to non-resident shareholders from the EU (or Switzerland, Norway, Iceland or Lichtenstein) may benefit from the participation exemption if the company who is the beneficiary of the dividend holds directly at least 10% (25% in the case of the indicated non-EU countries) of shares in the company paying the dividend for uninterrupted period of at least two years (this condition does not have to be met at the date of transaction).

5.4 Is there any special relief for reinvestment?

No, there is no such relief.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The formation of the subsidiary of a foreign company in Poland involves the payment of 0.5% transfer tax from the amount of share capital of the subsidiary (sources transferred on supplementary capital are free from transfer tax). The formation of a subsidiary will also involve non-fiscal costs such as administration charges and notary fees related with the company incorporation.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no such other duties. Please note, however, that transactions between a Polish branch and its head office fall outside the scope of VAT, whereas those between a foreign entity and its Polish subsidiary trigger VAT under general rules.

6.3 How would the taxable profits of a local branch be determined?

The tax base of a local branch of a foreign entity must be determined as if it was an independent entity with regard to some special adjustment items concerning administrative costs.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no specific branch profits tax in Poland. A branch is the organisational unit of a non-resident entity with economic independence and it is taxed according to general rules.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

The treaty relevant for country of the registered office of the foreign company should apply accordingly to the branch of the latter as constituting a PE.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax or other tax liability should apply to the remittance of profits by the branch.

7 Overseas Profits

7.1 Does Poland tax profits earned in overseas branches?

In general, Poland does not tax profits earned in overseas branches, in the case of branches located in countries that have signed a double tax treaty with Poland. In such cases, income derived through and attributable to overseas branches is taxed in the country where the branch is located, according to local tax regulations and tax treaty provisions.

In the case of branches located in countries without a double tax treaty signed with Poland, incomes derived through the branch will be subject to taxation in Poland (as Polish CIT regulations provides for taxation of worldwide income for companies being Polish tax residents). In such a situation the Polish company will be allowed to deduct from its Polish CIT any tax paid in the country where the branch is located (up to the amount of CIT that would be charged on the branch income in Poland).

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As a rule, Poland taxes the dividends received by a local Polish company from a non-resident company at 19% CIT, unless the qualified shareholder from the EU (or Switzerland, Norway, Iceland or Lichtenstein) applies for exemption, as provided by the Polish CIT Act. The requirements to apply exemption are a minimum shareholding ratio (generally 10%) and uninterrupted shareholding period (minimum two years). In order to benefit from exemption, the company paying dividend must provide the Polish company with an eligible certificate confirming its tax residence.

If exemption from CIT on a received dividend cannot be applied, the tax can be decreased by any dividend tax withheld abroad. For dividends received from companies located in countries other than EU Member States, Switzerland, Norway, Iceland or Lichtenstein and in which the Polish company holds more than 75% of the share capital, an additional deduction from Polish CIT is provided. In this case the Polish company is also allowed to deduct from due dividend CIT the amount of income tax charged abroad on the income subject to the dividend.

7.3 Does Poland have "controlled foreign company" rules and if so when do these apply?

Polish tax regulations do not provide any "controlled foreign company" rules.

8 Anti-avoidance

8.1 Does Poland have a general anti-avoidance rule?

Polish tax regulations provide a general anti-avoidance rule introducing the "substance over form" principle (Article 199a of the Tax Ordinance). According to Article 199a of the Tax Ordinance, Polish tax authorities are able to requalify the tax implications of a transaction if they find that it was illusory. However, in practice there are certain controversies regarding the use of anti-avoidance provisions by the tax authorities.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Polish tax regulations do not provide any requirements as to the disclosure of avoidance schemes. However, the background and tax merits of the projected transaction needs to be revealed to the tax authorities in order to secure it with a tax ruling (constituting a 'tax shield' for its recipient), which is typical practice when implementing tax optimisation schemes.

Ewa Opalińska

Gide Loyrette Nouel Warsaw Office
Metropolitan, Pl. Piłsudskiego 1
00-078 Warsaw
Poland

Tel: *+48 22 344 0000*
Fax: *+48 22 344 0001*
Email: *ewa.opalinska@gide.com*
URL: *www.gide.com*

Ewa Opalińska is a tax advisor at Gide Loyrette Nouel's Warsaw Office. She graduated from the Law Faculty at Warsaw's Cardinal Stefan Wyszyński University. She has a Postgraduate Diploma in Tax and Tax Law from Warsaw University. Ewa Opalińska specialises in international tax law issues and tax proceedings. She has wide experience in tax optimisation schemes and other issues related to corporate taxation, including investment funds, and real estate investments. Recently Ewa Opalińska has represented an international food company at a tax inspection and tax proceedings concerning corporate income tax, and a leading French energy producer at tax proceedings concerning an excise tax refund for electricity produced by the company. She has published articles in newspapers such as Rzeczpospolita, Poradnik Gazety Prawnej, Gazeta Prawna and Parkiet and she is co-author of "Taxes in 2009 - executory provisions with a commentary" published by Gazeta Prawna. Ewa speaks English and French.

Maciej Grela

Gide Loyrette Nouel Warsaw Office
Metropolitan, Pl. Piłsudskiego 1
00-078 Warsaw
Poland

Tel: *+48 22 344 0000*
Fax: *+48 22 344 0001*
Email: *maciej.grela@gide.com*
URL: *www.gide.com*

Maciej Grela is a tax advisor at Gide Loyrette Nouel's Warsaw Office. He holds a Master's degree in law from Warsaw University and received a Diploma in Business Law from the university's College of English and European Law operating under the auspices of Cambridge University. He has a postgraduate diploma in Tax Law at Warsaw University. Maciej Grela specialises mainly in public and tax law, especially in the taxation of corporate promotional and marketing activities, as well as in personal income tax issues. He has recently advised to a leading French automotive company on tax planning concerning the optimalisation of services providing by the company and represented an international group in a tax dispute relating to a subrogation contract concluded under Luxembourg law concerning transfer tax. Maciej is co-author of "Taxes in 2009 - executory provisions with a commentary" published by Gazeta Prawna. He speaks English.

GLN
Gide Loyrette Nouel

Gide Loyrette Nouel Warsaw Office provides tax advisory services relating to various types of transactions, such as mergers and acquisitions, restructurings, deals involving trade in real estate, industrial property and new technologies as well as financial transactions.

The Tax Department not only provides critical support for other practices, but offers a standalone service that provides high quality tax advice to the clients. In recent months, our tax advisors have developed a number of multi-jurisdictional and cross-border tax schemes that have helped our clients to save resources. The Tax Department works closely with the M&A and Real Estate departments assisting with mergers, acquisitions, privatisations, and spin-offs, providing tax optimisation structures. The Tax Department has also been active on the litigation front, representing clients on numerous domestic and international disputes.

Chapter 35

Romania

Andrei Dumitrache

Pachiu & Associates

Vlad Rădoi

1 General: Treaties

1.1 How many income tax treaties are currently in force in Romania?

To date, Romania has concluded approximately 80 double tax treaties, and most of them are still in force.

1.2 Do they generally follow the OECD or another model?

As a general rule, most double tax treaties concluded by Romania follow the OECD Model Tax Convention regarding Income and Capital Tax.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

An international treaty becomes part of the Romanian legislation upon consent of the Romanian State to become party to the respective treaty. The consent may be expressed under the following procedures: ratification; approval; adhesion; or acceptance. Tax treaties are concluded at State level and have to be ratified by law issued by the Parliament before entering in force. As a general rule, such treaties enter in force within a certain period of time after the last ratification instrument is delivered to the other contracting State (usually a couple of months), and effectively apply to the taxes which become due after January 1 of the year following that in which the treaty entered into force.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In most of the cases, tax treaties concluded between Romania and other contracting States do not contain provisions which would restrict the benefits of reduced taxation (e.g. by use of a SPV). However, the Romanian tax authorities have the right to deny the application of double tax treaties, provided that there is proper evidence that the facilities/benefits under the relevant tax treaty are being used abusively, for tax avoidance purposes.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

As provided in the relevant Romanian legislation, the provisions of the tax treaty ratified by Romania shall prevail over the domestic law and shall be binding for all Romanian authorities, as well as for all the Romanian legal entities and individuals. Furthermore, the domestic provisions cannot be invoked for justifying failure to apply a treaty's provisions in force in Romania. The provisions of an international treaty cannot be modified or revoked by internal regulations subsequent to the date of treaty enforcement but only according to its provisions or under the approval of the parties. According to the Constitution of Romania, when the provisions of an international treaty are contrary to the Constitution, it will not be ratified by the Romanian authorities until the appropriate amendments of the Constitution's provisions have been made.

Moreover, the Romanian Fiscal Code provides that, in the cases in which the withholding tax rate applicable under domestic law for income derived by a non-resident/foreign legal entity in/from Romania is different than the tax rate set out under the double tax treaty, the most favourable rate between the domestic and treaty tax rates shall apply.

2 Transaction Taxes

2.1 Are there any documentary taxes in Romania?

The most common documentary tax is the stamp duty, as provided by law no. 146/1997 regarding judicial stamp duty, as subsequently amended and modified to date by several normative acts. The tax is usually imposed on: (i) incorporation of companies and amendments to the articles of association of the company, including share transfer and changing of the shareholders' structure; (ii) registration of any deeds regarding an immovable with the local land register (e.g. establishment of a mortgage or other real property right); (iii) conclusion of deeds with a notary office - in some cases, the law requires the notarised form of a particular deed; (iv) legal claims filed with the court; and (v) claims filed with the Ministry of Justice and to the General Attorney Office of the High Court of Cassation and Justice.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The Romanian standard VAT rate is 24% applied to the supply of goods and services. For certain goods and services like medical products, drugs, accommodation services, school materials, books, etc., a reduced VAT rate of 9% will apply. Also, a reduced 5% VAT rate is applicable on the sale of dwellings, under certain conditions, as part of a governmental social programme.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

As a rule, VAT is applicable to all economic activities which have as an object the supply of goods or provision of services performed in exchange for payment on the territory of Romania by a taxable person acting as such. Other operations subject to VAT in Romania are the import of goods by any person, intra-community acquisitions and some operations assimilated to intra-community acquisitions. With regard to the import of goods, VAT will be charged on the customs value of the goods, defined under question 2.5. The Romanian Fiscal Code provides, however, for the following exemptions from VAT:

a. Exemption without credit:

- activities of public interest (e.g. healthcare and healthcare-related services, teaching activities (as such are defined under the law), social services, cultural activities and services, public postal services, sorts-related services, TV and non-commercial radio-related goods and services, etc.);
- most of the banking, financial, insurance and reinsurance activities with some exceptions (e.g. debt collection, factoring, etc.);
- authorised gambling; and
- some forms of lease of real estate assets and sale of land not used for construction purposes; and the sale of old buildings (a building is considered old after December 31 of the year following the year when the building was used for the first time) or buildings on which the transformation costs performed did not exceed 50% of its value, exclusive of tax.

b. Exemption with credit:

- export of goods, transport and related services;
- international transport of passengers;
- intra-community supply of goods;
- some operations performed in free trade zones or free warehouses;
- supply of goods to a bonded warehouse, VAT warehouse and related services and supply of services related to goods placed under a customs suspensive regime;
- supply of foreign goods placed under customs suspensive regime; and
- supply of goods and services to diplomatic missions, NATO forces and other international organisations.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The VAT revealed under a business and paid to the State budget may be recovered in two ways, by *deduction of VAT* and/or by *reimbursement of VAT*. Output VAT related to goods and services delivered to customers may, under certain conditions, be set off in the books of the taxpayer against input VAT paid for the purchase of goods and services. If the taxpayer performs transactions subject to different VAT rates (i.e. the regular 24% rate and the reduced 9% rate), specific records should be maintained by the taxpayer, in order to show the allocation of goods and services to each type of transaction. The deduction is performed on a *pro-rata* basis, subject to the amount of delivered goods and services and the apportionment of purchased goods and services to transactions chargeable at each VAT rate. In cases where the amount of VAT paid for goods and services by a taxpayer during the reporting period exceeds the amount of VAT collected for goods and services delivered to customers, the taxpayer is entitled to claim the reimbursement of the VAT from the State. Reimbursement shall not be available if the amount of VAT to be reimbursed is less than RON 5,000 (approx. €1,200).

Nevertheless, the tax payer may carry forward such balance between output and input VAT in order to set it off against VAT liabilities reported in future returns. As a general rule, the VAT is paid on a monthly basis. Businesses with a turnover under €100,000 during a fiscal year, calculated at the exchange rate from the last day of the fiscal year, may choose to pay VAT on a quarterly basis, except for the taxpayers performing intra-community acquisition of goods in Romania, for which the VAT shall be paid on a monthly basis.

2.5 Are there any other transaction taxes?

Customs duty is a tax collected by the Romanian State for goods imported (as a rule, exported goods are exempted from customs duties) in Romania, from outside the European Union. Customs duties are specified in the EU Common Customs Tariff. The Romanian Customs legislation provides for a certain situation under which the goods imported could benefit from favourable treatment and partial or total relief of customs duties. Customs duties are levied on an *ad valorem* basis, as well as a fixed amount applied to a specific quantity (specific taxes). Customs duties are computed on the customs value of the goods, which represents the acquisitions value of the goods together with the transportation expenses, insurance expenses and other expenses incurred.

2.6 Are there any other indirect taxes of which we should be aware?

The excise duty is an indirect tax levied by the Romanian state for trading in several categories of goods such as beer, wines, fermented drinks other than beer and wine, strong alcoholic drinks, ethylic alcohol, tobacco products, electricity, energy products (liquid/fossil fuels), coffee, perfumes, jewellers (gold/platinum), sail and motor boats etc., regardless of their domestic or foreign origin. The excise tax is levied on the basis of unit of weight or volume, subject to the type of goods, as well as on an ad valorem basis. Certain exemptions regard products like ethyl alcohol and other alcoholic products if they are denaturated, or used in the nutritional, pharmaceutical or cosmetic industries.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends paid by Romanian legal entities to legal entities registered in an EU or European Free Trade Association (EFTA) Member State or to the EU or EFTA permanent establishments of such legal entities are exempt from withholding tax in Romania, provided that: (i) the receiver of the dividends (the parent company in case of permanent establishments) is established under a specific corporate form; (ii) is a profit tax (or similar tax) payer in its jurisdiction, and (iii) has held at least 10% of the Romanian dividend payer's share capital for at least 2 years ending at the dividend distribution date. Dividends paid by a Romanian legal entity to foreign legal entities or the Romanian permanent establishments of legal entities which do not fulfill the criteria mentioned above, are subject to a 16% withholding tax, unless a more favourable tax rate is provided under the relevant double tax treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Currently, royalties paid by Romanian legal entities to legal entities registered in an EU or EFTA Member State or to the EU or EFTA permanent establishments of such legal entities are exempt from withholding tax in Romania, provided that the effective beneficiary of the royalties has held at least 25% of the value of/number of shares in the Romanian royalties payer share capital for at least 2 years ending at the royalties distribution date. Furthermore, payment of royalties made out of Romania shall be exempted from tax in Romania, if the effective beneficiary of the royalties is, among others, a tax resident of an EU Member State and, according to the definition given by the law to "associated companies", is a company related to the payer of royalties. This tax exemption for royalties paid between related companies (following transposition in the Romanian fiscal law of European Council's Directive 2003/49/EC on a common system of taxation) is applicable to all interest and royalties payment made between related companies in different Member States. Royalties paid by a Romanian legal entity to foreign legal entities or the Romanian permanent establishments of foreign legal entities which do not fall under any of the categories mentioned above are subject to a 16% withholding tax, unless a more favourable tax rate is provided under a relevant double tax treaty.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Withholding tax on interest paid by a local company to a non-resident shall be subject to the same tax treatment as applicable to royalties, described under question 3.2 above.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

According to the "thin capitalisation" rules applicable in Romania, interest paid by a Romanian company is fully deductable, unless the ratio between the long term debt of the company (> 1 year) and the total equity of the company is higher than 3. In case the ratio between the long-term debt of the company (> 1 year) and the total equity of the company is higher than 3, the interest paid by the Romanian legal entity shall not be deductable during the relevant fiscal year but may be carried forward to the following fiscal years, until fully deducted. Such "thin capitalisation" rules shall not be applicable with regard to interest paid for financing obtained from banks, credit institutions and any other legal entities that, based on authorisation, act as professional financing institutions.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

As set out under question 3.4 above, interest is a fully deductable expense as long as the debt/equity ratio in the interest paying company is lower than 3. Furthermore, the deductibility of interest paid by Romanian companies for funds obtained from legal entities, other than banks, credit institutions as well as any other legal entities which are authorised and act as professional financing institutions, is limited to the following ceilings: (i) for funds obtained in Romanian lei (RON), the reference interest rate of the National Bank of Romania, as published in the last month of each quarter; and (ii) for foreign currency, a maximum percentage whose value is yearly established by the Government's Resolution (e.g. 6% in 2011).

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Save for the debt deriving from loans or credit facilities received by the company from banks, credit institutions and any other legal entities that, based on authorisation, act as professional financing institutions, the "thin capitalisation" rules extend to the entire long-term debt of the company, irrespective of whether such debt is being guaranteed by the company's parent entity or not.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

According to the Romanian Fiscal Code, there are no further restrictions on tax relief for interest payments paid by a local company to a non-resident, in addition to those mentioned under questions 3.4-3.6.

3.8 Does Romania have transfer pricing rules?

The Romanian Fiscal Code enables the Romanian fiscal authorities to apply the "arm's length principle" to the transactions between related parties. If transfer prices are not set at arm's length, the Romanian tax authorities have the right to adjust the taxpayer's revenues or expenses, so as to reflect the market value. Romanian tax authorities may use certain methods for setting transfer prices as follows:

- Comparable Uncontrolled Prices, whereby the market price is established based upon the prices paid to other persons who sell comparable goods or services towards independent (unrelated) persons.
- Cost-Plus Method, whereby the market price is established based upon the costs of the good or service provided through the transaction. An appropriate gross margin ("cost-plus mark-up") is then added to such cost, to make an appropriate profit in light of the functions performed and the market conditions. The result of adding the cost-plus mark-up to the costs may be regarded as an "arm's length price" of the original controlled transaction and shall be subject to taxation.
- Resale Price Method, whereby the market price is based upon the resale price of the good/service sold afterwards to independent (unrelated) persons, after the costs deduction of such resale, of other costs of the taxpayer and to which a profit margin shall be added.
- Any other methods that are in line with the OECD Transfer Pricing Guidelines.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The standard profit tax rate in Romania is 16%. In case of night clubs, night bars, discotheques, casinos and businesses performing gambling activities, including those legal entities obtaining such through partnerships, the companies deriving income from such activities have to pay the higher amount between the value represented by the 16% profit tax and the value represented by 5% income tax. Representative offices of foreign companies in Romania are subject to a flat tax of EUR 4,000 per annum (in RON equivalent), regardless of their income during the fiscal year.

4.2 When is that tax generally payable?

The general rule set forth by the Romanian Fiscal Code is that companies have the obligation of paying an anticipated annual profit tax. The amount of anticipated income tax is determined based on the profit tax afferent to the previous exercise, indexed in consideration of the inflation rate. The anticipated annual profit tax is divided into four equal instalments and paid on a quarterly basis by the 25th day of the month following each quarter (i.e. the first payment has to be made on April 25, at once with the filing of the annual profit statement). Certain categories of tax payers, such as partnerships without legal personality, non-profit organisations and taxpayers which obtain profits from agricultural activities, benefit from variations of the general tax payment term.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

Taxable profit of a company is generally computed as the difference between the revenues derived from any source and the expenses incurred for obtaining the taxable income during the fiscal year. This difference is then adjusted for tax purposes by deducting non-taxable revenues and adding non-deductible expenses. Dividends, among other expressly provided types of income, are not included in the taxable base, for profit tax purposes.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Subject to the conditions presented under question 4.3, profit shown in commercial accounts may be different subject to the applicability of accounting rules regarding losses, accruals and other restrictions imposed by Romanian accounting standards.

4.5 Are there any tax grouping rules? Do these allow for relief in Romania for losses of overseas subsidiaries?

The Romanian legislation gives affiliated companies (the parent company and its subsidiaries) the possibility of preparing a consolidated annual report at group level. However, there are no rules which would enable the consolidation of profit and losses of a Romanian subsidiary with the profit and losses of its foreign parent company. Group trading losses and gains may be offset under certain conditions during corporate restructuring (i.e. mergers and split-offs). For VAT purposes, under certain conditions, Romanian legal entities liable to VAT, which are linked together by financial, economic and organisational aspects, may be regarded as a fiscal group.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Generally, distributed profits are subject to the same 16% profit tax as undistributed profits. The profit tax exemptions applicable for reinvested profit shall no longer be enforceable as of January 2011. However, under certain circumstances, undistributed profits may benefit from certain exemptions, if incorporated as a mandatory reserve. In this regard, profits apportioned for the establishment of the mandatory reserves are fully deductible. The current level of mandatory reserve is 20% of the amount of subscribed and paid-in share capital.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

Property taxes (e.g. land and buildings) are levied by local authorities based on the declared value of the immovable, the location of the immovable and on the square metres. In addition to property taxes, Romanian taxpayers (legal entities as well as individuals) have to pay healthcare taxes and other social contributions.

4.8 Are there any local taxes not dealt with in answers to other questions?

As a principle, local taxes are established by the local authorities on a yearly basis, within the limits provided by the Fiscal Code. The Fiscal Code provides for the following local taxes:

- tax on means of transportation, such as cars, buses, trucks, tractors, motorcycles, boats, yachts, etc.;
- tax for issuing of certificates, approvals and authorisations due to be paid prior to the issuing of such documents;
- tax for advertising and publicity services, paid by the beneficiaries of such services at rates of 1% up to 3% from the value of such services, as determined by the Local Council. The tax is not due for advertisements in the written and audio-visual media;
- tax on entertainment activities, due for artistic shows, sports competitions, etc. The value of the tax is 2% or 5% of the income, subject to the entertaining activity. There are special rules for determining the taxes for discotheques or video saloons;
- tax for hotel acommodation. The value of the hotel acommodation tax is determined by the Local Council, and may vary between 0.5% and 5% of the acommodation fee. The tax must be paid for the entire acommodation period, except for acommodation facilities located in a tourist resort, for which the tax must be paid only for one night, regardless of the acommodation period;
- health tax. Providers of advertising services pay a 12% health tax for tobacco products and alcohol. The tax is computed to the value of cashed advertising revenues. The health tax is also due but in different percentages by the producers and importers of tobacco products and some alcoholic drinks (other than beer, wine and other fermented drinks and intermediary products);
- pollution tax has to be paid for every car, usually, at the moment of the first registration in Romania. Such tax in computed based on the characteristics of the respective car, i.e. EURO emissions standard, CO2 emissions, volume engine, etc.; and
- special taxes. The local councils, the county councils or the General Council of Bucharest may levy special taxes for certain local public services, which are provided for the benefit of individuals or legal entities.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Capital gains, determined in accordance with the applicable fiscal and accountancy rules, obtained by Romanian companies, are included in the taxable profit of the company and subject to the 16% profit tax rate. Capital losses related to the diminishing in the value of stockholding are deductible and may be written off during the following 7 fiscal years for loss incurred as of 2009. Capital gains obtained in Romania by foreign companies from the disposal of shares held in Romanian companies or from the disposal of real estate assets located in Romania are subject to a 16% withholding tax, unless contrary or more favourable provisions are established in the relevant double tax treaty. With regard to losses incurred by a company, such annual losses established by the profit tax statement may be carried forward for a period of 7 years following the year when such losses have incurred but only for the losses incurred as of 2009. Capital gains obtained by foreign companies from Romania by disposing of assets (e.g. participation titles in Romania entities, real estate properties located in Romania) are subject to a 16% flat withholding tax rate in Romania, except derogatory provisions are found in the relevant double tax treaty. Usually, double tax treaties to which Romania is party provide that, save for, generally, capital gains obtained by disposing of real estate assets located in Romania, capital gains obtained by a foreign companies from any other sources are exempted from withholding tax in Romania.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The tax rate applicable to capital gains is 16%, unless a more favourable rate is established by the relevant double tax treaty.

5.3 Is there a participation exemption?

According to the Romanian Fiscal Code, there are no participation exemptions regarding capital gains.

5.4 Is there any special relief for reinvestment?

Currently there are no special reliefs for reinvestment, in force, in Romania.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The incorporation of a subsidiary shall differ depending upon the legal form of such subsidiary (e.g. limited liability company, joint stock company, etc.). For instance, with regard to the registration of limited liability companies with the Register of Commerce, taxes and fees may amount to approximately EUR 400 (including minimum share capital).

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

According to the provisions of the law regarding companies, a subsidiary of a foreign company is regarded as a distinct legal entity in Romania. As opposed to a branch, which does not have distinct legal personality from its parent, hence, the net profit (i.e. after subtracting 16% tax) would be transferred directly to the parent, the net profit of a subsidiary would have to be distributed to the parent as dividends, which often means adding a new layer of taxation on the parent's revenues. On the other hand, a branch is considered a permanent establishment of a foreign company in Romania; a fact that, under most of double tax treaties applicable in Romania, could trigger the application of withholding tax on certain revenues instead of exempting the income from withholding tax.

6.3 How would the taxable profits of a local branch be determined?

A branch's taxable profit shall only include those elements of income apportioned to the branch's activity. Only branch-related expenses shall be taken into account for the purpose of profit tax.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Under the Romanian fiscal legislation, (as well as under the provisions of the large majority of double tax treaties following the OECD Model Convention), a branch of a foreign legal entity is considered a "permanent establishment" of such foreign legal entity in Romania and it is subject to the same tax treatment as any other legal entity functioning under Romanian law. Therefore a Romanian branch's profit shall be subject to the general flat profit tax of 16% or the minimum fix amount of tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As mentioned in question 6.4, above, a branch is deemed to be a permanent establishment and shall benefit from the provisions of tax treaty (e.g. OECD Model Convention, followed by Romania in the majority of its double tax treaties), subject to the attribution of income and expenses rules to the branch. As a rule, only expenses incurred for the purposes of the branch, including executive and general administrative expenses, shall be deductible from the gross revenues.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Other than the profit tax owed by the branch in relation to the profits obtained by the branch from its activity in Romania, there are no other withholding taxes applicable on the remittance of profits by the branch.

7 Overseas Profits

7.1 Does Romania tax profits earned in overseas branches?

As a general rule, Romania taxes the worldwide income of a Romanian company with 16% flat profit tax.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Dividends received by a Romanian parent company from its subsidiary in an EU Member State to a Romanian company are exempt from tax on dividends in Romania provided that: (i) the Romanian parent company is subject to profit tax in Romania; and (ii) they have held at least 10% of the dividend payer's share capital for at least 2 years ending at the dividend distribution date. Dividends received by Romanian companies from subsidiaries for which the above exemption criteria are not met or from subsidiaries outside the EU are subject to 16% profit tax in Romania.

7.3 Does Romania have "controlled foreign company" rules and if so when do these apply?

The "controlled foreign company" rules apply to the receipt of dividends by a Romanian parent from its EU Member State based subsidiary, as mentioned in the answer to question 7.2 above.

8 Anti-avoidance

8.1 Does Romania have a general anti-avoidance rule?

As of 2005, the tax avoidance issues in Romania are tackled by the Romanian authorities with the observance of law no. 241/2005, for preventing and fighting tax avoidance. Moreover, after Romania's accession to the EU on January 1, 2007, the Fiscal Code enacted, in Title V, Chapter V, the provisions of the Directive no. 77/799/CEE regarding mutual assistance between competent authorities of the EU Member States in the field of direct taxation and taxation insurance bonuses, as amended.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

All Romanian legal entities have the obligation to submit a report regarding payments and payment obligations to non-residents, which must describe the purpose of the payment as well as identify the beneficiary of the payment. In case of Romanian entities that have the obligation to withhold and pay the due taxes for certain incomes they paid to non-residents, such Romanian entities have to file, on a yearly bases, with the fiscal authorities, a separate report regarding withholding taxes.

Pursuant to the latest measures for fighting tax evasion, starting as of August 1, 2010, all taxable persons and legal non-taxable persons performing intra-community operations, from a VAT perspective, shall have to register with the Intra-community Operators Registry held by the National Agency for Fiscal Administration, prior to the performance of such operations.

Furthermore, under specific circumstances, members (in case the tax payer is a partnership or family enterprise), shareholders, administrators, affiliates and third parties breaching a garnishment obligation in an enforcement procedure for tax liabilities, shall be held jointly liable with the tax payer in or with regard to which they hold the above mentioned capacities, for the tax payer's liabilities. Joint liability is subject, among others, to the actions of the above mentioned persons leading to the breach by the tax payer of its tax payment obligations or to its insolvency having been performed in bad faith.

Andrei Dumitrache

Pachiu & Associates
4-10 Muntii Tatra Street, 5th floor
Bucharest 1, RO 011022
Romania

Tel: *+40 21 312 1008*
Fax: *+40 21 312 1009*
Email: *andrei.dumitrache@pachiu.com*
URL: *www.pachiu.com*

Andrei is an experienced business lawyer specialising in finance, tax, estate planning and asset protection. In the field of taxation and asset protection, Andrei acts as advisor to domestic and foreign corporations and business ventures and high net worth individuals, on matters such as asset protection, planning of estate, domestic and cross-border tax optimisation and compliance, general tax advice on direct and indirect taxation, structuring of financial investment, divestment, and profits repatriation and offshoring. Andrei is also a regular contributor to the business and legal media on topics related to finance and taxation.
As a partner of the firm, Andrei heads the Finance Practice Group of the firm, which includes the Tax and Estate Planning (& Asset Protection) sub-practice groups.
Andrei is fluent in Romanian and English and conversant in French and German.

Vlad Rădoi

Pachiu & Associates
4-10 Muntii Tatra Street, 5th floor
Bucharest 1, RO 011022
Romania

Tel: *+40 21 312 1008*
Fax: *+40 21 312 1009*
Email: *vlad.radoi@pachiu.com*
URL: *www.pachiu.com*

Vlad is an experienced tax lawyer, specialising in EU and domestic indirect taxation. Before joining Pachiu & Associate, he has worked as a tax lawyer with one of the Big Four audit companies.
Vlad is a senior member of the Bucharest Bar Association and a member of the National Romanian Bars Association.
As an associate within the Tax Sub-Practice Group within the Finance Practice Group of the firm, Vlad's activity is focused on advice regarding indirect tax (mainly VAT) applicable to business activities in Romania and in the EU. In this capacity, Vlad has provided voluble advice and solutions on VAT and other duties related matters regarding international and intra-community trade with goods and services, real estate investment and acquisition and has been involved in various high value direct and indirect tax-related litigations.

PACHIU & ASSOCIATES
ATTORNEYS AT LAW • RECHTSANWÄLTE • ABOGADOS

Pachiu & Associates is an all Romanian medium-sized business law firm. Our purpose is to offer prompt, effective and personalised solutions to all legal matters and challenges which domestic and foreign businesses are confronted with in Romania. The firm's partners and associates are well regarded professionals in their areas of practice and all are members of the Bucharest Bar Association and of the National Romanian Bars Association. All lawyers are fluent in Romanian and English and some are fluent in German, French, Italian and Spanish.

The firm has extensive expertise in matters related to mergers and acquisitions, corporate governance, corporate disputes, securities, insolvency, commercial contracts, domestic and international taxation, labour law, real estate and construction, anti-trust law, intellectual property, banking and project financing, secured transactions, cross-border transactions, public procurement, and general litigation.

The firm maintains long term collaborations with some of the leading multinational law firms. Moreover, we may be of assistance worldwide through our membership in the Primerus International Society of Law Firms.

Chapter 36

Slovakia


Matej Firický


Tomáš Cibuľa

White & Case LLP

1 General: Treaties

1.1 How many income tax treaties are currently in force in Slovakia?

After the break-up of the Czech and Slovak Federal Republic ("**CSFR**") in 1993, the Slovak Republic acceded to the tax treaties signed by the former CSFR. Since then, the Slovak Republic has signed a number of new tax treaties. Currently, Slovakia has tax treaties with 63 countries, of which 62 are effective. This does not include the tax treaties currently being negotiated which have not take effect yet.

1.2 Do they generally follow the OECD or another model?

The tax treaties signed by the Slovak Republic generally follow the OECD Model Tax Convention. The specific tax treaty is signed with the U.S., which follows neither the UN nor OECD Model Tax Convention.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

The tax treaty, if signed, also needs to be approved by the Slovak Parliament and subsequently ratified by the Slovak President. Afterwards, upon the counterparty ratifying the tax treaty, the treaties are published in the Collection of Laws and become part of domestic law.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Slovak tax treaties do not usually include any specific anti-treaty shopping provision, except for those incorporated in the model tax treaties, e.g. principle of limitation of benefits to the "beneficial owners" of income.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Once the Slovak double tax treaties are ratified in compliance with Slovak legislation and published in the Collection of Laws, they prevail over Slovak domestic law.

2 Transaction Taxes

2.1 Are there any documentary taxes in Slovakia?

In Slovakia, no documentary taxes have been introduced.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

As of May 1, 2004, the Slovak value added tax ("**VAT**") system complies with the principles of VAT applied within the European Union (the "**EU**") by the Sixth Council Directive 77/388/EC (Recast Council Directive 2006/112/EC) of the common system of VAT.

Generally, a standard 20% VAT rate applies on the majority of taxable supplies with the place of the transaction being in Slovakia, unless these supplies are specifically exempt from VAT. The VAT rate would automatically be reduced back to 19%, provided budget deficit decreases below 3%. The reduced 10% VAT rate applies on qualified supplies such as supply of certain pharmaceutical products, medical equipment and books.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Under the Slovak VAT system, VAT is imposed on: (i) the supply of goods for consideration in Slovakia; (ii) the provision of services for consideration in Slovakia; (iii) intra-Community acquisitions of goods; and (iv) the import of goods from countries outside the EU.

VAT-exempt supplies with an input-VAT deduction entitlement include: (i) the supply of goods from Slovakia to another EU Member State; and (ii) the export of goods.

VAT-exempt supplies without an input-VAT deduction entitlement include, among others: (i) insurance services; (ii) the transfer and lease of real estate under certain circumstances; (iii) financial services; (iv) lotteries; (v) postal services; (vi) healthcare services; (vii) social care services; (viii) educational services; and (ix) other activities in the public interest.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

In general, the VAT payer is entitled to deduct VAT paid in respect of supplies used for the purposes of its taxable business activities. According to the Slovak VAT Act, input VAT cannot be deducted for example, from entertainment expenses. The VAT payer is also not able to deduct VAT paid in respect of supplies received to provide VAT-exempt supplies of goods and services (e.g. postal, insurance and financial services, the exempt supply and lease of immovable assets; see question 2.3).

If taxable supplies are received to perform taxable supplies where VAT deduction is allowed, as well as taxable supplies exempt without input VAT deduction, input VAT can be deducted proportionately based on the coefficient. The VAT paid in respect of acquired intangible assets or received services which are used for business purposes, as well as for purposes other than business, can generally be deducted only in a proportion reflecting the business use of such assets.

A taxable entity which becomes a VAT payer is entitled to deduct input VAT related to the input price of an asset, including depreciated assets (according to the Income Tax Act), acquired prior to its VAT registration. Separate rules for VAT deduction apply for late VAT registrations.

Special rules on the adjustment of input VAT that was deducted apply to capital goods. The initial input VAT deduction on acquired capital goods had to be adjusted if certain changes in the use of such goods (e.g. the use of the capital goods for exempt supplies when the input VAT had been fully deducted) occurred during the subsequent 5 calendar years, including the year of their acquisition (a ten-year period applies to real property).

2.5 Are there any other transaction taxes?

No real estate transfer, inheritance or gift taxes are levied in Slovakia.

2.6 Are there any other indirect taxes of which we should be aware?

The applicable legislation for excise duties is effective as of May 1, 2004, implementing the EU Directives. Specified consumer goods produced in Slovakia, supplied to Slovakia from another Member State, or imported from countries outside the EU, are subject to an excise duty upon various tax events specified in the relevant tax laws. Goods subject to excise duties include mineral oil, tobacco products, spirits, beer and wine. As of July 1, 2008, electric energy, coal and natural gas have also become subject to excise duty. Duty is charged according to the volume produced, imported or supplied with varying rates for each category.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

No, under the Slovak Income Tax Act, profit shares (dividends) distributed by an eligible Slovak legal entity are not subject to income tax in Slovakia. This applies for distributions made to the shareholders by the following qualified Slovak legal entities: a limited liability company (s.r.o.); a joint stock company (a.s.); and a limited partnership (k.s.), if distribution is made to limited partners (*komanditista*). The exemption does not apply to distributions made to partners of a general partnership (v.o.s.) and general partners of a limited partnership (*komplementár*).

However, dividends paid out of profits generated after January 1, 2011 by Slovak company to an individual insured in a Slovak health insurance system will be to a certain extent subject to Slovak health insurance (10% of maximum three-times average wage in Slovakia).

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

According to the Slovak Income Tax Act, there is a 19% withholding tax levied on payments for the use of intellectual property rights (industrial rights, software, copyrights) and know-how made by Slovak companies, unless the respective tax treaty stipulates otherwise.

Based on the provisions implementing the Interest and Royalty Directive, the royalty payments to a related party seated in another EU Member State are exempt from WHT if certain conditions are met.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

If the creditor is a non-resident for Slovak tax purposes, interest paid by a Slovak company will generally be subject to 20% WHT under the Slovak ITA. The majority of tax treaties signed by the Slovak Republic, however, eliminate the withholding tax on interest. If this is the case, the Slovak company paying the interest may automatically apply the reduced (zero) tax rate under the tax treaty. Taking into consideration the measure issued by the Ministry of Finance and the practical approach of the tax authorities, we recommend having a tax residence certificate confirming the recipient's tax domicile and eligibility for treaty benefits in the files of the Slovak company for the purposes of a possible tax audit.

Further, as a result of the fact that the Slovak Republic joined the EU, the Interest and Royalty Directive was implemented into Slovak law. Based on these provisions, the loan interest payments to a related party seated in another EU Member State are exempt from withholding tax if certain conditions are met.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

No thin capitalisation rules apply in Slovakia. However, if the amount of debt is significantly higher than the equity (registered capital) of a debtor, the tax authorities could theoretically object to the deductibility of interest on related party loans by invoking the general substance-over-form principle or the transfer pricing rules of Slovak tax legislation. This needs to be considered on a case-by-case basis.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

See also question 3.4 above. No further restrictions are adopted.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

There are no thin capitalisation rules effective in Slovakia. For more information, see question 3.4 above.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

No further restrictions other than mentioned in question 3.8 (transfer pricing) are adopted in Slovakia.

3.8 Does Slovakia have transfer pricing rules?

Under Slovak tax law, transactions realised between foreign-related parties should be subject to Slovak transfer pricing rules. The prices agreed between them should be set on an arm's length basis. The definition of related parties includes those related through personnel (through statutory representatives, members of statutory bodies or supervisory boards), those related economically (directly or indirectly holding more than 25% of the capital or voting shares), or those otherwise related (through a relationship arising with the aim of decreasing the tax base).

The determination of transfer prices between related parties is generally considered to be very sensitive from the tax perspective. According to Slovak tax legislation, if the prices contracted between related parties differ from prices that would be contracted between unrelated parties on the same or similar terms, and this difference decreased a tax payer's tax base, the tax base of the taxpayer should be adjusted by the ascertained difference.

Under Slovak tax legislation, an advance ruling from the tax authority on the transfer pricing method to be used between related parties may be obtained. Slovak transfer pricing legislation stipulates the methods available based on the OECD Transfer Pricing Guidelines.

As of January 1, 2009, a specific transfer pricing documentation must be maintained by each entity preparing its financial statements under IFRS if it carries out transactions with foreign related parties. Similarly to the EU Code of Conduct on transfer pricing documentation, the transfer pricing documentation should consist of (1) a "master file" containing mainly general information relevant for all EU group members of a multinational enterprise, and (2) "country-specific documentation" containing information relating to the respective local (Slovak) entity involved. Smaller entities preparing their financial statements under Slovak Accounting Standards would still be required to collect prescribed data on such transactions and to publish them in the notes to the financial statements.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The corporate income tax flat rate is set at 19%.

4.2 When is that tax generally payable?

The corporate income tax is generally payable within three months after the end of the tax period (calendar/financial year). In addition, corporate income tax prepayments might be payable monthly or quarterly (pro rata) during the current tax period, depending on the tax liability reported in the previous tax period.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The corporate income tax base is generally based on profit/loss determined according to the Slovak statutory accounting standards, which is further adjusted for non-deductible expenses and non-taxable income. For specific taxpayers (e.g. banks, insurance companies, mutual fund management companies, etc.), the accounting result is compiled according to IFRS, which is further adjusted for tax base calculation purposes. These adjustments include, among others, various items to exclude the impact of IFRS accounting.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Non-deductible tax expenses include, among others: (1) entertainment and travel allowances paid in excess of the statutory limits; (2) general accounting reserves and provisions, except for specific tax deductible reserves and provisions (special rules apply for banks and insurance companies); (3) fines and penalties except for contractual penalties; (4) taxes paid on behalf of other taxpayers; and (5) shortfalls and losses exceeding compensation received, except for specific losses.

Slovak tax law further specifically sets the rules for the tax deductibility of certain items, e.g. tax depreciation of assets, financial lease payments, etc.

4.5 Are there any tax grouping rules? Do these allow for relief in Slovakia for losses of overseas subsidiaries?

Tax grouping is not possible in Slovakia. Therefore, if one company is profitable and the other is making losses, the losses may not be credited against the profits. VAT grouping within Slovakia is allowed to certain extend.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, both the distributed and retained profits are taxed at the same rate (19%).

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

No further national taxes are being assessed. However, municipalities are entitled to assess several municipal taxes, such as real estate tax, tax on dogs, tax on the use of public areas, tax on accommodation, tax on vending machines, tax on non-winning game slot machines, tax on entry and parking of motor vehicles in the historic parts of a city, tax on nuclear devices, and a motor vehicle tax. The level of the applicable municipal tax rate is set by the municipalities. The municipal taxes are administered by the respective municipalities, except for the motor vehicle tax, which is the responsibility of the tax authorities. The most significant of these are real estate and motor vehicle tax.

Real Estate Tax

Only real estate located within the territory of the Slovak Republic is subject to real estate tax. In general, the owner of real property is obliged to submit a tax return for the calendar year (if any change occurs during the year) and to pay real estate tax, which is levied on buildings, land and apartments based on tax assessment.

The real estate tax base is calculated according to the area in square metres on buildings and apartments or the value of land. The basic and maximum tax rates for buildings, land, and apartments are stipulated in the Act on Municipal Taxes. However, the rates can be changed by the respective municipality.

Motor Vehicle Tax

The motor vehicle tax is payable by both individuals and legal entities for all vehicles used for business purposes. The tax rate is based on engine capacity for passenger cars, and weight and size for other vehicles. The level of the tax rate is determined by the municipalities, without any maximum limitation.

4.8 Are there any local taxes not dealt with in answers to other questions?

Except for immaterial judicial and administration fees, there are no local taxes other than those dealt with in question 4.7.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

No, there are no special rules for taxing capital gains and losses in Slovakia. Any capital gains and losses are included in the tax base of the Slovak company and taxed at the standard corporate tax rate of 19%.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

No, the same 19% corporate income tax rate applies to all profits realised by the Slovak company.

5.3 Is there a participation exemption?

Slovakia has neither participation exemption rules nor relief for reinvestment incorporated in its income tax law.

5.4 Is there any special relief for reinvestment?

In respect of state aid, individual tax relief can be granted. Such relief, however, is not necessarily linked to reinvestment.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The setting-up of a Slovak Company (and the subsequent increase of registered capital) will not trigger any Slovak capital duty, transfer taxes or other similar implications for its shareholders or the Slovak Company.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Generally, the rules for taxation of a subsidiary and a branch are the same (Profit/Loss Statement adjusted for tax purposes).

6.3 How would the taxable profits of a local branch be determined?

Generally, a permanent establishment is taxed on a profit and loss basis ("**P/L basis**") in Slovakia. If it is impossible to determine the tax base on a P/L basis, another method to determine the tax base can be used, e.g. percentage from annual turnover generated in Slovakia, cost plus method, etc.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

The tax base of a branch is taxed at the same corporate tax rate as the tax base of other Slovak legal entities, i.e. at 19%. However, according to the Slovak Income Tax Act, Slovak legal entities are required to withhold 19% tax securing from payments made to foreign entities which have a tax presence in Slovakia (including branches). The guarantee tax is then offset against the corporate income tax liability of the branch. However, this obligation does not apply to branches of entities seated in an EU country or for branches paying tax prepayments in Slovakia.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As a branch is not considered to be a separate tax payer, the majority of tax treaty benefits can not be applied to the branch, but the tax treaty may, under certain circumstances, eliminate or decrease the application of tax securing, as mentioned in question 6.4 above.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

The profits of a branch attributable to the Slovak permanent establishment are first taxed in Slovakia. Subsequently, the remittance of after tax profits to the headquarters is not subject to further taxation in Slovakia.

7 Overseas Profits

7.1 Does Slovakia tax profits earned in overseas branches?

Any company being the Slovak tax resident is taxed on its worldwide income in Slovakia. Nevertheless, certain provisions of double taxation treaties, e.g. elimination of double taxation, could still apply.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

No, there is no such tax being imposed.

7.3 Does Slovakia have "controlled foreign company" rules and if so when do these apply?

No specific CFC rules have been adopted in Slovakia so far.

8 Anti-avoidance

8.1 Does Slovakia have a general anti-avoidance rule?

A general anti-avoidance principle has been incorporated in Slovak tax law. To prevent abuse, the tax authorities are obligated to take into account the substance of a transaction, and to disregard the formal structuring (Substance-Over-Form Principle). Tax authorities can use their own assessment for the determination of the tax base of a taxpayer who performed operations that, in substance or purpose, were aimed at circumventing the tax law and which resulted in a reduction in the tax base. In addition, any business relation established solely for the purpose of the decrease of tax base/increase of tax loss should be subject to transfer pricing rules.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there is no such special disclosure requirement.

Matej Firický

White & Case LLP
Hlavné námestie 5
811 01 Bratislava
Slovakia

Tel: +421 2 5441 5100
Fax: +421 2 5441 6100
Email: mfiricky@whitecase.com
URL: www.whitecase.com

Matej Firický is an associate in the Bratislava Office of White & Case with both economic and legal background and has a ACCA (Association of Chartered Certified Accountants) Diploma in International Financial Reporting. Mr. Firický has participated in providing tax advisory services to multinational clients. His practice in the field of direct taxation involves tax advisory services to non-residents working in Slovakia, as well as *ad-hoc* advisory services to various domestic and international non-financial companies on issues concerning corporate taxation.
He has also been involved in the auditing of domestic and foreign companies and has acquired considerable experience in due diligences and in representing clients in tax inspections. At present, he is also engaged in the structuring and restructuring (mergers, acquisitions, de-mergers) of international companies active in Slovakia and in optimising the tax burden. He is a member of the Slovak Bar Association.

Tomáš Cibuľa

White & Case LLP
Hlavné námestie 5
811 01 Bratislava
Slovakia

Tel: +421 2 5441 5100
Fax: +421 2 5441 6100
Email: tcibula@whitecase.com
URL: www.whitecase.com

Tomáš Cibuľa works for White & Case since 2008. Prior to this, he had worked for several years for leading international advisory company in Bratislava.
Mr. Cibuľa has both legal and economic background, acquiring Slovak and international degrees in law and finance. His experience spans diverse fields of law that include not only taxation, but also dispute resolution, mergers & acquisitions or corporate law at the international level.
During his practice, Mr. Cibuľa has been involved in various projects in the area of direct and indirect taxation, where he has provided advisory services and prepared tax returns for international corporate clients in the pharmaceutical, energy and real estate sectors, as well as personal income tax returns for residents and non-residents. He also gained significant experience in projects such as due diligences, representing clients in tax inspections, international tax planning and tax optimisations.

WHITE & CASE

White & Case LLP is a leading global law firm with lawyers in 38 offices in 26 countries. As one of the first US-based law firms to establish a truly global presence, we provide counsel and representation in virtually every area of law that affects cross-border business. Our clients value both the breadth of our global network and the depth of our US, English and local law capabilities in each of our regions and rely on us to assist them with their complex cross-border transactions, arbitration and litigation matters. Recently, White & Case was named “Central and Eastern Europe Law Firm of the Year 2010” at the Chambers Europe Awards for Excellence.

The Bratislava office of White & Case, established in 1997, is perennially acknowledged by the independent benchmarking publications as one of the leading international law firms in the Slovak Republic. It offers multi-jurisdictional advice and provides legal services to major domestic and international corporations. Our 18 lawyers and tax advisors have acted as advisors on some of the largest corporate and commercial, financial and real estate projects, in addition to arbitration and litigation and tax matters in the Slovak Republic.

Slovenia

Leitner + Leitner, d.o.o.

Blaž Pate

1 General: Treaties

1.1 How many income tax treaties are currently in force in Slovenia?

There are currently 46 tax treaties in force in Slovenia.

1.2 Do they generally follow the OECD or another model?

Slovenia's tax treaties generally follow the OECD model.

Some of the treaties were concluded by Yugoslavia at a time when Slovenia was still a part of Yugoslavia. By way of succession, they remained applicable to Slovenia even after its independence in 1991. The majority of these "old" treaties have been renegotiated, but there are still some old treaties in force, such as those with Cyprus and Sweden.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

In order for a treaty to take legal effect in Slovenia, it must be ratified by the Slovene Parliament and published in the Official Gazette. A tax treaty enters into force and has legal effect as from the date determined in the treaty.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, the tax treaties concluded by Slovenia do not incorporate specific anti-treaty shopping provisions. There are, however, certain exceptions, such as the tax treaties with the USA and with Malta, both of which include a "limitation on benefits" clause.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Pursuant to the provisions of the Constitution of the Republic of Slovenia, all domestic laws and rules must comply with the general principals of international law and treaties, to which Slovenia has acceded. From this it may be derived that treaties generally may not be overridden by domestic law.

2 Transaction Taxes

2.1 Are there any documentary taxes in Slovenia?

There are currently no documentary taxes in Slovenia.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Slovenia has Value Added Tax at the standard rate of 20%. A reduced rate of 8.5% applies to items which are specifically enumerated in the Slovene VAT Act. These items include, but are not limited to food, medicine and medical equipment, and some residential buildings.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Slovene VAT regulations closely follow Directive 2006/112/EC, which gives Member States a certain degree of leeway regarding exclusions / exemptions. In general, the supply of goods and services as well as the import of goods and the Intra Community acquisition of goods, are subject to VAT. Several exclusions are, however, provided for in the Slovene VAT Act, which include but are certainly not limited to the sale of shares in a company, an active trade or business and the sale of securities. The sale of certain (used) real estate is also VAT-exempt unless the parties opt to treat the supply as a taxable transaction (in which case the standard rate of 20% applies).

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Taxable persons are generally entitled to deduct input VAT, insofar as the VAT is incurred in the provision of the business' own taxable transactions. Taxpayers rendering VAT-exempt services however, such as banking and financial services, are not entitled to deduct input VAT. Additionally, it may be noted that not all businesses are required to register for VAT purposes - namely businesses with an annual turnover of under 25,000 EUR are not obligated to register for VAT purposes.

2.5 Are there any other transaction taxes?

Apart from VAT, the real estate transfer tax should also be noted. Real estate transfer tax is levied on transfers of immovable property (land and buildings) located in Slovenia. In general, the tax rate is 2%. Typically, the taxable basis is the value of the consideration (that is, the purchase price). One of the exemptions from this tax refers to transfers of immovable property which are subject to VAT.

2.6 Are there any other indirect taxes of which we should be aware?

Custom duties are generally payable on goods imported from outside of the EU. Excise duties are levied on particular classes of goods (e.g. tobacco, alcohol and mineral oils).

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Dividends and other profit distributions paid to non-residents are subject to a final withholding tax levied on the gross amount. The rate is 15%, unless a reduced rate applies under a tax treaty.

Under the statute implementing the provisions of the EC Parent-Subsidiary Directive (90/435/EEC), outbound dividends are exempt from withholding tax if the recipient is an EU company subject to corporate income tax listed in the Directive and holds directly at least 10% of the capital or voting rights of the paying company. Moreover, a continuous minimum holding period of two years is required. If the two-year holding period has not yet lapsed, the exemption can be directly applied if the recipient lodges a bank guarantee.

Notwithstanding the above conditions, dividends are exempt from withholding tax if the recipient is an EEA company that is unable to set off the Slovenian withholding tax because it benefits from a participation exemption regime in its country of residence. In such a case, any withholding tax already paid may also be refunded.

Dividend payments made to non-resident pension funds, investment funds and insurance companies in respect of pension schemes are exempt from withholding tax under certain conditions.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In the event that a local company pays royalties to a non-resident, a withholding tax of 15% is levied, which may be reduced or eliminated pursuant to an applicable tax treaty and/or pursuant to the Slovene provisions implementing the Directive 2003/49/EC. No withholding tax is paid on royalties payments if at the time of the payment:

- the payments for the use of property rights are paid to the legitimate owner, which is a company member of an EU country other than Slovenia, or a branch of a company which is an EU member and is situated in a different EU Member State;
- the payer and the eligible owner are associated in such way that: the payer directly holds a share of at least 25% in the eligible owner's equity capital; the eligible owner directly holds a share of at least 25% in the payer's equity capital; or the same company directly holds a share of at least 25% in the equity capital of both the payer and the eligible owner, so long as exclusively companies of EU Member States are involved;
- the minimum share is held for at least 24 months; and
- the payer or eligible owner: is a company that has one of the forms to which the common system of taxation in connection with payments for the use of property rights applying to linked companies from different EU Member States applies; is a resident of an EU Member State for tax purposes in accordance with the law of that country; and is a taxpayer subject to one of the taxes in connection with which the common system of taxation regarding payments for the use of property rights applying to linked companies from different EU Member States applies.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Withholding tax at a rate of 15% applies to interest, with the exception of interest on loans raised and securities issued by the government of Slovenia, and interest paid by banks, and some other exemptions.

Again, it is important to note that also in the case of interest paid to a non-resident pension, investment or insurance fund, subject to certain conditions, a withholding tax is not levied on interest paid.

Regarding the implementation of the EC Interest and Royalties Directive, see question 3.2.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

As a general rule, the Slovene Corporate Income Tax Act limits the tax deductability of interest paid on loans granted by a shareholder or partner, holding at least 25% in the share capital or the voting rights of a taxpayer. Interest paid on such loans is not tax deductible if the loan exceeds five times (in 2011) the value of the shareholder's or partner's share in the capital of the taxpayer. This general limitation does not apply, however, if the taxpayer manages to prove that the excess loan could have been obtained from un-associated parties.

With regards to the thin capitalisation rules, Slovenia enjoys a transitional period. This transitional period shall continue until 2012, when the debt-to-equity ration fixed at 4:1 shall apply.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

A "safe harbour" exists only in relation to the interest rate on loans between related entities. In accordance with the transfer pricing rules, interest payments on loans granted by related entities are recognised as deductible expenses only up to the amount of the officially determined interest rate, which is published on a monthly basis on the website of the Slovenian tax authorities.

The taxpayer may, however, use an interest rate different from the rate officially determined if he proves that he could also, under comparable circumstances, have granted such a loan or have received it with that interest rate from an unrelated party.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The thin capitalisation rules would also extend to such loans granted by a third party. The rule also covers back-to-back loans and loans granted by a third party with a right of recourse against a qualified shareholder. A loan granted by a bank in connection with a deposit by a qualified shareholder with this bank qualifies as a back-to-back loan. Loans granted by a third party with a right to take recourse against a qualifying shareholder include loans from any third party for which a qualifying shareholder guarantees.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Interest payments made on loans granted to a Slovene resident company by a resident in a so-called low-tax jurisdiction are not tax deductible. According to the Slovene Corporate Income Tax Act, non-EU Member States with a general nominal tax rate lower than 12.5% fall within the scope of the definition of a low-tax jurisdiction. The Slovene Ministry of Finance compiles and publishes an official list of low-tax jurisdiction States.

At this point, it also must be highlighted that the arm's length principle should be taken into consideration in order for interest payments to associated entities to be fully deductible for tax purposes.

3.8 Does Slovenia have transfer pricing rules?

The Slovenian Corporate Income Tax Act provides for detailed transfer pricing rules, which very closely follow the OECD Guidelines.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Since 1 January 2010, a flat corporate income tax rate of 20% applies to all corporations. Subject to specific conditions, a reduced 0% corporate income tax rate may apply.

4.2 When is that tax generally payable?

An advance payment tax is generally paid on a monthly basis throughout the tax year. Each monthly advance payment amounts to one-twelfth of the tax liability determined in the tax return of the previous year.

The difference between the cumulative advance payments carried out within the relevant tax year, and the tax liability determined in the tax return filed for the respective tax year, must be paid within 30 days from the filing of the tax return.

The annual corporate income tax return must be filed within 3 months subsequent to the end of the tax year, which may differ from the calendar year.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In principle, a company's net income, therefore taxable basis, is determined in accordance to Slovene accounting principles and provided for in the company's financial statements. Slovene tax law however, provides for several adjustments for tax purposes, e.g. restrictions on the deduction of certain business expenses. As a general rule, expenses incurred in connection with the company's business activities, which fall within the definition of expenses that are commonly incurred in usual business practice, are tax-deductible.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

As stated above, expenses must be incurred in connection to the company's business activities. Expenses are considered not to be in connection with the company's business if they are not usually incurred in business practice, if they are not necessary for the company's business, or if they are of a private nature. More specific rules apply to the determination of the tax deductibility of expenses in certain cases, e.g. claim write-offs are recognised as deductible expenditures for tax purposes, only if the taxpayer has exercised all available means of collection thereof.

Furthermore, another main difference is provided with regards to dividends and capital gains. In general, subject to certain conditions, dividends which are conferred upon a resident company from a resident or non-resident, are not subject to a corporate income tax at the level of corporate shareholders. This general rule, however, does not apply if the dividends are paid by residents of low-tax jurisdictions.

4.5 Are there any tax grouping rules? Do these allow for relief in Slovenia for losses of overseas subsidiaries?

Slovene regulations do not provide for tax grouping rules.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

The same tax rate is levied upon both types of profits.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The Slovene system of property tax is currently being reformed and the new tax is expected to be implemented in the following years. Currently, property is taxed by three separate local and/or national taxes and dues, depending on the circumstances pertaining to each specific case.

4.8 Are there any local taxes not dealt with in answers to other questions?

The current property tax, which is applicable both to natural and legal persons who hold real estate, is a local tax. The tax is levied on the property value as determined by law. Property tax is levied at progressive rates, from 0.10% to 1.50%, as set by local municipalities.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

In Slovenia, there is no separate capital gains tax applicable to businesses. Capital gains are therefore considered as normal business income and are thus subject to corporate income tax.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains are generally subject to corporate income tax at the 20% rate, unless the conditions for the exemption are fulfilled (see question 5.3).

5.3 Is there a participation exemption?

The Slovenian Corporate Income Tax contains a participation exemption which applies to capital gains or losses resulting from the disposal of a qualified participation. Pursuant thereto, a resident company or the permanent establishment of a non-resident company is entitled to exclude 50% of the capital gains realised from the disposal of shares or other capital participations from the taxable base, provided that:

- the shares represent a participation of at least 8% of the capital or voting rights of the company;
- the shares have been held for at least six months;
- during the holding period, at least one person was employed by the taxpayer; and
- the participation is not in a company resident in a low-tax country.

Similar to dividends, 5% of related expenses are tax non-deductible.

5.4 Is there any special relief for reinvestment?

No specific relief is available for reinvested profits. However, companies can claim a tax deduction amounting to 30% of the amount invested in equipment and intangible assets. The relevant deduction may not exceed EUR 30,000, nor the taxable base. Any unused credit may be carried forward for five tax years.

Moreover, companies can also claim a tax deduction for 40% of the amount invested in research and development activities, whether these activities are carried out within the company or outsourced. The tax deduction may not, however, exceed the taxable base of the year in which the investments were carried out. Taxpayers carrying out their business activities in a region where the gross domestic product *per capita* (GDP *per capita*) is up to 15% lower than the average national GDP *per capita*, may claim a tax deduction for 50% of the amount invested in research and development. The amount claimed may increase to 60% of the invested amount, if the GDP *per capita* in the region where the company's business activities are carried out is more than 15% lower than the respective national average.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

No taxes or fees, apart from those connected to the registration of the subsidiary, are imposed upon the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Currently no such taxes or fees apply.

6.3 How would the taxable profits of a local branch be determined?

The determination of the taxable profit of a branch will generally be relevant only when the branch constitutes a permanent establishment for corporate income tax purposes. In this case, the Slovenian Corporate Income Tax Act states that the profit of a permanent establishment is the profit that would be attributed to it if it were an independent company performing the same or a similar activity or transaction.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Slovene regulations do not provide for a branch profits or similar tax applicable to branches. Profits attributable to such permanent establishment are subject to the standard corporate income tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

Under Slovenian tax law, a branch is not considered as a taxable entity for corporate income tax purposes and thus it is also not considered as a person entitled to tax treaty benefits.

However, if a branch qualifies as a permanent establishment within the meaning of a double taxation treaty, the treaty's non-discrimination provision may be relevant.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There is no withholding tax levied on the remittance of profits by the branch to the head office.

7 Overseas Profits

7.1 Does Slovenia tax profits earned in overseas branches?

Yes, residents are subject to worldwide income (including profits of branches). Slovenia grants a tax credit.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

When calculating the tax base, the taxpayer (local company) may exempt received dividends and other similar income, except hidden reserves, if the payer is:

- a resident of an EU Member State for tax purposes in accordance with the law of such Member State and is not deemed a resident outside the EU in accordance with an international treaty on the avoidance of double taxation concluded with a non-Member State, and is a taxpayer subject to one of the taxes in connection with which the common system of taxation applying to parent companies and subsidiaries from different EU Member States, whereby a company that is exempt from tax or that has the possibility of a choice of taxation, shall not be deemed to be a taxpayer; or
- liable to pay tax comparable to the tax according to this Act and is not a resident of the country – or in the case of a business unit, not situated in the country – in which the general average nominal level of tax on corporate profits is less than 12.5%.

7.3 Does Slovenia have "controlled foreign company" rules and if so when do these apply?

No, there are not.

8 Anti-avoidance

8.1 Does Slovenia have a general anti-avoidance rule?

Slovenia does not a special anti-avoidance rules as such. However, in general, the substance-over-form rule applies, while in the case of fictitious transactions, the underlying transaction is deemed to be effective from a tax perspective. Moreover, taxable persons are required to disclose certain data, which may affect the perceived risk relating to the taxable person by the tax authorities, in their annual corporate income tax returns. The tax authorities may base their investigation strategies on the submitted information.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No, there are not.

Blaž Pate, LL.M.

Leitner + Leitner, d.o.o.
Dunajska cesta 159
1000 Ljubljana
Slovenia

Tel: *+386 1 563 6750*
Fax: *+386 1 563 6789*
Email: *blaz.bate@leitnetleitner.si*
URL: *www.leitnerleitner.com*

Mr. Blaž Pate, dipl.iur. (University of Ljubljana) and LL.M. (Vienna University, programme in International Tax Law) is manager at Leitner+Leitner, d.o.o. in Ljubljana. Mr. Blaž Pate specialises in international tax and business law (in particular M&A transactions). Mr. Blaž Pate primarily serves international clients. Mr. Blaž Pate is a well-known lecturer in Slovenia and he publishes articles and books dealing with the international tax law. Before joining Leitner+Leitner, Mr. Blaž Pate worked as a lawyer.

leitner leitner

Leitner + Leitner, d.o.o. is a full-service tax and legal firm providing a broad range of advisory services. The firm's main expertises are in the field of Tax and Corporate law. The firm has offered complete tax and legal support in numerous M&A and other international deals.

Spain

Alejandro Escoda

Andreas Trost

Cuatrecasas, Gonçalves Pereira

1 General: Treaties

1.1 How many income tax treaties are currently in force in Spain?

There are 83 tax treaties in force in Spain as of October 4, 2011. In addition, there are currently 10 tax treaties in the Spanish parliamentary procedure.

1.2 Do they generally follow the OECD or another model?

The Spanish tax treaties do generally follow the OECD model, except for royalties and capital gains purposes, since most of the Spanish tax treaties reserve the right to tax royalties at source and several Spanish tax treaties provide the right to tax gains from the alienation of shares or other rights forming part of a substantial participation in a company or from real estate companies.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Tax treaties must be approved by the Spanish Parliament and published in the Spanish Official Gazette in order to be effective in Spain.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Spanish tax treaties usually do not include limitation of benefits articles (exceptions are the US and Malta treaties). However, a large number of them have anti-treaty shopping rules and some of these contain provisions which exclude from its application certain companies or territories that benefit from special regimes.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Tax treaties cannot be overridden by any rules of domestic legislation. The tax treaties prevail over the Spanish domestic legislation. This principle is enshrined in the Spanish Constitution.

2 Transaction Taxes

2.1 Are there any documentary taxes in Spain?

Stamp duty is levied on notarial deeds, certain corporate documents (such as promissory notes, bonds, transferable deposit certificates, etc.) and certain administrative documents formalised in Spain or those that have legal or economic effects in Spain. A fixed rate, which is usually not significant, applies in most cases. In addition, when the documents refer to a valuable object that may be registered in a public register (i.e. commercial or property register), a variable tax rate ranging from 0.5% to 2% may apply.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

VAT is levied in Spain. Spanish VAT follows the guidelines of the European Directives and it is levied in the Spanish peninsula and on the Balearic Islands. Certain areas such as Ceuta, Melilla and the Canary Islands are excluded from the geographical scope of Spanish VAT.

The applicable VAT rates are the following: (i) a standard rate of 18%; (ii) a reduced rate of 8%; and (iii) a super-reduced rate of 4%.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Spanish VAT is generally charged on: (i) supplies of goods and services performed by individual or corporate entrepreneurs within the territory of application of Spanish VAT; (ii) intra-EU acquisitions of goods; and (iii) importation of goods.

However, some transactions are not subject to Spanish VAT (e.g. transfer of a whole business) and some others are considered exempt (e.g. second and subsequent transfers of buildings and rental of dwellings).

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Spanish VAT is not always fully recoverable by all businesses. Spanish VAT is recoverable according to a *pro-rata* basis, based on the existent proportion between: (i) performed transactions by an entrepreneur on which Spanish VAT is levied; in respect to (ii) all transactions performed by an entrepreneur.

2.5 Are there any other transaction taxes?

Transfer tax is levied on the transfer of rights and assets located in Spain if such transfers are not taxed with Spanish VAT. The transfer tax rate applicable to real estate is generally 6%, except otherwise provided by the autonomous region where the real estate is located (most of them have established a 7% rate, however in 2010 some autonomous regions increased the rate up to 8%). The transfer of an entity's shares may be subject to transfer tax if more than 50% of its assets' market value consists of real estate properties located in Spain.

Capital tax is levied on share capital reductions at a 1% rate. Since December 3, 2010 there has been a capital tax exemption on share capital increases, incorporation of Spanish companies, contributions to Spanish companies that do not lead to a share capital increase and immigration of non-EU-companies (immigrations of EU-companies are not subject to Spanish capital tax).

An indirect tax similar to Spanish VAT applies in the Canary Islands, known as IGIC (*Impuesto General Indirecto Canario*). This is levied on: (i) supplies of goods and services performed by individuals or corporate entrepreneurs within the Canary Islands; and (ii) on the importation of goods to the Canary Islands. Another similar tax (IPSI) is levied in Ceuta and Melilla.

2.6 Are there any other indirect taxes of which we should be aware?

The most relevant of the other indirect taxes levied in Spain are the following:

- Special taxes on the manufacture and importation of alcoholic drinks or products, hydrocarbons, tobacco products and electricity, to Spain.
- Special taxes on registration of certain means of transport (i.e. registry tax for vehicles).
- Special taxes on certain hydrocarbons.
- Insurance premium taxes.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

According to Spanish domestic legislation, a 19% withholding tax rate is levied on outbound dividends. However, dividends paid by a Spanish subsidiary to an EU resident company may be exempt from withholding taxes in Spain if the requirements of the Spanish implementation of the EU Parent-Subsidiary Directive, summarised below, are met:

a) Both companies must be subject to and not exempt from a tax levied on corporate profits.

b) The profit distributed may not derive from the liquidation of the Spanish subsidiary.

c) Both companies must have one of the corporate forms that are mentioned in the annex of the EU Parent-Subsidiary Directive.

d) The parent company must hold at least a 5% direct participation in the share capital of the Spanish subsidiary, within the one-year period before the profit that is distributed becomes due (commitment is accepted).

However, this last requirement is also considered to be fulfilled if a 3% direct participation is held by the parent company and this participation reduction is due to a reorganisation transaction, subject to the Spanish implementation of the EU Merger Directive or a takeover bid. In these particular cases, the outbound dividends would be exempt from withholding taxes in Spain in the three years following the date on which such transaction was performed, provided that in the year in which the dividend is distributed the participation in the Spanish subsidiary is not fully transferred and the participation does not fall below 3%.

This regime does not apply if the majority of the voting rights of the parent company are owned, directly or indirectly, by individuals or companies that are not resident in an EU Member State, except if the parent company develops a business activity directly related to the business activity developed by the Spanish subsidiary, or its legal purpose is the administration and management of the Spanish subsidiary through the appropriate organisation of personal and material means, or it can be proved that it was incorporated for valid economic reasons and not only to benefit from this special regime.

As per an Agreement signed between the EU and Switzerland, dividends paid by a Spanish company to a Swiss company are not subject to withholding taxes in Spain under similar conditions as those laid down in the EU Parent-Subsidiary Directive.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

According to Spanish domestic legislation, a 24% withholding tax rate is levied on royalties paid by a local company to a non-resident.

However, as of July 1, 2011, royalty payments made by Spanish companies to EU resident companies are exempt from withholding taxes in Spain as per the Spanish implementation of the EU Interest and Royalties Directive. This special regime applies to royalty payments made by a Spanish-resident entity or by a permanent establishment located in Spain of an entity resident in another EU Member State, provided that the beneficial owner of the royalties is a company resident in another Member State or a permanent establishment located in another EU Member State of a company resident in another EU Member State, under the following requirements:

a) Both companies must be subject to and not exempt from a tax levied on corporate profits.

b) Both companies must have one of the corporate forms that are mentioned in the annex of the EU Interest and Royalties Directive.

c) Both companies must be EU tax residents and must not be considered resident of a third state by the provisions of a tax treaty with this third state.

d) Both companies must be associated. Two companies are considered to be associated if: (a) one of them holds directly at least 25% of the share capital of the other; or (b) a third EU company holds directly at least 25% of the share capital of the two companies. In both cases, a continuous minimum holding period of 1 year is required.

e) Royalties must be tax deductible in the Member State where the permanent establishment paying them is located.

f) The company that receives the royalties must receive them in its own benefit and not as an intermediary or authorised agent of another person and, being a permanent establishment; the amounts received must be effectively related with its activity and must be considered when determining the permanent establishment tax base.

This regime does not apply if the majority of the voting rights of the entity receiving the payment are owned, directly or indirectly, by individuals or companies not resident in an EU Member State, except if it can be proved that such entity was incorporated under valid economic reasons and not only to benefit this special regime.

Spain

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

According to Spanish domestic legislation, as a general rule, a withholding tax rate of 19% is levied on interest paid by a local company to a non-resident. However, no withholding taxes are levied on interest payments made by a local company to EU residents (whether individuals or entities) or EU-based permanent establishments of EU residents.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Thin capitalisation rules are provided by the Spanish Corporate Income Tax (CIT) legislation. These rules apply when the direct or indirect net interest-bearing borrowing from non-Spanish but related parties (excluding banks), exceeds, on average during the tax period, a 3:1 debt-to-equity ratio.

However, thin capitalisation rules do not apply to debt owed to non-resident related entities that are resident in an EU Member State, unless located in a country qualifying as a tax haven.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

The law establishes a 3:1 debt-to-equity ratio as safe harbour. Taxpayers may apply to the tax authorities for a higher debt-to-equity ratio, under an advanced pricing agreement (APA) scheme, unless the lender is resident in a tax haven country.

Loans granted between related parties shall follow Spanish transfer pricing rules (described in question 3.8 below); otherwise, the tax relief for that interest exceeding market value may be challenged by the Spanish tax authorities.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Thin capitalisation rules may extend to debt advanced by a third party but guaranteed by a parent company. If the loan granted by a related entity resident in an EU Member State is guaranteed or in turn granted by an entity which is not resident in the EU, thin capitalisation rules may also apply.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no other restrictions in addition to thin capitalisation rules and transfer pricing rules applicable on tax relief for interest payments by a local company to a non-resident.

3.8 Does Spain have transfer pricing rules?

Spanish CIT legislation has provided for new transfer pricing rules since December 2006. According to this legislation, transactions between related parties must follow the arm's length principle. Spanish transfer pricing methods are fully consistent with OECD transfer pricing guidelines. The preferential methods are the following: (i) comparable uncontrolled price; (ii) cost plus; and (iii) resale price. Alternative methods, in case the complexity of the information concerning the transactions prevents proper application of the above-mentioned methods, are the following: (i) profit split method; and (ii) transactional net margin method.

Documentation requirements concerning the set up of prices and conditions for related parties' transactions are provided for these purposes, as of February 19, 2009. Penalties may be charged if such documentation requirements are not fulfilled.

However, documentation requirements are not required for:

(a) Those companies with an annual turnover not exceeding €8,000,000 when the overall amount of the transactions performed with related parties does not exceed €100,000 annually.

(b) Transactions with related parties when the overall amount of the transactions performed during the tax year does not exceed €250,000.

However, certain transactions are not affected by the above-mentioned threshold, and are always subject to documentation requirements: transactions with tax-haven residents (with some exceptions); transactions carried out by certain entrepreneurs with certain related parties; transactions to transfer businesses, shares or stakes in non-listed entities; and transactions to transfer real estate or intangible assets.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The general tax rate for Spanish CIT purposes is 30%.

Small companies (turnover of the previous tax year below €10,000,000) benefit from a reduced rate of 25% that applies on the first €300,000 of profit. The excess is taxed at the general tax rate. As of January 1, 2011, companies that in the past qualified as "small companies" are still able to apply the reduced rate for the three following tax years.

CIT taxpayers that contribute to the maintenance or creation of employment under certain requirements benefit from a reduced tax rate of 20% on the first €120,202.41 of profit and the excess is taxed at a 25% rate. This special benefit ends in tax year 2011.

However, specific tax rates apply to certain companies, among others:

- Oil companies are taxed at a 35% rate.
- Insurance and credit companies are taxed at a 25% rate.
- Cooperatives are taxed at a 20% rate.
- Collective investment vehicles (such as mutual funds) are taxed at a 1% rate. As of January 1, 2010, dividends and other participations in profits derived by non-resident collective investment vehicles resident in another EU Member State and without a permanent establishment in Spain, that qualify as Undertakings for Collective Investment in Transferable Securities (UCITS) within the ambit of Directive 2009/65/CE of July, 13, 2009, are also taxed at a 1% rate.
- Pension funds are taxed at a 0% rate.

4.2 When is that tax generally payable?

CIT is payable within the first twenty-five calendar days following the six-month period after the end of the relevant tax period.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for CIT purposes is the profit according to commercial accounts, which is determined according to Spanish accounting rules, subject to certain tax adjustments set out by CIT legislation.

With effect for tax periods beginning as of January 1, 2012, net operating losses from previous tax years may be off-set against the tax base within a period of 18 years (instead of 15 years) as from its tax year of generation.

Certain limitations to the off-set of net operating tax losses apply in 2011, 2012 and 2013, to those companies with a turnover above €20,000,000 in the previous tax years, respectively.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main tax adjustments to the profits shown in commercial accounts are due to the following tax limitations:

- Asset depreciation is limited to a certain maximum annual rate depending on the type of asset. However, new material and real estate assets acquired in tax years 2011, 2012, 2013, 2014 and 2015 may be freely depreciated for tax purposes, even if not depreciated for accounting purposes.
- Certain expenses are not deductible for tax purposes (i.e. gifts, corporate income tax expenses, penalties, etc.).
- Provisions for bad debts are generally deductible for tax purposes when a period of six months has elapsed since the due date for payment.
- Portfolio depreciation provisions may not exceed the difference between the net book value at the beginning and at the end of the tax year of the subsidiary, taking into account the contributions and returns of contributions made during the tax year. Depreciation of tax haven subsidiaries is only deductible if such entities consolidate their accounts with the Spanish parent.
- Provisions for the decline of value of fixed return securities listed in organised secondary markets are tax deductible up to a limit of the overall decline in value undergone during the tax period by the fixed return securities owned by the taxpayer which are listed on such markets.
- Provisions to cover the decline in value of publishing, phonographic and audiovisual funds belonging to entities which carry on the corresponding production activity are only tax deductible when two years have elapsed since the respective productions were placed on the market.

4.5 Are there any tax grouping rules? Do these allow for relief in Spain for losses of overseas subsidiaries?

There are tax grouping rules in Spain, according to which the entities that belong to the tax group are taxed on a consolidated tax base.

The main aspects to be considered with regard to the tax grouping regime are the following: (i) the controlling entity (which may also be a permanent establishment) must hold a minimum, direct or indirect, participation of 75% in the dependent entities' share capital; (ii) all entities must be subject and not exempt from CIT and taxed at the same rate; (iii) the controlling entity may not be controlled by a Spanish resident entity which in turn may be considered a controlling entity; (iv) all entities must have the same tax period; and (v) entities in bankruptcy cannot belong to the tax group.

Application for this special tax regime must take place before the start of the tax year in which the tax group regime shall apply.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Tax is imposed at the same rate upon distributed profits and retained earnings (30%).

Dividends distributed by a Spanish resident company to another Spanish resident company are taxed at the level of the recipient at the general CIT rate of 30%. In order to avoid double taxation, the recipient is entitled to a 50% tax credit of the CIT due corresponding to such dividends. If such dividends derive from a participation of at least 5%, that has been held uninterruptedly during the year prior to the dividend distribution date, the tax credit is of 100% of the CIT due. This tax credit also applies to dividends derived from a direct participation of at least 3%, under the circumstances described under question 3.1 above.

Capital gains derived by a Spanish resident company from the transfer of a participation in a Spanish resident company are taxed at the level of the transferor at the general CIT rate of 30%. In order to avoid double taxation, the transferor is entitled to a tax credit of 100% of the retained earnings generated during the holding period of the participation if the capital gain derives from the transfer of a participation of at least 5% that has been held uninterruptedly during the year prior to the transfer.

4.7 Are there other national and generally applicable taxes (excluding those dealt with in "Transaction Taxes", above) - e.g. property taxes, etc.?

Net worth tax is not levied in Spain on the net worth of companies.

4.8 Are there any local taxes not dealt with in answers to other questions?

The main local taxes are the following:

- Tax on economic activities: annual tax levied on the development of economic activities within the Spanish territory. CIT taxpayers with a turnover below €1 million are exempt.
- Tax on real estate: annual real estate property tax levied on the ownership of real estate. The tax base is the "cadastral value", which is a value established by the local authorities, which basically depends on the location of the real estate property. The general tax rate ranges from 0.3% to 1.10%. This may be raised by the local authorities.
- Business tax on income: annual tax levied on registered legal persons conducting business, professional or artistic activities in Spain.
- Tax on urban land appreciation: tax levied on the increase in value of land classified as urban land. It becomes due when a property transfer takes place. The tax base is based on the "cadastral value" and the holding period of the urban land.
- Tax on construction and instalation projects: tax levied on those constructions done in a municipality, for which a licence is required.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There are no special rules for taxing capital gains and losses.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Capital gains are taxed as business profits at the general corporate income tax rate.

5.3 Is there a participation exemption?

Capital gains derived from the transfer of a participation in a non-resident company may be exempt if the requirements summarised below are fulfilled during the whole shareholding period:

- A direct or indirect participation of at least 5% in a non-resident company has been held for one year prior to its transfer.
- The non-resident company is subject to a tax comparable to Spanish CIT. This requirement is deemed to be met if the non-resident company is resident in a jurisdiction with which Spain has signed a tax treaty.
- At least 85% of the profits of the non-resident company derive from business activities in a foreign country other than a tax haven.

Limitations to the exempt capital gain apply under the following circumstances:

- If at least 15% of the assets of the non-resident company are located in Spain.
- If the acquisition value of the non-resident company was adjusted for tax purposes.
- If the stake in the non-resident company was acquired to a related entity that deducted a loss as a result.
- If in a previous transfer the stake in the non-resident company was valued according to the special rules provided by the Spanish implementation of the EU Merger Directive, and lead to no taxation.

5.4 Is there any special relief for reinvestment?

The Spanish CIT legislation provides for a 12% rollover relief, applicable to the capital gain derived from the transfer of certain assets, as long as the transfer value is reinvested in certain assets. The reinvestment must take place within a period of 1 year prior to the transfer and 3 years after the transfer.

The transfer of the following assets is eligible for the rollover relief:

- Tangible or intangible assets used for business activities for an uninterrupted period of one year within the three years prior to the transfer.
- Participation interest of at least 5%, held for at least 1 year prior to the transfer.

The proceeds from the transfer must be reinvested in the following assets which must be held for a 3-year period (real estate assets must be held for 5 years):

- Tangible or intangible assets used for business activities within the reinvestment period.
- Participation interest of at least 5% (certain limitations apply to reinvestment in certain entities).

Assets acquired from related parties do not qualify for reinvestment, except for new tangible assets or real estate investments.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

The incorporation of either a branch or a subsidiary is subject to 1% capital duty. However, since December 3, 2010 a capital tax exemption applies.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are not any significant taxes or fees that would be incurred by a locally-formed subsidiary but not by a branch of a non-resident company.

6.3 How would the taxable profits of a local branch be determined?

For tax purposes, a Spanish branch office of a foreign company is considered a permanent establishment in Spain. The branch office is subject to Non-Resident Income Tax.

The taxable profits of a local branch are determined in accordance with similar rules to those applicable to Spanish entities. The tax base is based on the commercial profit and the application of some tax adjustments.

However, there are certain limitations to the tax deductibility of a branch's expenses and which are summarised below:

- Payments made by a branch to its headquarters for royalties, interest, or commissions, in exchange for technical assistance or for the use of other assets or rights, are not deductible. Notwithstanding the above, interest paid by a branch of a foreign bank to its headquarters or to other permanent establishments, in order to carry out their activity, are tax deductible.
- The reasonable amount of management and general administrative expenses which correspond to the permanent establishment are deductible, provided that the following requirements are met:
  - Registration in its accounting statements.
  - Evidence of the distribution amounts, criteria and modules adopted.
  - Rationality and continuity of the allocation criteria adopted.
  - The costs of the own capital of the entity assigned, directly or indirectly, to the branch are not tax deductible.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Profits obtained by a branch are subject to a 19% branch tax when paid to its head office. However, such tax is not levied if the head office is located in an EU Member State (except if it is a tax haven jurisdiction) or in a country that has entered into a tax treaty with Spain (unless such tax treaty expressly entitles to charge this tax).

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A Spanish branch may only benefit from some of the provisions of the tax treaties entered into by Spain (i.e. mechanisms to avoid double taxation).

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Profits remitted by a Spanish branch to its head office are subject to withholding taxes in Spain in the same terms as dividends paid by a Spanish subsidiary to its parent company (see question 6.4 above).

7 Overseas Profits

7.1 Does Spain tax profits earned in overseas branches?

Profits earned in overseas branches are subject to Spanish CIT.

However, a direct tax credit for foreign taxes paid abroad (juridical double taxation) may apply. For this purposes, income from different permanent establishments, even if they are located in the same country, must be computed separately. This tax credit is limited to the equivalent Spanish tax that would be paid on such income if it was obtained in Spain. Any excess may be carried forward for 10 years.

However, a domestic exemption may apply if the following requirements are met:

- at least 85% of the income obtained by the permanent establishment is derived from business activities carried out outside the Spanish territory; and
- the permanent establishment has been subject to a tax comparable to Spanish CIT. This condition is deemed to be met if the permanent establishment is established in a country with which Spain has concluded a tax treaty, as long as the tax treaty includes an exchange of information clause.

7.2 Is tax imposed on the receipt of dividends from non-resident companies?

Dividends from non-resident companies are subject to Spanish CIT. A direct tax credit for foreign taxes paid abroad (juridical double taxation), in the terms described under question 7.1 above, may also apply.

Furthermore, in case of dividends distributed by non-resident subsidiaries in which the Spanish corporate taxpayer holds a direct or indirect participation in the share capital of at least 5%, an underlying tax credit will be granted with respect to those taxes paid by foreign subsidiaries on the profits which generated such dividends (economic double taxation). For these purposes, the participation must have been held for an uninterrupted period of one year on the date the dividend is due (or the company must commit itself to hold such participation for at least one year in case it had not been completed on such date).

Both tax credits for the avoidance of the juridical and economic double taxation are limited to the equivalent Spanish tax that would be paid on such income if it was obtained in Spain.

However, such dividends may be exempt from Spanish CIT if they fulfil the requirements provided under the participation exemption regime described under question 5.3 above.

7.3 Does Spain have "controlled foreign company" rules and if so when do these apply?

Controlled foreign company (CFC) rules are provided in Spanish CIT legislation. According to these, companies may be taxed in Spain with regard to passive income obtained by CFC, even though this income is not distributed to its shareholders, when the following requirements are met:

a) The CFC is resident in a low tax jurisdiction, meaning a jurisdiction with a corporate income tax rate of less than 22.5% (i.e., 75% of Spanish CIT rate). Spanish CIT legislation on CFCs does not apply to entities resident in EU Member States, provided that the taxpayer proves that the incorporation of the company was based on economic reasons and that this carries out business activities.

b) The resident taxpayer individual owns, directly or indirectly, alone or together with a related party, a share of at least 50% in the CFC. This percentage refers to capital, equity, results or voting rights in the CFC.

c) The CFC obtains passive income.

According to CIT legislation, passive income is income derived from the following sources:

(i) Real estate properties or rights over them, unless they are used for business activities or rented to related non-resident companies.

(ii) Dividends or other profit distributions, interest income and similar.

(iii) Credit, financial, insurance and service activities performed directly or indirectly with related individuals or entities resident in Spain, and which imply tax deductible expenses for the latter, except those related to export activities.

However, when more than 50% of the CFC's income from credit, financial, insurance and service activities comes from transactions with non-related individuals or entities (except from those related with export activities), it is not considered passive income.

The amount of positive income to be attributed to the shareholder must be determined according to the principles and criteria established in CIT legislation.

Finally, if the CFC is resident in a tax haven jurisdiction, it is presumed that: (i) its CIT rate is below 75% of Spanish CIT rate; (ii) it obtains passive income; and (iii) the income obtained by the CFC is 15% of the acquisition value of the CFC participation. However, these presumptions are refutable if the contrary is proved by the taxpayer.

8 Anti-avoidance

8.1 Does Spain have a general anti-avoidance rule?

New legislation entered into force in 2006 in Spain in order to prevent tax avoidance. This new legislation, among others, sets up new regulations regarding transactions between related parties and new scenarios under which companies incorporated in tax haven jurisdictions would be deemed tax resident in Spain.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

There are no general anti-avoidance rules or disclosure rules imposing a requirement to disclose avoidance schemes in advance of the company's tax return being submitted. However, the Spanish tax legislation provides some anti-avoidance rules with the aim to avoid tax fraud. These anti-avoidance rules entitle the Spanish tax authorities to issue the relevant tax assessments attending to the real facts and circumstances of the transactions performed by the taxpayers, irrespective of the qualification given by them.

Alejandro Escoda

Cuatrecasas, Gonçalves Pereira
Paseo de Gracia, 111
08008 - Barcelona
Spain

Tel: *+34 932 905 544*
Fax: *+34 932 905 555*
Email: *alejandro.escoda@cuatrecasas.com*
URL: *www.cuatrecasas.com*

Mr. Escoda joined the law firm Cuatrecasas, Gonçalves Pereira in 1986 and was appointed partner in 1996. He is extensively experienced in international mergers and acquisitions, cross-border investments, international reorganizations, designing holding and financial structures for international groups and planning multinational assets. He has been recommended by several directories, including Chambers Global, Chambers Europe, Plc Which Lawyer, Expert Guides, Who´s Who Legal, European Legal Experts, Best Lawyers, Legal 500, International Tax Review and Tax Directors Handbooks in Tax.
He is former Co-Chair of the Tax Section at the International Bar Association (IBA). He is also member of the Bar Association, the International Fiscal Association (IFA) and the European-American Tax Institute (E-ATI).
He has participated in and spoken at various seminars on international tax and has written several articles on this topic.
Mr. Escoda speaks English, French, Italian and Spanish.

Andreas Trost

Cuatrecasas, Gonçalves Pereira
Paseo de Gracia, 111
08008 - Barcelona
Spain

Tel: *+34 932 905 544*
Fax: *+34 932 905 555*
Email: *andreas.trost@cuatrecasas.com*
URL: *www.cuatrecasas.com*

Mr. Trost specialises in advising Spanish and foreign multinationals, venture-capital entities and investment funds, particularly on the international tax planning of their cross-border investments. He has vast experience advising on mergers and acquisitions and the restructuring of multinational groups. He also advises high net-worth clients with international interests. He has been recommended by several directories, including Best Lawyers or Who´s Who Legal in Tax for his excellent work.
Mr. Trost studied Law at the *Universitat de Barcelona*. He then completed a Masters in European and International Trade Law (LL.M.) at the University of Leicester in the United Kingdom in 1994. He lectured at *Universitat Pompeu Fabra* from 1994 to 2003, co-wrote various books on international taxation, and frequently speaks on postgraduate courses and at seminars on international taxation. Mr. Trost is a member of the Bar Association. He has also been a member of the International Fiscal Association since 1994.
Mr. Trost speaks English, French, German and Spanish.

CUATRECASAS, GONÇALVES PEREIRA

"EUROPEAN LAW FIRM OF THE YEAR" (The Lawyer, 2011)

With almost a century of professional practice, 25 offices worldwide, over 950 lawyers and an excellent reputation, Cuatrecasas, Gonçalves Pereira is a leading international benchmark for all legal issues in Spain and Portugal.

Deeply rooted in the Iberian business world, the firm advises, year after year, on some of the most strategic transactions in these markets. Some of its clients are leading companies on the Iberian Peninsula: the firm represents over 70% of the leading listed Spanish (Ibex 35) and Portuguese (PSI20) companies, and several companies listed on the Euro Stoxx 50 index.

The Corporate Tax Practice, one of the most renowned and largest in the Iberian market, with more than 300 lawyers in Spain and Portugal, has advised some of the most relevant and largest companies in Spain and Portugal on tax matters for many years. Its work is recognised by prestigious legal directories, nationally and internationally, on a yearly basis.

Chapter 39

Sri Lanka

Naomal Goonewardena

Sheranka Madanayake

Nithya Partners

1 General: Treaties

1.1 How many income tax treaties are currently in force in Sri Lanka?

Sri Lanka currently has 41 double tax avoidance treaties in force. These include both comprehensive and limited treaties. Comprehensive treaties form the vast majority of such treaties and are in force with the USA, the UK and most of Western Europe, as well as Russia and Australia. Much of Asia including China, India, Japan and Singapore are also covered under such comprehensive treaties as is most of the Middle East. Limited treaties form a small majority of the treaties in force and are currently entered into with Hong Kong, Oman, Jordan and Saudi Arabia, to cover limited areas such as shipping and air transport.

1.2 Do they generally follow the OECD or another model?

The United Nations Model Convention has been broadly followed, subject to certain variations influenced by the OECD Model.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. The income tax legislation (i.e. the Inland Revenue Act No. 10 of 2006, as amended ("IRA")) specifically provides that such treaties need to be approved by a resolution of Parliament and published in the *Gazette* in order for the same to have the force of law in Sri Lanka.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Such articles are generally not incorporated.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

The IRA provides that once the treaty has been approved by a resolution of Parliament, it shall have the force of law in Sri Lanka "notwithstanding anything in other written law". However, it is likely that any subsequent legislation which specifically seeks to amend the treaty would have an overriding effect.

2 Transaction Taxes

2.1 Are there any documentary taxes in Sri Lanka?

Stamp duty is the documentary tax applicable in Sri Lanka and is payable on a number of instruments, including promissory notes, share certificates and share transfer forms, as well as on conveyancing documents such as leases, mortgages, deeds of transfer and deeds of gifts.

The rates of stamp duty vary depending on the type of instrument and are generally ad valorem taxes. Stamp duty on transfers of land is charged on the value of the land at 3% for the first Rs.100,000 and 4% for the remaining value and gifts of land attract stamp duty of 3% for the first Rs.50,000 and 2% thereafter. Mortgages attract a stamp duty of 0.1% of the secured amount and leases are charged at 1% of the lease payments for the entire term, including premiums, up to a maximum term of 20 years.

Stamp duty of 0.5% is payable on the share issue forms and share transfer forms which are necessary documents for valid share issues and share transfers respectively. The rate is applied on the value of the shares issued/transferred and this may or may not be equivalent to the consideration exchanged.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

VAT legislation has been operative in Sri Lanka since 2002 (which replaced the previous GST regime) and is payable (in general) on the supply in Sri Lanka of goods and services and on the importation of goods into Sri Lanka. Currently, the applicable rate is 12% and exports in general are zero-rated.

There is also a special type of VAT, known as "Financial Services VAT", which is chargeable on persons supplying financial services at the rate of 12%. Unlike conventional VAT, however, Financial Services VAT is not payable on the basis of turnover but on a value addition basis.

In addition to VAT, Sri Lanka also has Nation Building Tax (NBT), which came into operation in 2009. It is a tax payable by any person that imports any article (other than personal baggage) into Sri Lanka, carries on the business of manufacture of any article or carries on the business of providing a service of any description. NBT is payable currently at a rate of 2% of the turnover of such person.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

Both VAT and NBT are subject to a vast number of exemptions which are frequently modified.

VAT for example is not chargeable on the supply or import of certain basic commodities and agricultural products. Essential services such as the supply of healthcare, public transport and residential accommodation are also exempted. The wholesale and retail trade is also VAT-exempt.

There is also a Simplified VAT (SVAT) System, whereby suppliers to businesses which are zero-rated are entitled to not charge VAT on transactions with such zero-rated persons, so long as certain formalities are complied with.

NBT is not chargeable on banking or finance services, medical services, electricity and water supplies, transport services, etc.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The excess of input VAT over output VAT can be claimed by persons who are liable to VAT and as long as they are registered under the VAT legislation.

It is important to note that only the VAT that has been paid on the goods or services *used for the purposes of the taxable supply* of such person on which output VAT is paid can be recovered as input VAT. As such, input VAT is not claimable on private expenses.

Input VAT can only be recovered up to a value equivalent to the output VAT of such person. Any excess input VAT can be brought forward to future periods, but again subject to the same restriction that recoverability cannot exceed 100% of output VAT.

Like VAT, NBT paid by manufacturers (although not service providers) may be set off against future NBT payments.

2.5 Are there any other transaction taxes?

Transfer tax is a significant tax that needs to be mentioned. There is a 100% tax payable when a non-Sri Lankan citizen (or company whose non-Sri Lankan shareholding exceeds 25%) buys immoveable property in Sri Lanka. This is subject to a limited number of exceptions, essentially relating to immoveable properties which are transferred to certain Board of Investment-approved enterprises and condominium properties situated on or above the 4th floor.

Other notable taxes are as follows:

- Share Transaction Levy: This levy is charged on share transactions on the Colombo Stock Exchange and is payable by both the buyer and the seller at the rate of 0.2% each on the value of the shares transacted.
- Telecom Industry Levy: A levy of 20% is payable on telecom services.
- Construction Industry Guarantee Fund Levy: This is a levy charged on every construction contractor on the contract value and the rate varies from 0.25% to 1%. There are certain exemptions from this levy available for special projects.

2.6 Are there any other indirect taxes of which we should be aware?

Economic Service Charge (ESC), which is in the nature of a minimum alternative tax, is payable by businesses whose aggregate turnover exceed Rs. 25 Million in one quarter in a year of assessment. ESC is generally charged at 1% but there are concessionary rates of 0.5%, 0.25% and 0.1% for certain industries.

ESC can be set off against the income tax liability of the business in that year of assessment, and where such liability is less than the ESC, it can be brought forward for the next 4 years. As such, ESC is to some extent an advance payment of income tax, although it does apply to non-income tax payers as well.

The other significant indirect tax is customs duty, which is levied at variable rates on all goods, wares and merchandise imported into or exported out of Sri Lanka. There are also a multitude of taxes and levies imposed at import point (which are sometimes product dependent) which are in the nature of excise duties, surcharges and cess, as well as the Ports and Airport Development Levy which could effectively increase the nominal rate of customs duty considerably.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

The IRA provides that a company resident in Sri Lanka must withhold 10% of the gross dividends distributed to its shareholders. There are certain exemptions to this general rule, most notably dividends paid by unit trusts or mutual funds approved by the Securities and Exchange Commission and dividends paid out of profits which arose from dividends received from other Sri Lankan resident companies.

This withholding applies to all shareholders, not just non-residents.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid to a non-resident are chargeable with income tax at the rate of 15% and this is normally levied in the form of a withholding tax.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Interest paid on loans by local companies to persons outside Sri Lanka is taxed at the rate of 15%.

The local company is entitled under the IRA to deduct 20% income tax from any interest on debentures, mortgages, deposits or advances paid to a non-resident, or in the event that a double taxation treaty is in force, at such rate as is specified in such treaty in relation to interest. There is provision for the Commissioner General of Inland Revenue to specify a different rate of withholding, after having regard to the total tax payable in Sri Lanka by such non-resident.

However, interest paid on corporate debt securities (i.e. interest bearing or discounted security issued by or on behalf of any company) is only subject to a withholding of 10%.

Furthermore, the following is exempted from the withholding provisions altogether:

- Interest paid out of income that did not arise in Sri Lanka.
- Interest on any loan or advance made by a banker.
- Interest paid to any person on moneys lying to his credit in foreign currency with any foreign currency banking unit.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Interest paid by a company on loans received from other members of its group is only tax deductible to the extent that such interest does not exceed 4 times the aggregate of its share capital and reserves. Where such subsidiary is a manufacturing company, the allowable deduction is restricted to 3 times the aggregate of its share capital and reserves.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There are no "safe harbour" rules.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

The current "thin capitalisation" regime does not extend to such debts.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no further restrictions.

3.8 Does Sri Lanka have transfer pricing rules?

Yes, the IRA specifically provides that transactions entered into between two associated undertakings shall be ascertained having regard to the arm's length price.

The Commissioner General has furthermore published detailed Transfer Pricing Regulations which provides for methods of ascertaining the arms' length price, assessing comparability and specifying the necessary records to be kept. The enforceability of these Regulations at present is however minimal.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The highest tax bracket generally is 28%. However, the import and sale or the manufacture and sale of liquor and tobacco products is taxed at 40%.

4.2 When is that tax generally payable?

The year of assessment in Sri Lanka is from the 1st of April in a given year to the 31st of March in the immediately succeeding year.

Income tax is payable on a self-assessment basis in four quarterly instalments on or before 15th August, 15th November and 15th February in a given year of assessment and 15th May in the next year of assessment, with the final payment being due on 30th September. The income tax return needs to be filed on or before the 30th of November in the next year of assessment.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for calculating corporate income tax would be the commercial accounts of a company, with adjustments made to comply with the provisions of the IRA.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The main differences would be that certain types of income may be exempt from tax whereas certain types of expenses would not be tax deductible. Furthermore, there may be certain items which are considered as income for tax purposes though not shown in the commercial accounts and certain expenses not shown in the commercial accounts which may be tax deductible.

A significant difference would be depreciation charges in the commercial accounts and the tax deductible capital allowances charged to ascertain taxable income. Only certain types of assets have the benefit of capital allowances and only at specified rates which would differ from the depreciation calculations in the commercial accounts.

With the recent implementation of IFRS in Sri Lanka, these differences may increase.

4.5 Are there any tax grouping rules? Do these allow for relief in Sri Lanka for losses of overseas subsidiaries?

There are no provisions for group relief in Sri Lanka.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, there is no distinction made between distributed and retained profits.

However it should be noted that "Deemed Dividend Tax" is applicable in Sri Lanka. The IRA provides that where a company has distributed less than 10% of its distributable profits in a given year (for clarity, we can call it "Y1"), the company is liable to deemed dividend tax in the next year of assessment (i.e. Y2), at the rate of 15% on 33⅓% the distributable profits of the company in Y1 less the amounts actually paid as dividends in the 18 months starting from the commencement of Y1.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

We have dealt with the more significant taxed in the preceding sections. However, the following may also be noted:

- Tourist Development Levy (TDL) is payable by every institution licensed under the Tourist Development Act No. 14 of 1968 other than travel agents at a rate of 1% on total turnover after deducting VAT and Service Charges.
- Bed Tax: A levy of US$ 20 per bed is chargeable on all five star hotels which charge a room rate of less than US$ 125 per night.
- Liquor Licences: There are annual licence fees imposed on persons who are involved in the sale of liquor.
- Port and Airport Development Levy (PAL) is charged at 5% on CIF value of imports other than specifically exempted articles.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are rates payables at the local authority / municipal level in relation to occupation of immoveable property, based on the assessed value of such property. In addition, a trade/business tax is also payable where a trade or business is being carried on in such property.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

After 1st April 2002, capital gains are no longer subject to taxation. As such, there are no special rules relating to taxing capital gains and losses.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

This is not applicable in Sri Lanka.

5.3 Is there a participation exemption?

This is not applicable in Sri Lanka.

5.4 Is there any special relief for reinvestment?

This is not applicable in Sri Lanka.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are no separate taxes or fees that would be significant, however the incidence of income tax will vary depending on whether it is a locally formed subsidiary or a branch of a non-resident company.

A locally-formed company is deemed to be resident in Sri Lanka and as such is liable to pay income tax on all its profits and income, wherever they arise or derive from, whether in Sri Lanka or overseas. Branches of a non-resident on the other hand would still being considered as non-resident entities and are only taxable on the profits and income arising out of or derived from Sri Lanka.

It should be noted however that the standard Double Taxation Treaty provides for the concept of a "permanent establishment" and it is only if the branch office satisfies such criteria that the profits attributable to such permanent establishment will be subject to income tax in Sri Lanka.

6.3 How would the taxable profits of a local branch be determined?

Taxable profits would be such profits and income arising in or deriving from Sri Lanka. This means that all profits and income derived from services rendered in Sri Lanka or from property in Sri Lanka or from business transacted in Sri Lanka, whether directly or through an agent, would be taxable. Head Office expenses incurred in relation to the branch office would be tax deductible, so far as such expenses do not exceed 10% of the taxable profits of the branch office.

The above is subject to the provisions relating to "permanent establishments" that may be applicable when a standard Double Taxation Treaty is in force.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There are no such taxes currently in force. A branch would be taxed at 28%, which is the corporate rate of income tax in Sri Lanka.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

The tax treaty would only provide for residents of a contracting state to be entitled to treaty relief. Since a branch does not satisfy such criteria, they would not be entitled to the benefit of such tax treaty.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

Profit remittances of a non-resident company are charged with income tax at the rate of 10% of such remittances. This is the liability of the non-resident company in Sri Lanka and the payment is not made as withholding tax.

7 Overseas Profits

7.1 Does Sri Lanka tax profits earned in overseas branches?

Yes. If the company is resident in Sri Lanka, all its profits and income – wherever it arises from – will be subject to income tax in Sri Lanka. As such, the overseas branches will be subject to the same income tax laws. However, there are several exemptions provided in the IRA for activities carried on outside Sri Lanka and for services rendered outside Sri Lanka.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As long as such dividends have been remitted into Sri Lanka through a bank, there will be no tax charged thereon.

7.3 Does Sri Lanka have "controlled foreign company" rules and if so when do these apply?

There are no such rules in force at the moment. However, it should be noted that in the case of a foreign company, if the control and management of its business is exercised in Sri Lanka, such company would be deemed to be resident in Sri Lanka for the purposes of the IRA.

8 Anti-avoidance

8.1 Does Sri Lanka have a general anti-avoidance rule?

There are provisions in the IRA that empower Income Tax Assessors to disregard transactions or dispositions which, in their opinion, are artificial or fictitious and reduce or have the effect of reducing the tax payable by any person and to make assessments accordingly.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

No such requirement exists.

Naomal Goonewardena

Nithya Partners
97A, Galle Road
Colombo 3
Sri Lanka

Tel: +94 11 27 12625
Fax: +94 11 232 8817
Email: fng@nithyapartners.com
URL: www.nithyapartners.com

Naomal Goonewardena is a founding partner of Nithya Partners. He has multidisciplinary qualifications in law and finance and is a leading attorney in financial and tax law in Sri Lanka. He advises companies from various industries on all aspects and types of taxation, especially income tax and VAT. He also represents companies in litigious tax matters.
Prior to joining the firm, he was a Senior Tax Manager at Ernst & Young. He has also been a lecturer in Tax Law at the Sri Lanka Law College since 2003. Furthermore, he is a member of the Committee of Taxation of the Ceylon Chamber of Commerce. He served as a legal advisor to the Board of Review of the Inland Revenue Department from 1998 to 2002.

Sheranka Madanayake

Nithya Partners
97A, Galle Road
Colombo 3
Sri Lanka

Tel: +94 11 271 2625
Fax: +94 11 232 8817
Email: sheranka@nithyapartners.com
URL: www.nithyapartners.com

Sheranka Madanayake, also with a multidisciplinary background of law and finance, joined Nithya Partners in January 2010 after completion of her legal studies. She is attached to the corporate division of the firm and handles commercial matters including mergers and acquisitions, debt markets and project finance. She also assists in tax matters and has been involved in corporate and personal tax structuring and advising, transfer pricing and taxation issues on employee share ownership/option schemes.

Nithya Partners
Attorneys-at-Law

Nithya Partners was established in 1997 with the goal of delivering a modern and responsive service in corporate and financial law. The firm's practice primarily focuses on corporate and financial law and we advise a broad range of local and foreign clients comprising several quoted and unquoted companies, multinationals, financial institutions, investment funds and statutory bodies. Apart from our involvement in some of the largest mergers and acquisitions and corporate restructurings in Sri Lanka in recent times, we have also played a lead role in several loan syndications, debt structuring and securitisations.

The firm's tax practice is the strongest amongst the legal firms in the country and we have consistently been ranked as the No.1 firm for tax in Sri Lanka by *Legal500* and the *Tax Directors Handbook*. The firm has a strong reputation for corporate tax planning expertise, advising clients on complex tax disputes and tax efficient structures and has acted on behalf of clients in a number of high profile tax cases.

Switzerland

Heini Rüdisühli

Jean-Blaise Eckert

Lenz & Staehelin

1 General: Treaties

1.1 How many income tax treaties are currently in force in Switzerland?

As of 30 June 2011 there are 96 income tax treaties in force to which Switzerland is a party. In addition, there are 10 tax treaties on inheritance tax in force, as well as 22 tax treaties on the taxation of maritime and air navigation companies. Please note that Switzerland has not concluded any tax treaty on gift tax, except an agreement with France concerning tax treatment of gifts made for non-profit making purposes. Since January 2010, treaties between Switzerland and Chile, Ghana, Qatar, Georgia and Columbia, respectively, entered into force. Switzerland has signed new agreements with Hong Kong, Malta, Tajikistan, Turkey and Uruguay, which must still be ratified by the relevant authorities before they can enter into force. Treaties with Oman, United Arab Emirates and Peru have all been initialised.

As a result of Article 15 of the agreement between Switzerland and the EU regarding savings tax, Switzerland has been granted equivalent rules to those laid down in the EU parent/subsidiary and interest/royalty directives (i.e. 0% withholding tax). These will apply in relation to all EU Member States, including Cyprus and Malta (Switzerland only recently concluded a double taxation treaty with the latter).

1.2 Do they generally follow the OECD or another model?

Most Swiss treaties follow the OECD model treaty. However, since Switzerland has traditionally had an extensive treaty network, there are some older treaties, such as, for the time being, that with the Netherlands, which do not follow the OECD model treaty. However, as a consequence of the bilateral agreements between Switzerland and the EU, most treaties with EU Member States will be re-negotiated in the near future, or have already been re-negotiated (i.e. the treaty with the Netherlands). Also, the treaty with the United States of America does not follow the OECD model exactly but rather the US model treaty. With respect to the exchange of information, Switzerland originally made a reservation with regard to Article 26 of the OECD model treaty so that the exchange of information would be granted only for the correct application of the treaty.

Since 2004, Switzerland changed its policy with respect to the exchange of information. It then accepted to exchange information in cases of tax fraud and modified its reservation to the OECD model accordingly. As from 2009, Switzerland generally concludes treaties providing for administrative assistance in accordance with Article 26 of the OECD model treaty. Already existing treaties have been revised or are under revision in this respect. The Federal Council furthermore decided in February 2011 that requests for the exchange of information are no longer compelled to indicate the names and addresses of the taxpayer and of the holder of the information if they can be identified by other means and as long as there is no "fishing" for information.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Double taxation treaties entered into by Switzerland do not have to be incorporated into domestic law before they take effect. In accordance with the monist system, international treaties form part of federal law once they have been ratified and thus immediately become valid sources of law. Treaties in general rank before domestic law in the Swiss legal system.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Double taxation treaties entered into by Switzerland do not normally incorporate anti-treaty shopping rules or "limitation of benefits" articles. In 1962 Switzerland enacted unilateral rules to avoid treaty-shopping ("Abuse Decree"). This Abuse Decree contains a number of tests that must be fulfilled by every Swiss resident company in order to be eligible for treaty benefits. Basically, these rules are still in force. However, in 1998 facilitations were introduced for holding companies, active companies and publicly quoted companies. In August 2010, the criteria to qualify for an active company were relaxed.

The treaties with Italy, Belgium and France have incorporated anti-abuse rules which originate from the Abuse Decree. The anti-abuse rules in these treaties basically aim at excluding persons who are not fully subject to taxation in Switzerland (i.e. holding and domiciliary companies as well as individuals taxed on the basis of a so-called lump-sum arrangement) from the benefits of the respective treaties. Since the anti-abuse rules of the above treaties are considered *lex specialis* as compared to the general anti-abuse rules of the Abuse Decree, the 1998 and 2010 facilitations mentioned above do not apply in relation to Italy, Belgium and France. Furthermore, the treaty with the United States in Article 22 contains limitation of benefit clauses. Other double taxation treaties express the possibility of restricting the application of the treaty through mutual agreement procedures, such as with Belgium, the United Kingdom, Morocco and the Netherlands. The double taxation treaty with Luxembourg stipulates that the treaty is not applicable to tax-privileged Luxembourg companies (such as a Holding 1929).

Lastly, according to the practice of the Swiss tax authorities, a foreign company claiming a refund of Swiss withholding tax must fulfil some substance requirements. This is particularly true where the treaty provides for a full refund of Swiss withholding tax, such as the treaties with the Netherlands, Luxembourg, Denmark and Sweden. When examining the situation, the Swiss tax administration looks into the real substance of the structure, and not merely its form. An "economic approach to the facts" is adopted, which gives weight to the overall business situation. The tax administration is assessing whether the structure has been arranged with the sole or the primary intention of securing full relief.

The Federal Tax Authorities have recently adapted their practice with regard to financing and IP companies of a group. An IP company will now be considered as effectively active (with sufficient substance) regardless of the number of employees. What matters more is the actual activity of the company, risks taken, functions assumed and the qualifications of the employee, in relation to the purpose of the company. Following a larger interpretation of criteria, the employee may also now formally be employed by another company of the same group.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Generally speaking, treaties rank before Swiss domestic law in the Swiss legal system. Hence, as a principle, treaties are not overridden by any domestic law, whether existing when the treaty took effect or introduced subsequently. However, there is some domestic law, such as the Abuse Decree, that has treaty-overriding power to a certain extent.

2 Transaction Taxes

2.1 Are there any documentary taxes in Switzerland?

The transfer of Swiss situated real estate is regularly subject to a cantonal or communal **Real Estate Transfer Tax**. The applicable tax rates vary from canton to canton. Normally they range between 1% and 3% of the transfer value of the real estate. However, some cantons do not levy real estate transfer taxes (e.g. the canton of Zurich).

Not only is a formal transfer of real estate subject to this tax, but also a so-called "economic change of ownership" which is the case when shares in a real estate company are transferred.

Furthermore, based on the Swiss Stamp Duties Act, the following stamp duties are levied by the Federation:

- Securities Issuance Tax;
- Securities Transfer Tax; and
- Insurance Premium Tax.

The **Securities Issuance Tax** is a stamp duty levied on the issue (= primary market) of certain Swiss securities, mainly shares, similar participating rights in corporate entities and bonds. The taxable person is the company or the person who issues the securities.

The rate is 1% of the capital contribution in the case of shares and participating rights. However, the issuance stamp tax levied on capital created or increased by a corporation or a limited liability company is exempted from the issuance stamp tax up to the amount of CHF 1 million. Furthermore, certain transactions, especially in the case of restructuring, are exempt from tax. Rescue companies created for restructuring purposes are exempt from issuance stamp duty, as are capital increases and additional contributions, provided previously existing losses are eliminated and the aggregated payments by the shareholders or members do not exceed CHF 10 million.

The issue of bonds is taxed at 0.06% or 0.12% per year to maturity.

The **Securities Transfer Tax** is levied on the transfer of certain Swiss securities, mainly shares, similar participating rights in corporate entities, bonds and shares in investment funds, and on foreign securities with similar functions, if a Swiss stockbroker ("*Effektenhändler*") is involved. As of July 1, 2010 remote members of the Swiss stock exchange no longer qualify as Swiss stockbrokers. Stockbrokers are mainly banks and other brokers but also companies holding taxable securities with a book value of more than CHF 10 million (holding companies).

The rates are:

- 0.15% in respect of Swiss securities; and
- 0.3% in respect of foreign securities.

The **Insurance Premium Tax** is levied on certain insurance premiums. The taxable person is the Swiss insurance company or the holder of a policy taken from a foreign insurance company. The standard rate is 5% of the premium. Life insurance premiums - if taxable - are taxed at 2.5%.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Switzerland introduced Value Added Tax in 1995. The system of tax is similar to the VAT in the European Union. The standard rate currently applicable as of 2011 is 8.0%.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The Swiss VAT system largely follows the 6th VAT Directive of the European Union (note: Switzerland is not a member of the European Union). A new VAT Act has recently been adopted in Switzerland. The principle aim of the new Act is to simplify the VAT legislation and make it more user-friendly, thus lightening the administrative burden for the taxpayers.

Taxable transactions

The following transactions are subject to VAT:

- supply of goods and services in Switzerland;
- self-supply in Switzerland; and
- import of goods or services.

Taxable persons

Taxable persons are all entrepreneurs (regardless of the legal form of the business) exercising a gainful business activity in Switzerland. However, they may request to be exempted from VAT if the turnover is less than CHF 100,000 per year. Furthermore, all persons (also private individuals) importing services for more than CHF 10,000 per year must pay VAT (to be declared in the so-called "reverse charge procedure").

VAT rates

The rates currently applicable (as of January 2011) are:

- 8.0% standard rate;
- 2.5% reduced rate (e.g. medicine, newspapers, books and food); and

- 3.8% lodging services.

VAT Exemptions and Zero-rated Transactions

Article 21 of the VAT Act provides for certain turnovers to be exempt from VAT. The most important exceptions are: hospital and medical care; education (school, courses etc.); cultural activities (theatre, museum, libraries etc.); insurance and reinsurance transactions; granting and negotiation of credits; transactions in shares and other securities; real estate transfers; and letting and leasing of real estate (in general). Input taxes in respect of exempt transactions are not deductible. In order to avoid competitive disadvantages the enterprise may, however, opt for VAT in certain cases. On the other hand, the taxpayer is allowed to deduct input taxes in these cases.

Article 23 of the VAT Act provides for a list of "zero-rated" transactions. Here the fact that no VAT is due on the respective turnover does not affect the deduction of input taxes. Typical examples are export of goods and services outside Switzerland and supplies in the field of international air transport.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

The VAT Act in principle grants deductibility for all VAT due or paid in respect of goods and services accumulated for the purpose of entrepreneurial activities ("input taxes"). Where a taxpayer has taxable and tax-exempt turnover (see question 2.3 above), he must reduce the input tax recovery proportionally. For smaller businesses, special rules apply. They may opt for a lump-sum method, whereby reduced VAT rates for the calculation of tax due take input tax into account.

For private goods, there are possibilities to proceed with a so-called fictive input tax deduction. Self-supply is calculated as a simple correction to the input tax and is not included in the calculation of the turnover.

2.5 Are there any other transaction taxes?

No, there are no other transaction taxes.

2.6 Are there any other indirect taxes of which we should be aware?

The consumption of certain alcoholic beverages, of tobacco and of mineral oil as well as emissions of carbon dioxide and the heavy traffic, are subject to State levies. The taxes are included in the retail price and are not disclosed to the end-user.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Profit distributions made by Swiss corporations, limited liability companies, and cooperatives are subject to withholding tax. Withholding tax is levied on interest, annuities, profit sharing and all other income derived from shares, social participations in limited liability companies and cooperatives, participation certificates or profit sharing certificates, issued by a person who is domiciled in Switzerland. Distributions made by partnerships are not considered as taxable dividend distributions. Profit distributions are defined as any benefit which may be financially quantified and which is made to the creditor or shareholder in excess of the paid-in nominal capital. They include ordinary dividend distributions, liquidation proceeds, stock dividends and constructive dividends (hidden profit distributions).

The Corporate Tax Reform II introduced a change from the so-called nominal value principle to the capital re-investment principle, which allows a tax exempt repayment of capital re-invested by shareholders. Only distributed profits remain subject to WHT. This new rule will enter into force as per January 1, 2011.

The applicable WHT rate is 35%, whether paid to a Swiss resident or to a non-resident recipient.

Swiss resident recipients can normally obtain a full refund of dividend WHT, provided they have properly reported the gross amount of the dividend received as taxable income.

Non-resident recipients may apply for a full or partial refund of dividend WHT pursuant to the provisions of the applicable treaty.

On most inter-company cross-border dividend payments, Swiss-based companies with substantial foreign shareholders may apply for a reduction of the WHT at source and the Swiss company has to pay the non-refundable WHT only. However, before the due date of dividend payment, the paying Swiss company has to file a request for the application of the reporting procedure with the FTA.

The authorisation, if applicable, is granted on the basis of form 823B or 823C. This form has to be signed by both companies and has to be stamped by the State of residence of the parent company.

In case the reporting procedure does not apply, the 35% WHT due on dividend distributions has to be withheld by the Swiss company and be paid to the FTA. The foreign (parent) company may reclaim all or part of the WHT, based on the applicable double taxation treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Switzerland does not levy WHT on royalties, whether paid to a resident or a non-resident person.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Withholding Tax

Interest paid on bonds and interest paid on bank deposits is subject to Swiss WHT. The applicable rate is 35%. There is no WHT on private and commercial loans (including inter-company loans). However, the definition of a "bond" - according to Swiss WHT law - is rather large.

Tax at Source

Non-resident recipients of interest paid on a loan which is secured by mortgages on Swiss real estate are subject to federal and cantonal taxes levied at source on gross income. The federal tax is 3%; the cantonal taxes vary between 13% and 21%.

System of tax Retention on Interest Payments

According to the agreement between Switzerland and the EU on the taxation of savings income, Switzerland agreed to introduce a special withholding tax (retention tax). Interest payments from non-Swiss sources made by a Swiss paying agent to a beneficial owner who is an individual and resident of an EU Member State are subject to a retention tax in Switzerland.

Tax retention rate: Currently 20% on the gross interest amount, 35% after 2011.

The EU Member State in which the beneficial owner of the interest payment is a resident receives 75%, and Switzerland retains 25% of the retention tax.

In the case of express instructions from the beneficial owner, instead of retaining tax, the paying agent will report the interest payments to the Swiss Federal Tax Administration, who will exchange the information with the tax authorities of the EU Member State of residence.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Switzerland has introduced thin capitalisation rules. They are laid down in a circular letter issued by the FTA. Interest paid by a Swiss resident payer is normally not subject to WHT. However, to the extent that interest is paid on amounts of debt exceeding the maximum debt allowed according to the circular letter, it is re-qualified as a hidden dividend, if paid to a shareholder or a related party to the shareholder. As a consequence, such interest is not deductible for the paying company. In addition, it is subject to the 35% Swiss WHT like any other dividend.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

According to the circular letter issued by the Federal Tax Authorities for finance companies, the maximum debt allowed is 6/7 of total assets (fair market value). For other companies, the maximum debt allowed is defined for certain types of assets as follows:

- cash: 100%;
- accounts receivable: 85%;
- inventory: 85%;
- other current assets: 85%;
- bonds in CHF: 90%;
- bonds in foreign currency: 80%;
- quoted shares: 60%;
- non-quoted shares: 50%;
- investments in subsidiaries: 70%;
- loans: 85%;
- furniture and equipment: 50%;
- property, plant (commercially used): 70%;
- other real estate: 80%; and
- intellectual property rights: 70%.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

As a principle, the thin capitalisation rules are only applicable to debt advanced by shareholders or related parties to the company. However, if debt is advanced by a third party, but guaranteed by the parent company, the thin capitalisation rules could nevertheless apply.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

The provisions of the Abuse Decree Circular of 1962 with regard to equity-debt ratios, as well as maximum rates allowed for the remuneration in the form of interest, are generally not applicable since the Abuse Decree Circular of 1999.

In addition to the thin capitalisation rules mentioned above, the FTA publishes maximum rates allowing that the interest will not be considered a hidden profit distribution (deemed dividend).

Otherwise, there could be provisions in the applicable double taxation treaty regarding beneficial ownership.

3.8 Does Switzerland have transfer pricing rules?

Historically, due to the moderate taxation of corporations in Switzerland, foreign companies have been trying to shift profits into rather than out of Switzerland. Switzerland does not have explicit transfer pricing rules in its tax laws. However, one of the general principles governing Swiss corporate income tax law is the principle of "dealing at arm's length". This is particularly important as Switzerland does not know the concept of consolidated taxation for corporate income tax purposes. Another important principle of Swiss tax law is the concept of tax avoidance. Pursuant to this rule, any transaction which in itself does not make economic sense and which can only be explained with the goal of saving tax is disregarded. Transfer pricing issues are normally dealt with by the Swiss authorities by applying these principles.

In addition, in a letter issued in 1997, the Federal Tax Administration instructed the cantonal authorities that when taxing multinational enterprises, they have to take into account the OECD Transfer Pricing Guidelines. In 2004, it issued a new circular replacing the previously existing one. The 2004 circular states that the arm's length principle is also applicable when choosing the method of determination of mark ups, and that implies for financial services or management functions that the cost plus is not an appropriate method (or only in very exceptional cases).

Hence, although there are no explicit Swiss rules on transfer pricing, the principles to be observed in Switzerland are similar to those of other OECD Member States.

With respect to inter-company loans, the FTA publishes yearly, by way of a circular letter, rules regarding loans and advances between related parties. Thus, maximum rates are stipulated regarding loans from the shareholders to the company and minimum rates regarding loans from the company to the shareholders and related parties.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Corporate profits are taxed at the federal as well as at the cantonal level.

Corporate profits tax is itself deductible from the taxable corporate profits. Therefore, the statutory rates are higher than the effective tax rates.

At the federal level, the statutory corporate profits tax rate is 8.5%, corresponding to an effective tax rate of 7.83%.

The cantonal tax rate varies from canton to canton. A corporation is liable to corporate profits tax in each canton where it has a permanent establishment or a piece of real estate. Some cantons foresee a progressive tax rate, others foresee a flat rate. In addition to this initial tax rate, most of the cantons foresee cantonal and communal tax multipliers. These multipliers vary from year to year, depending on the financial needs of the local authorities.

In 2010, effective corporate profits tax rates were (federal, cantonal and communal tax included):

- Zurich 21.17%.

- Geneva 24.17%.
- Zug 15.64%.

It should be noted that in each canton, special tax relief, which can significantly reduce the above rates of taxation, may be granted. This is especially the case for so-called auxiliary companies. Also, special rules apply to holding companies.

4.2 When is that tax generally payable?

The tax year is the business year. The basis for corporate taxation is the applicable accounting period, which may end at any date within a calendar year. During the year, companies will pay provisional instalments on the basis of the tax return of the previous year. If the amount of taxes so collected is lower than the final tax due, the difference will bear interest.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base is the annual profit as reported in the commercial accounts. This tax base is subject to various adjustments such as depreciation, provisions and expenses which are not commercially justified.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

At both federal and cantonal levels, tax laws provide for the possibility of carrying forward losses for seven years. It should be noted that in certain circumstances such carry forward may also be used in mergers and similar operations.

In addition, interest paid on hidden equity (see question 3.4 above) is not tax-deductible.

4.5 Are there any tax grouping rules? Do these allow for relief in Switzerland for losses of overseas subsidiaries?

There are no tax consolidation rules with regard to corporate tax. Thus, each company is taxed as a separate tax payer. Mergers and other transactions of two or more companies 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.

There is an exception with regard to VAT: A VAT group consisting of closely associated legal entities, partnerships and individuals who have their domicile or corporate seat in Switzerland can be treated as a single tax-liable entity for VAT purposes. As a consequence, intra-VAT group transactions are not subject to Swiss VAT (even if accounted by the VAT group leader).

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

Whether profits are retained or distributed, they are subject to the same annual income and capital tax (capital tax is levied at cantonal and communal level only). However, the Corporate Tax Reform II introduced the option for cantons to choose to credit corporate income taxes to the capital levied in their territory (see question 4.8 below). When the company distributes its profits, it must withhold a 35% withholding tax, which is fully or partly refundable depending on the country of residence of the beneficiary. To allow for a tax-neutral repayment of excess capital to the shareholders, the Corporate Tax Reform II introduces a change from the so-called nominal value principle to the capital contribution principle, according to which the repayment of the capital reinvested by the shareholders is also tax free at the level of the shareholders. This also applies to share premiums or additional contributions. This rule will come into force as per 2011. Only distributed profits remain subject to dividend taxation.

4.7 Are companies subject to any other national taxes (excluding those dealt with in “Transaction Taxes”) - e.g. tax on the occupation of property?

There may be, at the cantonal level, certain other taxes payable depending on the canton. Thus, certain cantons may levy a tax on real estate situated in such cantons. In the canton of Geneva, there is a “professional tax” which is calculated as a percentage of turnover, rent paid and number of employees.

4.8 Are there any local taxes not dealt with in answers to other questions?

The Swiss cantons levy a so-called capital tax. This tax is based on the corporation’s net equity (i.e. paid-in capital, open reserves and retained profits). The amount which is subject to tax may also be increased by the debt re-characterised as equity in the application of the Swiss thin capitalisation rules (see question 3.4 above). The rate of tax varies from one canton to another, but it generally does not exceed 1%. Some cantons foresee a different tax rate for holding companies or other tax-privileged companies. For example, in Geneva the maximum rate of tax is 0.2% and for holding companies only 0.03%. Again, cantonal and communal multipliers will apply.

The Corporate Tax Reform II introduced an improvement in this regard, as the cantons may opt for crediting corporate income taxes to the capital taxes levied in their territory. Hence, companies generating enough profit will not have to pay capital tax additionally. Loss-making or only low profit-making companies continue to be subject to capital tax (to some extent). Once again this new federal rule provides only a possibility for the cantons which they will then have to integrate into their legislation.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

With two exceptions, which will be dealt with hereunder (participation reduction and replacement of certain assets), there is no special set of rules for taxing capital gains realised by legal entities. Hence, as a principle, capital gains form part of taxable profit; capital losses are tax deductible.

In certain cantons special rules apply to capital gains arising from the sale of real estate. Such capital gains may be taxed separately from other income of the company; i.e. regardless of the profit of the company.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

All income (including capital gains) earned by a company is taxed as business income. The only exceptions to that rule are the realisation of a capital gain on a qualifying participation (see question 5.3 below) and the capital gain on real estate (see question 5.1 above).

5.3 Is there a participation exemption?

If a corporation realises a capital gain on the sale of a qualifying participation, it is entitled to a participation reduction.

a. Capital gains for which relief is available

To qualify for relief on capital gains, a Swiss company must make a profit on the sale of a participation which represents at least 10% of the share capital of another company which it has held for at least one year. It should be noted that if a company is a registered venture capital company, the relief is available if the participation represents 5% of the share capital of another company.

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 which 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.

b. Calculation of tax relief

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. The following formula must be applied in each tax period to determine the amount of the tax relief available:

Tax relief = A x B / C

Where:

A= corporate income tax;

B= net qualifying capital gain; and

C= total net profit.

The amount of net qualifying capital gain is determined as follows:

= gross qualifying capital gain – (Financing costs + administrative costs)

Financing costs are defined as interest on loans and other costs which are economically equivalent thereto. They are generally attributed to qualifying capital gains by reference to the ratio between the book value of the qualifying participation and total assets.

Administrative costs are usually fixed at 5% of gross dividend income (unless actual proven administration costs are lower).

5.4 Is there any special relief for reinvestment?

According to the provisions of the new Merger Law, a company can transfer certain business assets and investments to Swiss group companies without realising capital gains. Hence, hidden reserves available on such assets can be rolled over. In addition, in some cantons hidden reserves available on real estate can be rolled over to a new piece of real estate replacing the original piece sold (i.e. the capital gain is not taxed, but can be deferred for tax purposes in the case of replacement of certain pieces of real estate). Finally, in the canton of Geneva, the gain realised on real estate is subject to the special tax, but the amount is then credited against the tax on corporate profits.

Cantons that subject corporations to this special tax foresee the tax deferral on real estate by analogy to the generally applicable set of rules. Therefore, the tax deferral is available, whether or not the capital gain is taxed according to the special tax or the corporate profit tax.

The Corporate Tax Reform II foresees an extension of the replacement purchase. The profit generated by the sale of a production facility remains tax-free if it is reinvested to purchase a replacement. In the future, this will apply even if the operating asset serves a different purpose than the production facility sold. This rule will enter into force on 1 January 2011.

Finally, capital losses are recognised immediately, whether or not the company acquires similar assets in replacement.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Securities issuance tax is levied upon creation or increase of the par value of participation rights (see question 2.1 above). The participation right can take the form of shares of Swiss corporations, LLCs, cooperatives, as well as profit-sharing certificates and participation certificates. A contribution to the reserves of the company (even though the share capital is not increased) made by the shareholders as well as the transfer of the majority of shares of a Swiss company that is economically liquidated, are also subject to the tax. The securities issuance stamp tax is levied at a flat rate of 1%. It is only levied to the extent that the share capital of the company exceeds CHF 1 million. Special rules apply when shares are newly issued in the course of reorganisations, mergers, spin-offs and similar transactions. Such types of transaction are normally exempt from the 1% tax.

Securities issuance tax is not levied on the capital allocated to a branch.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, there are no such other significant taxes or fees, but notary fees on the notarisation of the articles of incorporation would become due.

6.3 How would the taxable profits of a local branch be determined?

A foreign entity is liable to Swiss corporate tax on income and capital attributable to the Swiss permanent establishment. In general, taxable income of permanent establishments is determined on the basis of its separate financial statements as if it were a corporate entity separate from its head office (direct method).

In the past, the indirect method has been preferred for both the determination of taxable income/capital of domestic permanent establishments of foreign companies and of taxable income/capital of foreign permanent establishments of Swiss companies. Accordingly, Swiss double taxation treaties normally contain a corresponding reservation in favour of the indirect method.

Special rules apply with respect to profit allocation of permanent establishments of banks and insurance companies.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

A branch is subject to the same profits tax and capital tax as a Swiss company, i.e. there is no special branch profits tax.

There is no withholding tax or other special tax on profit repatriations from the branch to its head office.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch would not benefit from any tax provisions of tax treaties entered into by Switzerland as it is not a resident of Switzerland, pursuant to Swiss domestic law.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

The remittance of profits by a Swiss branch to a foreign head office is not subject to withholding tax or any other tax.

7 Overseas profits

7.1 Does Switzerland tax profits earned in overseas branches?

Swiss tax law generally provides for the exemption of tax liability for enterprises, permanent establishments and real estate located abroad.

A Swiss enterprise may compensate losses of a permanent establishment abroad with profits generated in Switzerland if the State in which the establishment is located has not already taken account of those losses for tax purposes. The provisions of the tax treaties remain applicable.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

The taxation of dividends received will depend on the importance of the participation held.

At the federal and cantonal levels, the participation reduction regime applies, 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 the local company holds at least 10% of the participation or participation rights with a market value of at least CHF 1 million.

At the cantonal level only, the privileged tax status as holding company is available in cases where the participation or the income there from represent at least two-thirds of the total assets or of the income. Such holding companies (without commercial activity in Switzerland) do not pay profit tax at the cantonal level.

7.3 Does Switzerland have "controlled foreign company" rules and if so when do these apply?

Switzerland does not have "controlled foreign company" rules.

8 Anti-avoidance

8.1 Does Switzerland have a general anti-avoidance rule?

In Switzerland, there are very few written and specific anti-avoidance rules, but it is the general principle of abuse of law or tax evasion that applies. In order to remove the uncertainties regarding the tax consequences of a planned transaction (the abuse of law concept is very large), the tax payer may request an advanced tax ruling. The tax administrations are prepared to discuss in advance specific questions (law or facts) on taxation. While doing this, the tax consequences of the planned activities can be defined in a binding tax ruling - the principle of protection of good faith applies.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Aggressive tax planning is generally admitted by Swiss tax law provided that the tax payer does not commit an abuse of law or tax evasion (which is not a criminal offence). According to the tax evasion concept, a structure or a transaction may be disregarded and the tax treatment assessed according to the economic situation underlying the transaction, as far as the following three cumulative conditions are met: i) the form chosen by the taxpayer is unusual; ii) the form has been chosen only for tax purposes (tax savings); and iii) the tax payer would make significant tax savings in the hypothesis in which the structure was recognised by the tax authorities. Provided that these three conditions are met, the tax authorities disregard the form chosen and used by the tax payer and re-qualify the transaction from an economic point of view. This approach is very similar to the substance over form theory. In addition to that, even though the form is not abusive, the tax authorities may disregard it in the cases where the tax law explicitly refers to economic concepts (e.g. the concept of fringe benefits).

Heini Rüdisühli

Lenz & Staehelin
Bleicherweg 58
8027 Zurich
Switzerland

Tel: +41 58 450 8000
Fax: +41 58 450 8001
Email: heini.ruedisuehli@lenzstaehelin.com
URL: www.lenzstaehelin.com

Heini Rüdisühli was born in 1962. He studied Law at the University of Bern and was admitted to the bar in 1988. He acquired the diploma as a Certified Tax Expert in 1992. After serving as a Tax Manager in an international accounting firm from 1988 until 1995, Heini Rüdisühli became an Associate with Lenz & Staehelin in Zurich, where he has been a Partner since 2001. His main field of activity is tax law, which covers tax planning for companies and private individuals, including international tax law, tax consulting (ancillary to other main sectors of the firm's activities) and representation before the authorities and courts. He practises in German and English. Heini Rüdisühli is a member of several organisations in relation to his activity as a lawyer and he regularly gives lectures, seminaries and conferences in Switzerland and abroad.

Jean-Blaise Eckert

Lenz & Staehelin
Route de Chêne 30
1207 Geneva
Switzerland

Tel: +41 58 450 7000
Fax: +41 58 450 7001
Email: jean-blaise.eckert@lenzstaehelin.com
URL: www.lenzstaehelin.com

Jean-Blaise Eckert was born in 1963. He studied law at the University of Neuchâtel and was admitted to the bar of Neuchâtel in 1989 and to the bar of Geneva in 1991. He studied Business Administration in the United States (University of Berkeley, Haas Business School), where he acquired an MBA in 1991. He acquired a diploma as a Certified Tax Expert in 1994.
Jean-Blaise Eckert joined Lenz & Staehelin in Geneva in 1991. In 1996 and 1997, he worked as Tax Manager in the Tax and Legal Department of a regional headquarters of Reuters. He became a Partner of Lenz & Staehelin in 1999. His field of activity is tax law, with a special focus on tax planning for multinational groups of companies. Part of his activity is also devoted to private, individual taxation. He practices in French and English.
Jean-Blaise Eckert is a member of several professional organisations in Switzerland, a member of the Swiss Committee of the International Fiscal Association and has been a reporter to the IBA and IFA congress on Swiss tax matters. He regularly gives seminars and conferences in Switzerland and abroad.

LENZ & STAEHELIN

Lenz & Staehelin is one of the largest law firms in Switzerland, having offices in Geneva, Zurich and Lausanne. The firm comprises more than 100 lawyers and provides advice to corporate and individual clients from Switzerland and abroad on a wide range of legal issues. Lenz & Staehelin operates on both national and international levels; in Switzerland it has a prominent position in the two main language areas, and is equipped to provide its international clients with advice on transnational legal problems.

Chapter 41

Ukraine

Bate C. Toms

B.C. Toms & Co

Mykhailo Razuvaiev

1 General: Treaties

1.1 How many income tax treaties are currently in force in Ukraine?

As of 19 September 2011, Ukraine has 68 income tax treaties in force which apply to 69 states, i.e. the treaty with Yugoslavia applies to Serbia and Montenegro. Four of these treaties; those with Cyprus, Spain, Malaysia and Japan, were entered into with the USSR and are still applied by Ukraine as a legal successor of the USSR. 64 of the treaties were entered into by Ukraine, including two new Ukrainian treaties that came into force in 2010 and 2011 with Libya and Pakistan (the provisions of the Ukraine-Pakistan Tax Treaty will only be applicable in Ukraine with respect to corporate profits tax starting from 1 January 2012). The treaty with Cuba has been ratified by Ukraine, but has not yet entered into force, and a treaty with Luxemburg has been signed but not yet ratified by Ukraine (ratification is not presently under consideration).

Since 2007, the governments of Ukraine and Cyprus negotiate the conclusion of a new double tax treaty between Ukraine and Cyprus, to replace the USSR-Cyprus treaty that is still being applied by Ukraine. The text for this new treaty has not yet been officially published, but it is anticipated that it will impose a 5% withholding tax on dividend payments and 10% withholding tax on interest and royalty payments. At this stage, it is unclear when this new Cypriot-Ukrainian treaty will be executed.

1.2 Do they generally follow the OECD or another model?

Generally, Ukrainian income tax treaties are based on the OECD Model Treaty, with certain variations. The income tax treaties entered into by the USSR that are still applied by Ukraine, as noted above, are simpler in structure, do not limit their benefits to the "beneficial owners" of income and are, in principle, more favourable than the treaties entered into by Ukraine. The tax treaty with the USA also stands apart, as it generally follows the U.S. Model Treaty.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

In order to enter into force, an income tax treaty has to be ratified by the Ukrainian Parliament (*Verkhovna Rada*), and then the ratification instrument has to be exchanged with that of the other country.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

The treaty between Ukraine and the USA contains comprehensive anti-treaty shopping rules, generally following the U.S. Model Treaty. The treaty with the United Kingdom includes a "limitation of benefits" article. Under certain other treaties, particularly the recent ones, only a "beneficial owner" of income may claim certain treaty benefits, such as reduced or eliminated tax rates for interest, dividends and royalty payments. The new Tax Code of Ukraine, No. 2755-VI, dated 2 December 2010, which generally took effect on 1 January 2011, except for its Chapter III on corporate profits tax which became effective only on 1 April 2011 ("Tax Code"), introduced the concept of beneficial owner in domestic legislation. In particular, the Tax Code provides that the term "*beneficial (actual) recipient (owner) of income*" means an entity (individual) that has a right to receive income excluding an entity (individual) acting as an agent, a nominal bearer (owner) or an intermediary with regard to such income. However, the practice for application of this concept reflected both in international treaties and domestic legislation has not yet been well-developed. Presently, these standards are still applied in a formalistic way, with legal owners presumptively treated as beneficial owners; which practice is expected to change in future.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Under the Constitution of Ukraine, duly ratified international treaties constitute an integral part of Ukrainian legislation. Thus, under the Constitution of Ukraine, provisions of treaties and domestic legislation have the same legal force, which presumably permits the application of the later-in-time rule. However, the Tax Code explicitly provides that in the case of a conflict between the provisions of ratified treaties and domestic laws, the provisions of the treaties shall prevail.

2 Transaction Taxes

2.1 Are there any documentary taxes in Ukraine?

Ukraine does not have a stamp duty in the traditional sense. However, certain transactions in Ukraine are subject to a State duty and payments to the State Pension Fund of Ukraine. State duty is payable for the notarisation of certain contracts and unilateral deeds and the filing of documents with courts. Beginning 1 November

2011, the State duty payable for the filing of documents with the court will be replaced with a court duty. Documents which are subject to mandatory notarisation, and thus to the payment of such State duty, include contracts for the sale or other disposition of buildings, land and other real estate, mortgage and property management agreements, agreements for the leasing of buildings or the part thereof, foundation agreements, agreements for the sale of vehicles and certain powers of attorney and wills. The parties to a contract may also choose to notarise it even if this is not mandatory, for example to evidence its execution, and in this case, they will have to pay the State duty.

The rates for the State duty for the notarisation of documents depend on the type of document being notarised, the duty generally ranges from 0.1% to 5% of the contract value. Where the contract value cannot be determined (e.g. for powers of attorneys, wills, etc.), the rate generally varies from 2% to 30% of the official non-taxable monthly minimum income of a citizen (which is currently equivalent to about USD 0.04 and 0.64, correspondingly).

State duty is also payable for the issuance of securities (with some exceptions, including for State and municipal bonds and privatisation securities) at the rate of 0.1% of the nominal value of the securities (but not more than 50 minimum monthly salaries, as established on 1 January of the year when the issuance is made).

The rates of the court duty for filing documents with a court depend on the type of filing and the court involved. The court duty can range from 3% of the minimum monthly salary, as established on 1 January of the year when the filing is made (which is about USD 3.6), to 1% of the value of the claim involved in the lawsuit.

The following transactions are subject to payments to the State Pension Fund of Ukraine: the purchase of real estate (other than, *inter alia*, the purchase of real estate by State enterprises using State or municipal budget funds); the transfer of passenger cars (other than those provided to disabled people or transferred by inheritance); the sale of jewellery made of gold, platinum and/or precious stones (other than wedding rings); and mobile phone services, with certain exceptions. These payments to the State Pension Fund of Ukraine are based on rates of 1% for the purchase of real estate, 3% for the transfer of cars, 5% for the sale of jewellery and 7.5% for mobile phone services.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

There is a value added tax ("VAT") in Ukraine. The standard VAT rate of 20% is charged on the majority of VAT-taxable transactions. This rate will be reduced to 17% beginning in 2014. The export of goods and certain other transactions are presently subject to a zero VAT rate.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In Ukraine, generally the supply of goods and services within Ukraine and the import and export of goods are VAT-taxable events, subject to certain exceptions. To begin with, certain transactions are not subject to VAT, including the issuance and sale of securities, certain banking, insurance and asset management services and reorganisation of legal entities. Certain transactions are VAT-exempt, including the sale of land (except for land under buildings which cost is included into the cost of such buildings), the sale of certain goods, such as many infant foods and medicines, as well as municipal transport services and the importation of natural gas. Similarly, certain goods (except for excisable goods) imported by UEFA or participants of the EURO 2012 Football Championships are exempt from VAT until 1 September 2012. In addition, the export of goods and the sale of certain services are presently taxed at a zero VAT rate.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

In general, a VAT-taxable person may receive a credit for all input VAT, provided that it intends to use the goods or services purchased in its commercial activities in VAT-taxable transactions. If such goods or services are later used in VAT-exempt transactions, or if as goods they constitute fixed assets and later become non-production assets, for VAT purposes such goods or services will be deemed to have been sold in a deemed transaction that will then be subject to VAT, so that the original credit is effectively extinguished.

No VAT credit is available if the input VAT is not confirmed by a VAT invoice or a customs declaration or other required document.

If goods or services are used only partially in VAT-taxable transactions, appropriate allocations must be made and the corresponding part of the input VAT is credited.

No VAT credit is available to a person not registered in Ukraine as a VAT payer. A foreign entity may recover input VAT incurred, but only for transactions conducted through its permanent establishment (i.e. branch office) in Ukraine that it has registered as a VAT payer. If services are supplied in Ukraine by a foreign entity, a Ukrainian resident, the recipient of the services, is required to report VAT according to the so-called "reverse-charge" mechanism.

If the taxpayer's input VAT exceeds its output VAT, then the taxpayer may claim VAT reimbursement from the State, subject to compliance with certain criteria and according to the existing procedure. The amount of VAT claimed for reimbursement may not exceed the amount of VAT paid to suppliers and/or State budget in previous reporting periods. The Tax Code, in addition to maintaining the existing procedure for VAT reimbursement from the State (which usually involves an unplanned on-site tax inspection), introduced a procedure for so-called "automatic" VAT reimbursement. This automatic VAT reimbursement procedure is intended to be applied to taxpayers subject to certain criteria; it does not envisages on-site tax inspections and is conducted in the shorter terms. In addition, the Tax Code provides for a penalty for the late reimbursement of VAT, which previously was not the case.

2.5 Are there any other transaction taxes?

There are presently no other transaction taxes.

2.6 Are there any other indirect taxes of which we should be aware?

The most important of the other indirect taxes are excise tax and customs duties.

Excise tax is imposed on certain excise taxable items produced in, or imported into, Ukraine. In particular, excise tax applies to tobacco and alcohol products, certain oil products, liquefied gas and motor vehicles. The rates of excise duty are specific for each type of product and are calculated either as a percentage of the sales price or as a fixed amount based on the quantity, weight or volume of the goods.

Import customs duties are imposed on goods imported into Ukraine and may be of the following types: preferential; privileged; or full. Goods from most countries are subject to privileged rates ranging from 5% to 15%.

The Ukrainian Unified Customs Tariff Law provides for certain exemptions (including on a temporary basis) from customs duties for specific categories of goods. For example, a temporary exemption is presently applied (1) for the importation of certain goods by companies in the aircraft industry (effective until 1 January 2016), and (2) for the importation of certain goods for the construction of EURO 2012 sport facilities and for use by UEFA or participants of the EURO 2012 Football Championships (effective until 1 September 2012 and not applicable for excisable goods), etc.

Ukraine still retains some customs export duties, which apply to limited types of goods, including in particular, natural gas, scrap metal, livestock, raw hides, certain oil seeds and certain grains (the export customs duty for certain grains is valid until 1 January 2012).

In order to protect the economic interests of Ukrainian producers, an anti-dumping, special or compensatory duty may be introduced on certain types of products, in addition to the general customs duties.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Unless an income tax treaty provides otherwise, dividends paid abroad are subject to a withholding tax at a 15% rate when paid to a non-resident company.

Under the majority of Ukraine's income tax treaties, this withholding tax rate may be reduced to 5%, provided that the recipient owns a 20% or 25% (depending on the treaty) shareholding in the local Ukrainian company making the distribution. The Ukrainian tax treaties with Finland, France, the Netherlands and Sweden provide for a zero withholding tax rate for dividends subject to certain conditions, and the Soviet income tax treaty that is still applied for Cyprus provides for a general zero withholding tax rate for dividends. The treaties with Cyprus and the Netherlands are the most favourable.

It is expected that the negotiated Ukraine-Cyprus tax treaty will increase withholding taxes on dividends to 5%, but this treaty has not yet been signed or ratified. The most recently effective Ukrainian tax treaties provide the following withholding tax rates on dividends: (1) the treaty with Libya – 5% or 15% (the lower rate applies if the recipient owns at least 25% of the Ukrainian company's capital); and (2) the treaty with Pakistan – 10% or 15% (the lower rate applies if the recipient owns at least 25% of the Ukrainian company's capital).

Before or at the time of a dividend distribution, an advance tax of 23% of the amount of the dividend must also be paid by the distributing company (advance tax is accrued on top of dividends, i.e. the amount of dividends is not reduced by the amount of such advance tax). This advance tax payment may then be used by the distributing company to offset its corporate profits tax liabilities in future accounting periods. Such advance tax is not applied to dividends paid by: (1) entities registered as payers of a fixed agricultural tax; (2) Ukrainian holding companies which redistribute dividends received from their subsidiaries (exception is applicable only to the amount of dividends received by such holding company from its subsidiaries); and (3) insurance companies. Advance tax is also not applicable to dividends paid to (1) individuals, and (2) institutes of mutual investment and property management funds.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Unless an income tax treaty provides otherwise, royalties paid abroad by a local company are subject to withholding tax at a 15% rate when paid to a corporate non-resident. The majority of Ukraine's income tax treaties reduce this withholding tax rate for royalties to 10%. A number of treaties, including the treaties with Austria, Belgium, Canada, Denmark, Finland, France, Germany, Japan, the Netherlands, Spain, Switzerland, Sweden and the United Arab Emirates, provide for a zero withholding rate for royalties payable for certain types of intellectual property.

A general zero-tax rate for any types of royalties is provided for by a few income tax treaties, including the old Soviet treaty with Cyprus and the Ukrainian treaties with Armenia and the United Kingdom.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Unless an income tax treaty provides otherwise, interest paid abroad by a local company to a non-resident company is normally subject to a 15% withholding tax. No withholding tax is charged on interest payable to non-resident companies on Ukrainian State securities placed abroad through authorised non-resident representatives, or on interest payable to non-residents for loans provided to the Ukrainian State which are reflected in the Ukrainian State budget or the budget of the National Bank of Ukraine, or loans guaranteed by the State.

Under the majority of Ukraine's income tax treaties, the withholding tax on interest, if applicable, is reduced to 10%. The old Soviet tax treaties with Cyprus and Spain, and the Ukrainian tax treaties with the United Kingdom and the USA, provide for a zero withholding tax rate for interest.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

There are no prescribed debt-equity ratios as such.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

This is not relevant in Ukraine.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

This is not relevant in Ukraine.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Yes. If 50% or more of the charter capital of a local company is owned or "managed" by non-residents, then any interest payable by the local company to such non-residents or to their affiliates is deductible only to the extent that such interest does not exceed: (a) the interest income received by such local company within the applicable reporting period; plus (b) 50% of the taxable income of the local company calculated without taking into account any interest income received by it. Interest not deducted in current reporting period may be carried forward and deducted in subsequent reporting periods subject to the same limitation as described above.

3.8 Does Ukraine have transfer pricing rules?

Yes. In general, arm's length prices should be used (1) for determining the corporate profits tax consequences of transactions with related parties, as well as for barter transactions and certain other transactions involving in-kind transfers, (2) for determining the primary book value of the fixed capital assets in certain cases, and (3) to determine the taxable base for VAT purposes. Such transfer pricing rules should also apply to transactions between foreign companies and their branches in Ukraine.

Arm's length price rules are applied, to begin with, by presuming that the stated contract price is an arm's length price, but this presumption may be challenged by the tax authorities. The principal method used for determining arm's length prices is, with certain exceptions, the Comparable Uncontrolled Price method pursuant to which the tax authorities may adjust the price of transactions between related parties to the "usual price" for profits tax purposes. The usual price is essentially the market price for equivalent transactions where the goods or services are sold to independent persons under usual economic conditions. Where these rules apply, if the contract price is higher than the usual price at the time of the purchase, the usual price should be applied for tax purposes.

For natural monopolists, the arm's length price may be established by the Resale Price method or, in certain cases, by the Cost Plus method, under regulations to be promulgated by the Cabinet of Ministers of Ukraine.

The new transfer pricing rules, as provided by the Tax Code, will come into effect on 1 January 2013.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The standard corporate profits tax rate beginning 1 April 2011 is 23%. This rate will be gradually reduced as follows: 21% - beginning 1 January 2012; 19% - beginning 1 January 2013; and 16% - beginning 1 January 2014. This rate applies to the taxable income of Ukrainian companies and the permanent establishments in Ukraine of foreign companies. As an exception, a zero corporate profits tax rate applies to the income of life insurers.

Certain legal entities may opt to use the simplified taxation system, according to which VAT registered entities pay corporate profits tax at a rate of 6% of their sales proceeds, and non-VAT registered entities pay at a rate of 10%. There is also a minimal tax under a simplified taxation regime provided for private entrepreneurs with relatively small turnover.

In addition, certain types of non-business Ukrainian sourced income of non-residents are subject to 15% withholding tax. Such Ukrainian source income includes dividends, interest, royalties, lease payments, income from the disposal of real estate located in Ukraine, income from transactions with securities or other corporate rights, broker fees, agency fees and several other types of Ukrainian source income paid by Ukrainian residents or Ukrainian permanent establishments of non-residents to non-resident companies. Reduced tax rates (or tax relief) may apply based on tax treaties applied by Ukraine, as discussed above, and special rules may apply if the recipient is a company which has a permanent establishment in Ukraine.

Lower withholding tax rates apply to insurance income (zero, 4% and 12% rates) and freight income (6%). A higher 20% withholding tax rate applies to income from advertising services.

The Tax Code also provides that certain small businesses may temporary apply (until 1 January 2016) for complete tax holidays (i.e. a zero corporate profits tax), provided that respective criteria are met.

4.2 When is that tax generally payable?

Under the generally applicable rules, corporate profits tax must be assessed and reported for each of the first three quarterly fiscal periods, including for the fiscal year through each such quarter, and for the full fiscal year reporting period, within 40 days after the end of each such period. The tax should be paid quarterly, within 10 calendar days after each tax declaration for a reporting period must be filed, so that the tax must be paid within 50 calendar days after the end of each of the first three quarterly reporting periods and after the end of the fiscal year. A fiscal tax year is a calendar year. At the same time, for agricultural companies engaged in the production, processing and sale of agricultural products, a fiscal year starts on 1 July and ends on 30 June.

Withholding taxes should be paid no later than on the date that the income is paid.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In general, the taxable income for corporate profits tax purposes is determined by deducting from the adjusted income any allowable expenses and depreciation deductions. The adjusted income includes all revenues from all types of activities received or accrued by a taxpayer during the relevant tax accounting period, both from Ukrainian and foreign sources.

However, special rules for determination of the tax base exist with respect to taxpayers conducting certain types of activities, e.g. insurance companies.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Generally, taxable income differs significantly from the profit shown in commercial accounts. This is mostly due to the exemptions for certain types of income not to be considered as taxable income; the existence of severe restrictions on the deductibility of certain expenses for tax purposes.

4.5 Are there any tax grouping rules? Do these allow for relief in Ukraine for losses of overseas subsidiaries?

There is no system for group taxation in Ukraine, and therefore the members of a corporate group must file separate tax returns. There are no provisions under Ukrainian law that would allow the losses of one group member to be applied to reduce the profit of another group member.

However, if a Ukrainian company has a branch (which is not a separate legal entity) located in a regional or municipal jurisdiction different from that where the company itself is registered, then such company may decide to file a consolidated tax return, in which case the amounts of corporate profits tax payable respectively at the principal location of the company and at the location of each branch are allocated following a set procedure.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

The same corporate profits tax rate applies both to distributed and retained profit.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The most significant national taxes and duties not discussed above include personal income tax, land tax, rental payments, duties for the use of natural resources and the mandatory payment of a single social contribution to the State Pension Fund.

4.8 Are there any local taxes not dealt with in answers to other questions?

The principal local taxes and duties include property tax, single tax for individual entrepreneurs, duties for performing certain types of entrepreneurial activity, tourist and parking duties. In general, these taxes and duties do not significantly influence the taxpayer.

Property tax will be due from 1 July 2012 and will be applicable to individuals and legal entities (including non-residents) which own residential property. This will tax residential area of the property at an annual rate of 1% to 2.7% of the minimum monthly salary as of 1 January of the reporting year (depending on the residential area of the property), per each metre of the residential area of such property. Once a year, individuals may reduce their tax base by 120 sq. m. of residential area for an apartment and by 250 sq. m. of residential area for a house.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

There is no separate special regime for the taxation of capital gains and losses, other than for gains and losses from transactions qualifying as trading in securities or in corporate rights other than securities and certain other exceptions, as noted below.

To begin with, profits and losses by corporate entities from such qualifying transactions are determined and accounted for separately for each type of securities and corporate rights other than securities. At the same time, operations with shares of the joint stock companies are accounted together with corporate rights other then securities. Losses from trading in securities of a certain type may not be used to offset income from other activities or trading in securities of a different type. Instead, the losses exceeding those that may presently be offset for a particular type of securities may be carried forward indefinitely and used to offset income from trading in the same type of securities in future periods. This special tax treatment does not apply to the issuance of securities or their redemption by the issuer.

Similar rules exist for the taxation of the capital gains of individuals from transactions with securities and corporate rights other than securities. As opposed to capital gains and losses for companies, however, the financial results of transactions in all types of securities and corporate rights by an individual conducted within a tax year are aggregated. The resulting capital gains, if any, are included in the annual taxable income of the individual and are taxed at the end of the year under the generally applicable tax rules, unless a special rule applies so that such capital gains are taxed by withholding at the time of the realisation of such gains. Any net losses may be carried forward indefinitely and used to offset gains from the individual's transactions in securities and corporate rights in future periods.

Starting from 1 January 2011, capital gains by individuals from the initial sale or other disposition during a calendar year of certain types of real estate, i.e. dwellings (houses, apartments or parts thereof) and summer houses, are exempt from personal income tax, provided such real estate is owned by the seller during the period exceeding three years. Gains on (1) the subsequent sales of such real estate within a tax year, or (2) the sale of real estate that does not meet the criteria above, are subject to tax at a rate of 5%.

The gains by individuals from the disposal of movable property are generally taxed at 5% personal income tax rate. However, the sale of one passenger car, motorcycle or motor scooter during a tax year is subject to a 1% rate tax.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

In general, the same corporate profits and personal income tax rates apply both to capital gains, such as gains from securities transactions, and to business profits or any other income, subject to the exceptions noted above and certain other minor exceptions.

5.3 Is there a participation exemption?

Dividends paid to a Ukrainian company by a local company are excluded from the taxable income of the recipient. The same rule exists with respect to dividends paid to a Ukrainian company by a foreign company, provided that the Ukrainian company has at least a 20% direct or indirect share participation in this foreign company and such non-resident does not have an offshore status. However, dividends paid in Ukraine to a permanent establishment of a foreign company are subject to taxation at the standard corporate profits tax rate. Dividends paid to non-resident individuals or companies are subject to withholding tax, as discussed above.

Before or at the time of a dividend distribution, the distributing company is required to pay an advance tax at the standard corporate profits tax rate on the amount of the distributed dividends, subject to certain exemptions. Such advance tax may ordinarily be used by companies to offset their corporate profits tax liabilities. As mentioned above, an exception from paying such advance corporate profits tax is provided for Ukrainian holding companies which redistribute dividends received from their subsidiaries (exception is applicable only to the amount of dividends received by such holding company from its subsidiaries).

5.4 Is there any special relief for reinvestment?

Where the dividends are paid to individual shareholders in the form of shares (or participation interests for limited liability companies) in the company making the distribution, and such distribution does not change the shareholding ratio among the shareholders in the company and results in an increase of the charter capital of the distributing company, such dividends are not taxed to the recipient individual shareholders.

Where such a pro-rated distribution of shares (or of participation interests) is made, the distributing company is not required to pay the advance corporate profits tax (presently at the standard 23% rate) on the dividend amount.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

Normally, there is no tax or capital, or similar duty payable on the formation or increase of the capital of a company under Ukrainian law, except for the formation of an open (public) joint stock company. For an open (public) joint stock company, an issuance of shares requires the payment of a State duty in the amount of 0.1% of the par value of the shares issued, as observed above, but not exceeding 50 minimum salaries as established on 1 January of the respective year.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

Generally, no other significant taxes would be incurred.

6.3 How would the taxable profits of a local branch be determined?

For Ukrainian tax purposes, a Ukrainian branch of a foreign company constituting a permanent establishment in Ukraine is treated as a separate entity independent of its head office, and it is generally taxed under the same rules as a Ukrainian legal entity is taxed. However, several special methods may be applied for calculating the income that will be subject to tax in Ukraine of such a permanent establishment.

Under the principal method, known as the "*direct method*", where a non-resident entity accounts separately for profits received in Ukraine through its permanent establishment, the taxable income of such a permanent establishment is determined by reducing its worldwide income by the deductible expenses incurred directly by such branch. Transfer pricing rules apply to transactions between the foreign company and its branch in Ukraine.

Where the foreign company has operations both in Ukraine and in other jurisdictions and does not account separately for profits received in Ukraine, the amount taxable in Ukraine is determined by the so-called "*split balance sheet method*" by an allocation of the income and expenses between the non-Ukrainian offices and the Ukrainian branch, based on a correlation of the total expenses, number of employees, value of fixed assets, etc. of the foreign company as a whole, as compared to those of the branch, with certain adjustments.

If a direct calculation may not be used to determine the amount taxable in Ukraine or a non-resident entity cannot provide information required to use the split balance sheet method, then the Ukrainian taxable amount is determined by the so-called "*indirect method*" as a difference between the income of the branch and its expenses, determined by applying a 0.7 coefficient to the income of the branch (i.e. the taxable income is determined as being equal to 30% of the gross income of the branch).

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax as such in Ukraine. As observed above, under the general tax rules, a branch of a foreign company in Ukraine constituting a permanent establishment is generally taxed under the same rules as a Ukrainian legal entity and, for most taxation purposes, is treated as if it is a separate legal entity independent of its head office.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

As a rule, tax treaties contain criteria for the determination of whether a branch constitutes a taxable permanent establishment in Ukraine. If the activity of the branch does not meet the criteria for a taxable permanent establishment under the applicable tax treaty, then it should not be taxable, and the non-resident should therefore not be subject to profits tax in Ukraine based on its branch. Ukrainian tax treaties do not exempt payments from a branch to its head office from withholding tax.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

The remittance of the Ukrainian source profits of a branch (other than proceeds or other types of compensation for services, works or goods provided by such a branch to Ukrainian residents) to its head office is subject to 15% withholding tax. Such remittances to a head office should not be subject to the advance tax that applies to dividend distributions.

7 Overseas Profits

7.1 Does Ukraine tax profits earned in overseas branches?

Profits of an overseas branch of a Ukrainian entity generally are not taxed in Ukraine.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

As observed above, dividends paid to a local company by a foreign company are exempt from corporate profits tax, provided that the Ukrainian company has at least a 20% direct or indirect share participation in this foreign company and such non-resident does not have an offshore status.

7.3 Does Ukraine have "controlled foreign company" rules and if so when do these apply?

Controlled foreign company rules are not present in Ukraine.

8 Anti-avoidance

8.1 Does Ukraine have a general anti-avoidance rule?

There is no general anti-avoidance rule under Ukrainian law. However, as indicated above, there are certain restrictions aimed at preventing tax avoidance. To begin with, transfer pricing rules apply to prevent expenses from being overstated or income being understated.

As observed above, the Tax Code introduced the concept of beneficial owner in domestic law. Under this concept, in order for a non-resident company receiving Ukrainian-source income (e.g.

Ukraine

dividends, royalties or interest) to benefit from a tax treaty, such non-resident company must be qualified as a "beneficial (actual) recipient (owner) of income".

In addition, a limitation is provided on the deductibility of expenses incurred in transactions with companies registered in certain countries designated as tax havens. Only 85% of payments, of whatever kind, to residents of tax havens, are deductible for tax purposes. The tax havens affected are those designated as such in the relevant resolution that is periodically issued by the Cabinet of Ministers of Ukraine.

The deductibility of interest paid by a local entity to a non-resident company, which directly or indirectly owns or manages at least 50% of the charter capital of such local entity, is limited to the amount of such local entity's own interest income, plus 50% of its taxable income, excluding interest income of such entity.

Royalties paid by a local entity to a non-resident company and expenses related to the purchase of consulting, marketing or advertising services from a non-resident company may be deducted up to 4% of the local entity's prior year sales revenue. However, royalties are not deductible if: (1) paid to residents of certain tax havens; (2) paid to recipients that are not treated as beneficial owners of such royalty payments; or (3) paid with respect to IP rights that were initially registered in Ukraine and later sold abroad. In addition, the Tax Code provides a ban on the deduction of expenses related to the purchase of consulting, marketing or advertising services by local entity from residents of certain tax havens.

Expenses of a local entity for engineering services from a non-resident company may be deducted up to 5% of the customs value of the equipment imported based on the respective contract. However, such expenses are not deductible if: (1) paid to residents of certain tax havens; or (2) paid to recipients that are not treated as beneficial owners of such income.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Ukrainian law does not contain requirements to make disclosure of avoidance schemes.

Bate C. Toms

B.C. Toms & Co
18/1 Prorizna Street
Suite 1, Kyiv, 01034
Ukraine

Tel: *+380 44 490 6000 / 278 1000*
Fax: *+380 44 278 6508*
Email: *bt@bctoms.net*
URL: *www.bctoms.net*

Bate C. Toms is the Managing Partner of B.C. Toms & Co. For over 18 years, he has handled many of the largest transactions in Ukraine, including many of the most significant Ukrainian investments and acquisitions in oil and gas and agriculture in particular. Mr. Toms has advised on most IPO's for Ukrainian companies, including the first and several of the largest, a significant portion of all loans for Ukraine and the first successful foreign bank led Ukrainian project financing as well as many of the largest real estate acquisitions and oil and gas projects. Mr. Toms has written numerous articles on Ukrainian law, including as the principal author of the ICC book "Doing Business with Ukraine". He also serves as the Chairman of the British-Ukrainian Chamber of Commerce.
Mr. Toms studied law at Washington and Lee University (B.A., *magna cum laude*, 1971) Phi Beta Kappa, Cambridge University (Magdalene College - Law Tripos I, 1972) and Yale Law School (J.D., 1975, editor of the Yale Law Journal). As an undergraduate, he studied Soviet Studies at Institut d'Etudes Politiques de Paris (1969-1970).

Mykhailo Razuvaiev

B.C. Toms & Co
18/1 Prorizna Street
Suite 1, Kyiv, 01034
Ukraine

Tel: *+380 44 490 6000 / 278 1000*
Fax: *+380 44 278 6508*
Email: *mr@bctoms.net*
URL: *www.bctoms.net*

Mr. Razuvaiev is an associate lawyer with B.C. Toms & Co. Mr. Razuvaiev received his law degree from the National Technical University of Ukraine "KPI" (Masters Degree, 2008). His main areas of expertise are taxation and financial law. Mr. Razuvaiev regularly advises clients on tax issues for cross-border business transactions. He is fluent in Ukrainian, Russian and English.

B.C. TOMS & CO
LAW OFFICES
Kyiv - London

B.C. Toms & Co was the first western law firm to open a Ukrainian office, in 1991, and our Kyiv office is now one of the larger law firms in Ukraine. Our firm was founded by Bate C. Toms, a Yale Law School graduate with substantial previous experience practicing in the US and Western as well as Eastern Europe as a partner of a large multinational law firm. We are ranked both in the European Legal 500 (www.legal500.com), the IFLR 1000 (www.iflr1000.com), the PLC Which Lawyer (www.practicallaw.com) and in the Chambers Europe (www.chambersandpartners.co.uk), the principal European legal directories, as among of the leading law firms in Ukraine. Our law practice areas includes banking and securities, oil and gas and natural resources, agricultural investments, trade and project finance, real estate, construction, energy, mergers and acquisitions, project finance, tax, privatisation and litigation.

United Kingdom

William Watson

Slaughter and May

Zoe Andrews

1 General: Treaties

1.1 How many income tax treaties are currently in force in the UK?

The UK has one of the most extensive treaty networks in the world, with over 100 comprehensive income tax treaties currently in force. The UK Government reviews the UK's tax treaty priorities each year and there is a rolling programme for the negotiation of new treaties to replace current treaties.

1.2 Do they generally follow the OECD or another model?

They generally follow the OECD model, with some inevitable variation from one treaty to the next.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. A tax treaty must be incorporated into UK law and this is done by way of a statutory instrument. A treaty will then enter into force from the date determined by the treaty and will have effect in relation to each tax covered from the dates determined by the treaty.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, the UK has avoided wide limitation of benefits articles but has instead made specific provision in particular articles. For example, the Dividends, Interest or Royalty article may provide that the UK will not give up its taxing rights if, broadly, the main purpose or one of the main purposes of the creation or assignment of the relevant shares, loan or right to royalties is to take advantage of the article.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

In the past this has occurred only rarely. In August 2011 HM Revenue & Customs ("HMRC") published a Technical Note which, to widespread consternation, proposed the introduction of a general override targeting what HMRC regard as the abuse of tax treaties. If enacted, this would mean that income or gains apparently protected from UK tax (including withholding tax) by one of the UK's treaties lost that protection where there was a "scheme" that had as a main purpose securing the benefit of the treaty. However the proposal was withdrawn only a month later and does not now seem likely to proceed.

2 Transaction Taxes

2.1 Are there any documentary taxes in the UK?

Stamp duty is a tax on certain documents. It is chargeable only on instruments relating to stock and marketable securities, on instruments transferring an interest in certain partnerships and on bearer instruments. There is an *ad valorem* rate of duty on a transfer on sale of stock or marketable securities of 0.5% of the consideration. Bearer instruments can be transferred by delivery and so the stamp duty charge arises on issue, or in certain cases on first transfer, at the *ad valorem* rate of 1.5%.

See the answer to question 2.5 below for details of the stamp duty land tax that applies to land transactions.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The UK has had VAT since becoming an EC Member State in 1973. The UK VAT legislation gives effect to the relevant EC Directives. There are three rates of VAT:

- the standard rate of VAT is 20% and applies to any supply of goods or services which is not exempt, zero-rated or subject to the reduced rate of VAT;
- the reduced rate of VAT is 5% (e.g. for domestic fuel); and
- there is a zero rate of VAT which covers e.g. books, children's wear and foodstuffs.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

The exclusions from VAT are as permitted or required by the Directive on the Common System of VAT (2006/112/EC) (as amended) and some examples of exempt supplies are:

- certain supplies of land;
- insurance services; and
- banking and other financial services.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input tax is only recoverable by a taxable person (a person who is or is required to be registered for VAT). Input tax is attributed in accordance with the nature and tax status of the supplies that the person intends to make.

Input tax on supplies wholly used to make taxable supplies is deductible in full. Input tax wholly used to make exempt or non-business supplies is not deductible at all. Where a taxable person makes both taxable and exempt supplies and incurs expenditure that is not directly attributable to either, e.g. general overheads, the VAT on the expenditure must be apportioned between the supplies. The standard basis of apportionment is the ratio of taxable supplies to total supplies expressed as a percentage. HMRC may allow or direct the use of a different method of apportionment.

2.5 Are there any other transaction taxes?

Stamp duty land tax ("SDLT")

SDLT is a tax on transactions involving immovable property and is payable by the purchaser at the rate of 4% of the consideration for the property (there are lower rates of SDLT for consideration of £500,000 or less and, for transactions involving residential property where the consideration is in excess of £1 million, the rate is generally 5%). It is a compulsory, self-assessed transaction tax and is chargeable whether or not there is a written document.

Stamp duty reserve tax ("SDRT")

SDRT is charged in respect of an agreement to transfer chargeable securities for money or money's worth whether or not the agreement is in writing. Subject to some exceptions, "chargeable securities" are stocks, shares and units under a unit trust scheme. SDRT is imposed at the rate of 0.5% of the amount or value of consideration. A higher rate of 1.5% is imposed in respect of certain transactions involving issues into or transfers to non-EU depositaries and clearance services but there are arguments, based on the ECJ case of HSBC Holdings (C-569/07), that this charge is in breach of the Capital Duties Directive and contrary to EU law.

SDRT liability is imposed on the purchaser and is directly enforceable. Where a transaction is completed by a duly stamped instrument within six years from the date when the SDRT charge arose, there is provision in many cases for the repayment of any SDRT already paid or cancellation of the SDRT charge.

2.6 Are there any other indirect taxes of which we should be aware?

Customs duties are generally payable on goods imported from outside the EU. Excise duties are levied on particular classes of goods (e.g. alcohol and tobacco). Insurance premium tax is charged on the receipt of a premium by an insurer under a taxable insurance contract. Environmental taxes include the following: landfill tax, aggregates levy, climate change levy and a carbon reduction charge.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

In most cases, no withholding tax is imposed on dividends paid by a locally resident company to a non-resident. "Property income dividends" from UK Real Estate Investment Trusts are, however, subject to withholding tax at the rate of 20% if paid to non-resident shareholders (or to certain categories of UK resident shareholder); this may be reduced to 15%, or in some cases less, by an applicable double tax treaty.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

In the absence of a double tax treaty and provided that the UK legislation implementing the EC Interest and Royalties Directive (2003/49/EC) does not apply, the rate of withholding tax on most royalties is 20% for the tax year 2011-2012. There is no withholding tax on film and video royalties.

The UK legislation implementing that directive provides that there is no withholding tax on the payment of interest or royalties by a UK company (or a UK permanent establishment of an EU company) to an associated EU company. The exemption does not apply to the extent that any interest or royalties would not have been paid if the parties had been dealing at arm's length. An EU company for these purposes is a company resident in a Member State other than the UK.

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

In the absence of a double tax treaty and provided that the UK legislation implementing the EC Interest and Royalties Directive does not apply, the rate of withholding tax on "yearly" interest paid to a non-resident is generally 20%. There is no withholding tax, however, on interest on quoted Eurobonds.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

The UK has a thin capitalisation regime which applies to domestic as well as cross-border transactions following the <u>Lankhorst-Hohorst</u> case (C324/00).

A borrower is considered according to its own financial circumstances for the purposes of determining the amount which it would have borrowed from an independent lender. The assets and income of the borrower's direct and indirect subsidiaries can be taken into account to the same extent that an unconnected lender would recognise them, but the assets and income of other group companies are disregarded.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There are no statutory safe harbour rules. Historically, HMRC adopted a rule of thumb that a company would not generally be regarded as thinly capitalised where the level of debt to equity did not exceed a ratio of 1:1 and the ratio of income (EBIT) to interest was at least 3:1. HMRC's current guidance moves away from this to apply the arm's length standard on a case-by-case basis and sets out broad principles that should be considered.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes. A company may be thinly capitalised because of a special relationship between the borrower and the lender or because of a guarantee given by a person connected with the borrower. A "guarantee" for this purpose need not be in writing and includes any case in which the lender has a reasonable expectation that it will be paid by, or out of the assets of, another connected company.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There is a further restriction on tax relief for finance expenses of groups of companies in certain circumstances. The "worldwide debt cap", as it is known, limits the aggregate UK tax deduction for the UK members of a group that have net finance expenses to the worldwide consolidated gross finance expense of that group. The main intention is to prevent non-UK multinationals reducing the tax paid by their UK subsidiaries by "dumping" debt in the UK.

So that most groups can ignore the regime, it includes a "gateway test" based on principal rather than interest. This simply compares the aggregate of the net debt of the UK-taxpaying members of the group for an accounting period with the worldwide gross debt of the group as a whole. If the aggregate UK net debt does not exceed 75% of the worldwide gross debt then the debt cap will not apply.

Financial services groups fall outside these rules if certain conditions are met.

3.8 Does the UK have transfer pricing rules?

Yes. The UK transfer pricing rules apply to both cross-border and domestic transactions between associated companies.

If HMRC do not accept that pricing is arm's length they will raise an assessment adjusting the profits or losses accordingly. It is possible to make an application to HMRC for an advance transfer pricing agreement which has the effect that pricing (or borrowing) in accordance with its terms is treated as arm's length.

In cross-border transactions the double taxation caused by a transfer pricing adjustment can be mitigated by the provisions of a tax treaty.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax is 26% for 2011/12 but the UK Government has announced that it will be cut to 25% for 2012/13 and then by a further 1% per annum, resulting in a rate of 23% for 2014/2015.

4.2 When is that tax generally payable?

For companies other than "large" companies, corporation tax is due and payable nine months after the end of the accounting period for tax purposes.

Large companies are generally companies with profits in the accounting period in question in excess of £1.5m, but this threshold is proportionately reduced if there are associated companies (or the accounting period is less than 12 months). Large companies have to pay corporation tax in quarterly instalments based on an estimate of the tax they are likely to pay. The first instalment payment is due 6 months and 13 days from the start of the accounting period and the last instalment (which will be the balance of the corporation tax liability) is due 3 months and 14 days from the end of the accounting period.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

In general terms, tax follows the commercial accounts subject to adjustments.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Certain items of expenditure which are shown as reducing the profits in the commercial accounts are added back for tax purposes and deductions may then be allowable. For example, in the case of most plant or machinery, capital allowances on a reducing balance basis (at various rates depending on the type of asset and the level of expenditure incurred – the rules are not very generous) are substituted for accounting depreciation.

UK tax legislation has been amended to deal with various issues arising from companies adopting International Accounting Standards to draw up commercial accounts and in certain circumstances related adjustments are required for tax purposes.

4.5 Are there any tax grouping rules? Do these allow for relief in the UK for losses of overseas subsidiaries?

Yes. The UK does not permit group companies to be taxed on the basis of consolidated accounts but the grouping rules achieve a degree of effective consolidation for various tax purposes. A group consists in most cases of a parent company and its direct or indirect subsidiaries, but the exact test for whether a group exists depends on the tax in question.

Group relief group

Losses (other than capital losses) can be surrendered from one UK resident group company to another UK resident group company. Losses can also be surrendered by or to a UK permanent establishment of a non-UK group company. A UK permanent establishment of an overseas company can only surrender those losses as group relief if they are not relievable (other than against profits within the charge to UK corporation tax) in the overseas country. Similarly, a UK company can surrender the losses of an overseas permanent establishment if those losses are not relievable (other than against profits within the charge to UK corporation tax) in the overseas country.

Following the judgment of the ECJ in Marks and Spencer v David Halsey (C446/03), the UK legislation permits group relief to be given in the UK for otherwise unrelievable losses incurred by group members established elsewhere in the EU, even if they are not resident or trading in the UK. However, the applicable conditions are very restrictive. In 2009, the European Commission referred the UK to the ECJ for inadequate implementation of the ECJ ruling in Marks and Spencer, on the basis that these conditions make it virtually impossible for taxpayers to benefit from cross-border loss relief.

Capital gains group

There is no consolidation of capital gains and losses but it is possible to make an election for a gain (or loss) on a disposal made by one capital gains group member to be treated as a gain (or loss) on a disposal by another group member.

Capital assets may be transferred between capital gains group members on a no gain/no loss basis. This has the effect of postponing liability until the asset is transferred outside the group or until the company holding the asset is transferred outside the group. When a company leaves a capital gains group holding an asset which it acquired intra-group in the previous six years, a degrouping charge may arise. However, in many cases the degrouping charge will be added to the consideration received for the sale of the shares in the transferee company and will then be exempt under the substantial shareholding regime (see question 5.3 below for details of this regime).

Stamp duty and SDLT groups

Transfers between group companies are relieved from stamp duty or from SDLT where certain conditions are met.

VAT group

Transactions between group members are disregarded for VAT purposes (although HMRC have powers to override this in certain circumstances). Generally, two or more bodies corporate are eligible to be treated as members of a VAT group if each is established or has a fixed establishment in the UK and they are under common control.

On 24 June 2010 it was announced that the European Commission has decided to refer the UK (and six other EU Member States) to the ECJ in relation to its VAT grouping rules. The Commission argues that the UK's VAT grouping rules are in breach of the provisions of the VAT Directive because they allow non-taxable persons (such as dormant companies and some holding companies) to join a VAT group. Along with many UK advisers, HMRC believe that this is permitted by the VAT Directive.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, it is not.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes", above) are there - e.g. tax on the occupation of property?

Business rates are payable by the occupier of business premises based on the annual rental value. The rate depends on the location of the business premises and the size of the business. Business rates are a deductible expense for corporation tax purposes.

There are special regimes for the taxation of certain types of activity or company, such as oil exploration (profits from which are subject to a "supplementary charge") and Real Estate Investment Trusts (which are not generally taxed on income or gains from investment property).

4.8 Are there any local taxes not dealt with in answers to other questions?

Companies are not generally subject to any local taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Corporation tax is chargeable on "profits", which includes both income and capital gains. There is however a separate regime for computing capital gains. This contains more exemptions but also has the effect that capital losses can only be used against gains, not against income.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The same rate of corporation tax is applied to both. However, in relation to capital gains there is an inflation-linked basis adjustment, which means that the effective rate of tax can be less than the headline corporation tax rate.

5.3 Is there a participation exemption?

Yes. A substantial shareholdings exemption allows trading groups to dispose of trading subsidiaries without a UK tax charge, though it is narrower and more complex than the participation exemption which may be found in other countries.

Capital gains realised on the disposal of assets by non-residents are not subject to corporation tax unless the assets were used for the purposes of a trade carried on through a UK permanent establishment (see question 6.3 below).

5.4 Is there any special relief for reinvestment?

There is rollover relief for the replacement of certain categories of asset used for the purposes of a trade. Rollover is available to the extent that the whole or part of the proceeds of disposal of such assets is, within one year before or three years after the disposal, applied in the acquisition of other such assets.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

A UK resident subsidiary would pay corporation tax on its worldwide income and gains, subject to the point noted in question 7.1 below, whereas a UK branch would be liable to corporation tax only on the items listed in the answer to question 6.3. And the charge to UK corporation tax imposed on a non-resident company only applies where the non-resident company is <u>trading</u> in the UK through a permanent establishment. This means that a branch set up for investment purposes only and not carrying on a trade is not subject to UK corporation tax, though certain types of income arising in the UK – notably rent and interest – may be subject to income tax through withholding (at 20%).

6.3 How would the taxable profits of a local branch be determined?

Assuming that the local branch of a non-resident company is within the UK statutory definition of "permanent establishment" (which is based on the wording of Article 5 of the OECD Model Convention), it will be treated as though it were a distinct and separate entity dealing wholly independently with the non-resident company. It will also be treated as having the equity and loan capital which it would have if it were a distinct entity, which means that the UK thin capitalisation rules will apply to it.

Subject to any treaty provisions to the contrary, the taxable profits of a permanent establishment through which a non-resident company is trading in the UK would comprise:

- trading income arising directly or indirectly through or from the permanent establishment;
- income from property and rights used by, or held by or for, the permanent establishment (but not including exempt distributions); and

- capital gains accruing on the disposal of assets situated in the UK and effectively connected with the operations of the permanent establishment.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

The UK domestic legislation does not give treaty relief against UK tax unless the person claiming credit is resident in the UK for the accounting period in question. This means that the UK branch of a non-resident company cannot claim treaty relief.

Unilateral tax credit relief may be allowed for tax paid outside the UK in respect of the income or chargeable gains of a UK branch or agency of a non-UK resident person if certain conditions are fulfilled. Tax payable in a country where the overseas company is taxable by reason of its domicile, residence or place of management is excluded from relief. The maximum credit relief is limited to that which would have been payable if the branch or agency had been a UK resident person and the income or gains in question had been income or gains of that person.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No, it would not.

7 Overseas Profits

7.1 Does the UK tax profits earned in overseas branches?

As a general rule, and subject to tax treaty provisions, the UK taxes the profits earned in overseas branches of UK resident companies. For accounting periods beginning after 19 July 2011, however, a UK company can elect for the profits (including capital gains) of its overseas branches to be exempt from UK taxation. The downside of such an election is that the UK company cannot then use the losses of the overseas branch. An election is irrevocable and covers all overseas branches of the company making the election.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Foreign dividends and UK dividends (other than "property income dividends" from a UK Real Estate Investment Trust) are treated in the same way. They are generally exempt in the hands of a UK company, subject to some complex anti-avoidance rules and an exclusion for dividends paid by a "small" company which is not resident in the UK or a "qualifying territory".

7.3 Does the UK have "controlled foreign company" rules and if so when do these apply?

The UK currently has a comprehensive controlled foreign company ("CFC") regime, which attributes worldwide profits of a CFC to the UK parent. A CFC is, broadly, a company under UK control, resident outside the UK and taxed at an effective rate of less than 75% of the effective rate of corporation tax. There are various exemptions, covering for example most trading with third parties, but the scope of some of the exemptions is problematic; in particular, there is an overriding motive defence but its requirements are very hard to satisfy.

The UK's CFC rules were amended following the ECJ decision in Cadbury Schweppes (C-196/04). However, it is clear that the changes did not go far enough and the European Commission has issued a "reasoned opinion" to the UK Government requesting further amendment. A consultation on the full reform of the rules is underway with legislation to be enacted in 2012. The stated aim is to give the CFC regime a narrower focus that is in line with the shift in the UK's corporate tax system over the past few years, moving away from taxing worldwide profits towards a more territorial approach. So profits which naturally arise outside the UK are not supposed to be caught under the revised rules.

There will also be a new set of exemptions, including a finance company partial exemption which would by 2014 result in an effective UK corporation tax rate of 5.75% on profits derived from the provision of funding to other non-UK members of the relevant group.

8 Anti-avoidance

8.1 Does the UK have a general anti-avoidance rule?

There is currently no general anti-avoidance rule ("GAAR") in the UK, although there is an informal consultation on the possibility of a GAAR. A study group, chaired by Graham Aaronson QC, is due to report on the possible scope and design of a GAAR in October 2011.

There are, however, targeted anti-avoidance rules ("TAARs") scattered throughout the legislation, including a specific anti-avoidance rule restricting deductions of interest where one of the main purposes of the transaction is the obtaining of a relief. Another example of a TAAR is an "anti-arbitrage" rule which is aimed at the use of hybrid instruments or hybrid entities.

There are likely to be further TAARs introduced over time in response to specific avoidance schemes and also as part of the UK Government's commitment to review "high risk areas" of the tax code.

8.2 Is there a requirement to make special disclosures of avoidance schemes?

The UK has disclosure rules which are designed to provide HMRC with information about potential tax avoidance schemes at an earlier stage than would otherwise have been the case. This enables HMRC to investigate the schemes and introduce legislation (often a new TAAR) to counteract the avoidance where appropriate.

William Watson

Slaughter and May
One Bunhill Row
London, EC1Y 8YY
United Kingdom

Tel: *+44 20 7090 5052*
Fax: *+44 20 7090 5000*
Email: *william.watson@slaughterandmay.com*
URL: *www.slaughterandmay.com*

William Watson joined Slaughter and May in 1994 and became a partner in the Tax Department in 2004. His practice covers all UK taxes relevant to corporate, financing and real estate transactions; besides corporation tax, this includes VAT, the various stamp duties and other direct taxes. He also advises regularly on tax disputes.
William's transactional work has to date ranged from cross-border mergers and reconstructions for major corporate groups, through securitisations and structured finance transactions on the financing side to real estate acquisition and development.

Zoe Andrews

Slaughter and May
One Bunhill Row
London, EC1Y 8YY
United Kingdom

Tel: *+44 20 7090 5017*
Fax: *+44 20 7090 5000*
Email: *zoe.andrews@slaughterandmay.com*
URL: *www.slaughterandmay.com*

Zoe Andrews joined Slaughter and May as a tax professional support lawyer in 2004. Prior to that, she had four years experience of corporate tax practice advising on a range of international and domestic matters including tax structuring and tax aspects of corporate finance, mergers, acquisitions and disposals.

SLAUGHTER AND MAY

Slaughter and May is a leading international law firm recognised throughout the business community for its commercial awareness and commitment to clients. We have a diverse and extensive international practice advising on the full range of commercial, financing and other matters. We have a commitment to delivering top quality legal advice, combined with commercial awareness and a "can do" approach.

Our firm is unique among major UK law firms. We:

- are client focused, rather than product focused - we work with our clients to anticipate their business needs and offer solutions;
- place quality of advice before growth in numbers - our measured organic growth is sustained by lawyers recruited, trained and developed within the firm;
- work with the world's best firms internationally, rather than using the services of multiple branch offices; and
- manage large and complex transactions from beginning to end and deliver them on time.

Our tax group is involved both in structuring transactions and in advising on the documentation to implement transactions. We have particular expertise in mergers and acquisitions, flotations and privatisations, demutualisations, company reorganisations, private equity, investment funds, investigations and disputes, transfer pricing, debt and equity capital market transactions, structured finance, asset finance and leasing and securitisations.

"This corporate titan maintains a leading position in the market due to its expertise in the tax dimensions of corporate, financial and commercial deals." Chambers UK, 2011

Chapter 43

USA

Stuart L. Rosow

Proskauer Rose LLP

Amanda H. Nussbaum

1 General: Treaties

1.1 How many income tax treaties are currently in force in the United States?

The U.S. currently has 59 bilateral income tax treaties in force. These treaties cover 68 countries, including nearly every member of the European Union, Switzerland, Canada, Mexico, China, Japan, Australia and New Zealand. The U.S. treaty with Bermuda is available only to non-U.S. insurance and reinsurance companies. The only G-20 nations not covered are Argentina, Brazil and Saudi Arabia. The income tax treaty network in South America is limited, with a treaty in force with Venezuela and a treaty with Chile awaiting ratification. The U.S. also has entered into Exchange of Information Agreements with certain countries where an income tax treaty has not been agreed.

Some, but not all, of the U.S. income tax treaties also provide relief from the excise tax imposed by the U.S. on certain policies issued by non-U.S. insurers or reinsurers covering U.S. lives or U.S. perils (the "FET").

1.2 Do they generally follow the OECD or another model?

The United States generally follows the U.S. model income tax treaty, most recently modified in 2006, which is similar but not identical to the OECD model treaty. There are several notable differences between the U.S. model and the OECD model. For example, the U.S. model includes a "limitation on benefits" article (see question 1.4) and a "savings clause" that prevents U.S. citizens and residents from using the treaty to avoid taxation of U.S. source income. Although the United States uses the U.S. model rather than the OECD model treaty as the basis for negotiating new or amended treaties with other countries, the U.S. model technical explanation notes that the development of the 2006 U.S. model took into account the OECD model and deliberately adopted many OECD model provisions.

The U.S. model lags behind some of the current U.S. negotiating positions on treaty articles. For example, although not reflected in the U.S. model, a trend has developed in U.S. treaties in favour of a zero rate of withholding on dividends paid by a U.S. affiliate to its non-U.S. parent, subject to certain stock ownership requirements.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

No. Although not incorporated into domestic law, treaties have the force of federal law, and pre-empt State and local law (see question 1.5). Under the U.S. Constitution, the President makes treaties, and the Senate must advise and consent to their ratification by a 2/3 vote. In practice, tax treaties are negotiated by the Treasury Department, signed by a representative of the executive branch, signed by the President, and sent to the Senate for ratification. Once the other Contracting State carries out its corresponding internal procedures, instruments of ratification are exchanged between the Contracting States. A U.S. treaty signed by the President has no effect, however, prior to its ratification by the U.S. Senate. There are currently several new and revised treaties, as well as protocols amending existing treaties, pending before the Senate, and the timetable for Senate ratification of these treaties and protocols is uncertain.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation on benefits" articles)?

Yes. Most United States treaties incorporate a limitation on benefits ("LOB") article. The purpose of the LOB provision is to prevent bilateral treaties from conferring benefits on persons that do not have a sufficient relationship to one of the Contracting States, i.e., persons other than "qualified persons." The definition of qualified person varies widely among different treaties. In the U.S. model treaty, a qualified person includes an individual, a publicly-traded corporation and subsidiaries that meet certain trading and ownership requirements, as well as certain tax-exempt organisations, pension funds, trusts, estates, partnerships, and other companies. In some treaties, a resident of a Contracting State that is not a qualified person may be entitled to claim treaty benefits with respect to certain items of income derived from one State if it is derived in connection with the active conduct of a trade or business in the other State. In general, LOB provisions in more recent U.S. treaties are more restrictive than those negotiated in earlier treaties, and there is significant variation in the formulation of the LOB provisions from treaty to treaty.

In addition to the LOB articles included in U.S. treaties, the United States has authority to limit treaty-shopping by statute and under the common law. These include anti-conduit and hybrid entity regulations, as well as certain case law anti-abuse doctrines.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Yes. A treaty may be overridden by a domestic law enacted after a treaty takes effect. Under the U.S. Constitution, and as restated in the Internal Revenue Code, treaties and federal statutes have the equal force of law; in general, therefore, the one enacted later in time will prevail. When possible, a U.S. court will attempt to construe statutes to avoid any conflict with the terms of ratified treaties and *vice versa*. In the case of a direct conflict, however, a later-in-time federal statute will override the provisions of a ratified treaty. For example, in 1980, the Foreign Investment in Real Property Tax Act ("FIRPTA") introduced a tax on dispositions of foreign-owned real estate, and explicitly overrode existing treaty provisions. More recently, rules adopted to prevent "earnings stripping" (deductions for certain interest paid by a corporation to a tax-exempt or partially tax-exempt related person) arguably contradict the non-discrimination article of previously-enacted U.S. treaties, and the "FATCA" information reporting and withholding tax statute (see question 8.1) may override or delay the availability of benefits available under income tax treaties. Additionally, the U.S. has codified the common law "economic substance" doctrine, which could potentially apply even when the technical requirements of a treaty are satisfied.

2 Transaction Taxes

2.1 Are there any documentary taxes in the United States?

There are generally no documentary or stamp taxes imposed by the U.S. federal government. State and local governments often impose transfer taxes on the recordation or registration of documents, especially with respect to transfers of real estate.

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

The United States does not have VAT or any similar tax. While there is no federal-level consumption tax, State and local governments generally impose sales and use taxes on retail sales of tangible personal property and certain services, the incidence and rates of which vary among jurisdictions.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

There is no VAT in the United States. Although exemptions from State and local sales and use taxes vary by jurisdiction, common exemptions include: "occasional" or "casual" sales; goods or services purchased for resale; goods or services used or consumed in manufacturing; certain corporate transactions, such as transfers in connection with incorporations, liquidations, and reorganisations; and essential purchases, such as food, prescription drugs and occasionally clothing. Tax-exempt organisations are generally excused from sales and use taxes on purchases pertaining to exempt purposes.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Although retailers are generally required to collect and remit sales tax, the tax is imposed on the ultimate consumer or purchaser. Therefore, as a technical matter, sales and use taxes are not paid out of business revenues, making recovery unnecessary.

2.5 Are there any other transaction taxes?

No, there are not.

2.6 Are there any other indirect taxes of which we should be aware?

Federal excise taxes apply to a range of goods and services, including tobacco, alcohol, air transport and telephone services. Federal tariffs are levied at various rates on most imported commodities. The FET is an excise tax on certain policies written by foreign insurers and reinsurers (see question 1.1), and the U.S. Internal Revenue Service ("IRS") has ruled that in certain cases the FET may be assessed even where a non-U.S. insurer retrocedes to another non-U.S. reinsurer. Legislation generally codifying this interpretation has been proposed in the past, but whether or not such legislation might be enacted is uncertain.

State severance taxes are imposed on extractive sources such as timber and minerals in some jurisdictions. *Ad valorem* real property and, in a few cases, personal property taxes, are typically assessed on an annual basis at the State and local level. States and localities impose a variety of specialised taxes, such as taxes on hotel occupancy, and the number and scope of these taxes varies by jurisdiction.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

Yes. There is a 30% withholding tax on dividends paid by a U.S. company to a non-resident shareholder. This tax can be reduced, and in some cases eliminated, by an applicable treaty. Treaties often apply different withholding rates for dividends paid by a real estate investment trust ("REIT") or a regulated investment company ("RIC"). There is a statutory provision intended to prevent the avoidance of the withholding tax on dividends by use of "equity swaps" and other derivative transactions, and administrative guidance interpreting this statute is expected.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Yes. There is a 30% withholding tax on royalties paid by a U.S. company to a non-resident recipient. This tax can be reduced, and in some cases eliminated, by an applicable treaty. Under some treaties, different withholding tax rates apply to different types of royalties (e.g., motion picture/television, industrial and natural resource).

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Yes. There is a 30% withholding tax on interest paid by a U.S. company to a non-resident lender. As with dividends and royalties, this withholding tax may be reduced or eliminated by applicable treaty.

However, unlike its treatment of dividends and royalties, the United States provides a broad statutory exemption from withholding tax for "portfolio interest". The portfolio interest exemption generally applies to interest payments by U.S. persons on: (1) registered-form obligations if the holder certifies its status as a non-U.S. person; and (2). foreign-owned bearer form obligations (for obligations issued before March 18, 2012). Non-U.S. holders of registered-form obligations usually satisfy the certification requirement by providing a completed IRS Form W-8BEN (or similar IRS form) to the payor of the interest. Portfolio interest does not include interest:

(1) received by a 10% shareholder of the borrower; (2) received by a controlled foreign corporation related to the borrower; (3) received by a bank on a bank loan; or (4) "contingent interest" (interest based on the receipts, sales, cash flows, income, profits, dividends or distributions of a debtor or a related party). Due to these limitations, non-U.S. recipients of interest often are required to provide a statement that they are not a bank or related to the borrower, in addition to any IRS form. In addition, bank deposit interest paid by a U.S. bank (or its non-U.S. branch) is exempt from withholding tax, as is short-term original issue discount.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

The United States does not condition its available exemptions from withholding tax on interest on a borrower's level of equity capitalisation. A thinly capitalised borrower, however, could result in the IRS asserting that an instrument that is in form debt is in fact equity for tax purposes, in which case the stated interest on the debt may be subject to the dividend withholding tax (and generally not deductible by the borrower). Additionally, two statutory regimes may potentially limit the deduction of interest by a relatively thinly-capitalised U.S. borrower.

Under the "earnings stripping" rules, a borrower will defer, and may lose, its deduction for "excess interest expense" (i.e., interest expense in excess of 50% of cash flows) paid to or guaranteed by certain related parties. In addition, a thinly-capitalised U.S. issuer can deduct only a relatively minimal amount of interest on "corporate acquisition indebtedness" (generally, convertible subordinated debt issued to fund an acquisition).

The U.S. has a statutory provision permitting the promulgation of regulations distinguishing corporate debt from corporate equity, but previously proposed regulations were withdrawn long ago, and it is not known when or if new proposed regulations might be forthcoming.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There is no safe harbour under current U.S. tax laws for determining whether debt will be recharacterised as equity, and the debt-equity analysis is ultimately based on all of the facts and circumstances surrounding the borrowing. The earnings stripping rules described above do not apply to corporations with debt to equity ratios of less than 1.5 to 1 and the limitations on corporate acquisition indebtedness described above do not apply to corporations where such ratio is less than 2 to 1.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

If a foreign parent guarantees third-party debt of a thinly-capitalised U.S. subsidiary, the IRS may assert that in substance the loan was actually made to the foreign parent, which in turn advanced the funds to its U.S. subsidiary as an equity contribution. In this situation, any payments by the U.S. subsidiary to the third party lender would be recharacterised as dividends to the foreign parent. Additionally, a guarantee by a foreign parent may trigger application of the earnings stripping rules discussed in question 3.4, even though the lender is unrelated to the U.S. subsidiary, and, in general, guarantee fees paid to the foreign parent are treated as U.S. source income and thus potentially subject to U.S. withholding tax.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

Other than the restrictions on the portfolio interest exemption discussed in question 3.3, there generally are no other restrictions on tax relief for interest payments by a local company to a non-resident. However, the anti-conduit rules, the "economic substance" doctrine and certain common law doctrines could be asserted by the U.S. tax authorities to recharacterise a transaction that formally complies with these restrictions as either non-compliant or not a true loan, which could limit or deny the availability of the tax relief described above.

3.8 Does the United States have transfer pricing rules?

Yes. U.S. transfer pricing rules allow the IRS to apportion income, deductions, credits, or allowances from cross-border transactions among related entities, if it determines that such apportionment is necessary in order to prevent evasion of taxes or to reflect income clearly. These rules may apply to transfers of services, tangible property or intangible property. Large multinational companies with significant operations in the U.S. often engage experts to review their transfer pricing arrangements to ensure compliance with U.S. law. Several U.S. tax treaties provide for competent authority relief to resolve disagreements between treaty interpretations that result in double taxation that is contrary to the treaty's intent, which can include relevant transfer pricing disputes.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

Currently, the top federal tax rate for corporations is 35%. Most States and some local governments also impose income or similar taxes on corporate earnings.

4.2 When is that tax generally payable?

A corporation's tax year must match the annual period it uses for its commercial books and records, which can either be a calendar year or a fiscal year. Estimated tax payments are due quarterly. A corporation's final tax return and the payment of its remaining tax liability is due on the 15th day of the 3rd month after the end of its tax year (March 15 for a calendar year corporation), although an automatic 6-month extension is available with interest on any unpaid tax liability.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The United States has a parallel but separate system of tax accounting for determining a corporation's tax base that is distinct from other regimes that may apply for commercial, financial or statutory purposes. This system is set out in the Internal Revenue Code. Under this system, a corporation must first calculate its gross income, which includes income from services, sales of inventory (minus cost of goods sold), dividends, royalties, interest, rent and other income. Gross income also includes capital gains from sales of property. From gross income, a corporation computes its taxable income by subtracting various deductions for costs incurred in its business such as wages, depreciation, rents, interest and other ordinary and necessary business expenses.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Although the United States generally accepted accounting principles, referred to as GAAP, and tax accounting are similar in many respects, they differ in a few important ways. GAAP generally polices a reporting company's incentive to accelerate revenue and defer expenses, while tax accounting polices a company's incentive to defer income and accelerate expenses. In many cases, differences between the two systems can be traced to these competing biases. GAAP and tax accounting differ, for example, in the treatment of prepaid or contingent income and expenses. Under GAAP, income is recognised over the period to which it relates, and if a payment is received before it is earned it is held in suspense as deferred revenue. For tax purposes, income is generally recognised upon the earlier of the date of receipt or the date on which it is earned. GAAP recognises expenses in the period to which such expenses are economically attributable and often provides for the recognition of unpaid estimated expenses through reserves. By contrast, for tax purposes, business expenses cannot be deducted until the amount can be determined with reasonable accuracy, all events have occurred that fix the fact of the liability and economic performance has occurred. As a result, reserves for estimated expenses are generally not deductible in computing taxable income.

4.5 Are there any tax grouping rules? Do these allow for relief in the United States for losses of overseas subsidiaries?

Yes. In the United States, corporate members of an "affiliated group" may, and almost always do, elect to file a consolidated Federal income tax return. An affiliated group is one or more chains of U.S. corporations where a common parent corporation owns at least 80% of the stock (by vote and value) of another "includible corporation," and one or more "includible corporations" (including the common parent) own at least 80% of the stock of the next lower tier of "includible corporations". Generally speaking, the consolidated return regime taxes affiliated corporations as if they were a single taxpayer with respect to transactions with third parties. This provides affiliated groups with the benefit of being able to use losses from one affiliate to offset the income of another affiliate. Income and losses on transactions between affiliates, however, generally are deferred under complex rules until realised in a transaction outside of the group. The consolidated return rules are complex, and there are important exceptions to these general results.

Non-U.S. companies, tax-exempt corporations, and certain other companies are not includible corporations, so they may not be members of an affiliated group (and thus may not join in filing a consolidated return). Nevertheless, the U.S. owner of a non-U.S. company may elect to treat that company as a pass-through entity for U.S. tax purposes, but only if the non-U.S. company is not a type of entity that is required to be treated as a corporation under applicable U.S. tax regulations. If the election is available and made, the subsidiary's income, gains, expenses and losses flow through to its U.S. parent (and thus would appear on the U.S. parent's consolidated return).

State laws governing whether and when corporations may file consolidated returns do not necessarily correspond to the federal rules described above, and vary from State to State.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No. A corporation is generally taxed at the same rate on its distributed and undistributed earnings. There is, however, a second level of tax imposed at the shareholder level when earnings are distributed by the corporation. The earnings of partnerships and certain types of specialised corporations are not subject to this double taxation. Partnerships and electing small business corporations do not pay an entity level tax on their earnings, but their distributed or undistributed earnings flow through to their shareholders and are taxed at the shareholder level. RICs and REITs do not pay corporate level tax on their distributed earnings, but they are subject to tax on some of their retained earnings.

There are two "penalty tax" regimes imposed on corporations: an extra "accumulated earnings" tax applies to retained earnings, the purpose being to discourage corporations from accumulating excessive earnings to avoid the shareholder level tax on dividends; and certain personal holding companies are subject to tax on personal holding company income (generally income from passive activities), but only to the extent such income is undistributed.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

There are a number of federal excise taxes, as noted above. There are also federal unemployment taxes, along with social insurance taxes on employers, employees and the self-employed.

Healthcare reform legislation enacted several new taxes, the most important of which for businesses are excise taxes on certain employer-provided health insurance, and a 3.8% surtax on high-income individuals and certain trusts and estates (but not corporations) in respect of "net investment income" (generally, passive income, including dividends), effective as of January 1, 2013.

The U.S. has an estate and gift tax regime that is beyond the scope of this discussion.

4.8 Are there any local taxes not dealt with in answers to other questions?

There are a host of State and local taxes that might apply to corporations conducting business or entering into transactions in the United States. The State governments have plenary taxing authority in their own right, and as such these tax regimes vary widely. Large multinational corporations doing business in multiple States often devote significant resources to state and local tax planning.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Corporate taxpayers may deduct capital losses, but only to the extent of capital gains. Excess capital losses generally may be carried back three years and carried forward five years to offset capital gains from such years.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

While individual taxpayers are entitled to preferential rates on gains derived from the sale or exchange of a capital asset held for more than one year, corporate taxpayers bear tax at the same rate on both capital gain and ordinary operating income (see question 4.1). As a result, the principal issue for corporate taxpayers is not a rate difference, but the character mismatch described in question 5.1.

5.3 Is there a participation exemption?

There is no participation exemption in the United States. A U.S. corporation is fully taxed on dividends received from a foreign subsidiary and on gain from the sale or exchange of stock in a foreign subsidiary. Additionally, there are anti-deferral regimes that generally require current inclusion of passive income of a more-than-50% owned foreign subsidiary (see question 7.3).

A foreign tax credit generally is available, subject to complex limitations, for foreign taxes paid by a U.S. corporation and for its allocable share of the foreign taxes paid by the foreign subsidiary when dividends are distributed by that foreign subsidiary (see sections 6 and 7).

Non-U.S. shareholders are generally exempt from U.S. tax on capital gain from the sale of stock of a U.S. corporation, subject to certain exceptions for U.S. corporations that own substantial amounts of real estate.

5.4 Is there any special relief for reinvestment?

Several means of relief are provided under U.S. law. For example, many mergers and other transactions involving stock consideration are exempt from immediate taxation as tax-free "reorganisations", under the theory that the transaction represents a mere change in corporate form and the assets invested remain in corporate solution. Also, corporate sellers of publicly-traded securities may defer recognition of gain if they reinvest the proceeds in a "specialised small business investment company". Finally, certain exchanges of "like-kind" or replacement property are exempt from immediate taxation.

Additionally, the "penalty tax" on accumulated earnings is avoided to the extent that a corporation reinvests such accumulated earnings (or expects such accumulated earnings will be required to meet the reasonable needs of the business).

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no federal taxes upon incorporation of a subsidiary.

There may be State filing fees and State franchise taxes imposed upon formation, the magnitude of which depends upon the particular jurisdiction of incorporation.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No. There are no additional Federal taxes that would be incurred by a locally-formed subsidiary that is fiscally transparent, but not by a branch of a non-resident company. Annual State franchise taxes and filing fees may differ, depending upon the particular jurisdiction of formation.

However, if a foreign parent forms a U.S. subsidiary that is a corporation (or elects to be taxable as a corporation), such as a U.S. subsidiary, they would be treated as a U.S. taxpayer in their own right, and would be subject to tax on its worldwide income in the same manner as any other domestic U.S. corporation. A branch of a non-resident company, by contrast, is generally only subject to U.S. tax on its U.S. effectively connected income ("ECI") or, if the foreign parent is treaty-eligible, its income that is attributable to a U.S. permanent establishment.

6.3 How would the taxable profits of a local branch be determined?

In the absence of an applicable treaty, a U.S. branch of a foreign corporation will be subject to U.S. corporate income tax at regular rates on net ECI income. Generally, ECI will include gross income and expenses properly allocable thereto. Complex rules govern the allocation of a foreign corporation's worldwide interest income and expense to its U.S. branch, and include special rules applicable to non-U.S. banks and non-U.S. insurance companies. If a treaty applies, then a branch will be subject to U.S. federal income tax only on the profits attributable to a U.S. permanent establishment. The tax burden may be reduced (but never increased) if a treaty applies.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

Yes. In the absence of a treaty, a branch of a foreign corporation is subject to a 30% branch profits tax on its after-tax "dividend equivalent amount". A branch's dividend equivalent amount is its effectively-connected earnings and profits for the taxable year to the extent that they are not reflected in the corporation's U.S. net equity.

A branch cannot literally pay a "dividend" for U.S. income tax purposes, because a dividend is defined as a distribution from a corporation to its shareholders. The branch profits tax is therefore intended to tax the branch on the repatriation of its earnings in a manner similar to the taxation of a dividend paid by a U.S. subsidiary, which is subject to withholding tax at a 30% or reduced treaty rate.

Treaties may reduce or eliminate the branch profits tax. Typically, treaties that reduce the rate of dividend withholding tax also reduce the rate of branch profits tax. If a treaty reduces the rate of dividend withholding tax but does not address the branch profits tax, the branch profits tax generally is limited by statute to the treaty rate of dividend withholding.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A U.S. branch of a non-U.S. entity generally will not be treated as a resident of the U.S. within the usual treaty definition, and thus will not be eligible for benefits provided by treaty to U.S. persons.

An entity with a U.S. branch may, however, benefit from a reduction of U.S. tax under a treaty between the United States and the entity's home country. For example, if the entity is a tax resident of the treaty partner, the amount of its branch's income subject to U.S. tax may be limited to its profits attributable to a permanent establishment in the United States, which may reduce its tax burden (see question 6.3). If the entity is a qualified resident, remittances from the branch may be eligible for a reduction of the branch profits tax under a treaty (see question 6.4).

6.6 **Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?**

Yes. The branch profits tax imposes a tax if profits are remitted by the branch (see question 6.4).

7 Overseas Profits

7.1 **Does the United States tax profits earned in overseas branches?**

The answer depends on whether a "branch" is treated as fiscally transparent for U.S. federal income tax purposes.

If an overseas "branch" is a foreign subsidiary of a U.S. entity treated for U.S. tax purposes as a "pass-through" (i.e., as fiscally transparent), or a true branch (i.e., the overseas operations of the U.S. entity are undertaken directly), U.S. federal income tax generally would be imposed on the income of such a branch on a current basis, regardless of where earned and whether or not such income is immediately remitted or remains invested overseas. The effect of such worldwide current taxation of a branch may be mitigated by the U.S. foreign tax credit, although this credit is subject to a complex system of limitations based on several different factors.

If, in the alternative, an overseas "branch" is treated for U.S. tax purposes as a corporation (i.e., fiscally opaque), then the U.S. owner generally would not be subject to current U.S. taxation on its earnings until remitted to the U.S. parent entity (see question 7.2), unless one of the "anti-deferral" regimes were to apply, including the controlled foreign corporation regime (see question 7.3).

Another anti-deferral regime applicable to U.S. shareholders of foreign corporations is the passive foreign investment company ("PFIC") regime. In general, a foreign corporation is a PFIC with respect to a U.S. shareholder if 75% of its income for a taxable year is passive income (within the meaning of the PFIC rules), or if 50% of its assets held at the end of any quarter of the taxable year generate passive income. If a U.S. shareholder owns stock in a PFIC, such U.S. shareholder will be subject to negative U.S. tax consequences upon receipt of certain distributions from the PFIC or the sale of the PFIC stock, unless either a "qualified electing fund" ("QEF") election is made or, when permitted, a mark-to-market election is made. If a QEF election is made by an eligible U.S. shareholder, the U.S. shareholder generally would include its share of the subsidiary's ordinary income and net capital gain on a current basis in a manner similar to that of a partnership (but would not receive the benefit of losses or deductions of the foreign corporation). A U.S. shareholder that is subject to the controlled foreign corporation rules (see question 7.3) generally is not subject to the PFIC regime simultaneously, although the interaction of the two regimes is complex.

7.2 **Is tax imposed on the receipt of dividends by a local company from a non-resident company?**

As in question 7.1, the answer depends on whether or not the non-resident company is fiscally transparent. If a non-resident company is treated as a corporation for U.S. tax purposes, and no anti-deferral regime applies, then the U.S. shareholders of such non-resident company generally would be treated as receiving a taxable dividend upon receipt of a distribution (including certain deemed distributions by operation of other provisions of the Internal Revenue Code) from the non-resident company, to the extent of such non-resident company's undistributed "earnings and profits" (as determined for U.S. tax purposes). If the foreign corporation is subject to either the PFIC (see question 7.1) or the controlled foreign corporation (see question 7.3) anti-deferral regime, the amount subject to dividend taxation generally will be reduced to the extent that such amounts constitute income previously taxed to the U.S. shareholder. Certain U.S. corporations may be eligible for an indirect tax credit for some foreign taxes paid by the non-resident company when such a distribution is received.

If a non-resident company is treated as a fiscally transparent entity for U.S. tax purposes, then the receipt of a distribution generally would not be a taxable event, since the underlying profits would have been subject to tax on a current basis when earned (see question 7.1).

7.3 **Does the United States have "controlled foreign company" rules and if so when do these apply?**

Yes. The U.S. controlled foreign corporation ("CFC") rules can apply to non-resident companies that are taxable as corporations for U.S. federal income tax purposes. Such a foreign company will be a CFC if more than 50% of either the total value or the total combined voting power of the foreign company is held by one or more U.S. persons, each of whom owns (directly or by attribution) 10% or more of the total combined voting power of the non-U.S. company.

The CFC rules are intended to act as an anti-deferral regime. As such, treatment of a foreign company as a CFC generally requires the 10%-or-more U.S. shareholders to include in U.S. taxable income on a current basis their allocable share of non-U.S. income that is "Subpart F income" – generally, income from passive sources (e.g., interest, dividends, rents, royalties and gains from disposition of stock), certain foreign sales and services income and certain non-U.S. oil and gas income. The categories of income subject to current inclusion are subject to numerous exceptions and special rules, a complete discussion of which is beyond the scope of this summary.

Income of a CFC that is not Subpart F income generally is not subject to current inclusion; rather, such income is subject to tax when distributions are actually made to the 10%-or-more U.S. shareholders (see question 7.2) or when deemed distributed by being invested in U.S. property, including as a result of the CFC providing a guarantee to, or pledging its assets on behalf of, its U.S. owners. To the extent that amounts distributed to a 10%-or-more U.S. shareholder have been previously taxed in the U.S. as Subpart F income, such distributed amounts generally are not taxed again.

Additionally, there is a somewhat different set of anti-deferral rules for non-U.S. companies that are 25% owned by U.S. persons and that earn insurance income from related parties; such non-U.S. companies are known as "RPII CFCs" and the RPII CFC rules, while similar in concept to the general CFC rules, have a number of important differences reflecting special considerations applicable to insurance companies.

8 Anti-avoidance

8.1 **Does the United States have a general anti-avoidance rule?**

Although there is no overarching anti-avoidance rule under U.S. federal tax law, numerous statutory and regulatory provisions are designed to discourage evasive tax planning. Examples include: civil penalties covering a range of non-compliant activities, including inaccurate filings and tax shelters; prohibitions on acquiring another corporation with losses or other tax attributes with the principal purpose of evading federal income tax; anti-deferral regimes that prohibit inappropriate deferrals of U.S. tax on foreign earnings of U.S. multinational corporations; transfer pricing regimes that prohibit deferrals or avoidance of U.S. intercompany tax by U.S. multinational corporations through sales or other transactions on non-arm's length terms; treaty-shopping restrictions; and reporting requirements for taxpayers who engage in certain abusive transactions. Additionally, the United States has codified the "economic substance" doctrine, which may result in the recharacterisation of transactions that do not change the taxpayer's economic position (apart from U.S. tax) in a meaningful way and do not have a substantial non-tax purpose, and the incremental tax liability imposed as a result of such recharacterisation will be subject to a 20% penalty, increased to 40% if the transaction is not disclosed to the IRS.

In addition to specific statutory provisions, judicial doctrines have been developed to prevent tax results that are inconsistent with the intent of Congress; a court or the IRS may recast the legal form of a transaction to reflect the underlying economic reality. For example, a court or the IRS may apply the "step-transaction" doctrine by combining multiple parts of an overall plan when the separate treatment of each part produces an inappropriate tax result. The step transaction doctrine seeks to tax a particular transaction in accordance with its substance, without regard to its legal form; that is, where literal statutory or regulatory compliance results in an unintended tax consequence, a court may recharacterise the transaction appropriately.

The United States also recently enacted a new information reporting and withholding tax regime (known as "FATCA") generally applicable to certain "withholdable payments" made by "foreign financial institutions" (in each case defined very broadly). The statutory effective date for the FATCA regime is January 1, 2013; however, the IRS has announced a phased implementation of these rules that extends the date of enforcement of some of the most important provisions to January 1, 2014 or January 1, 2015. The regulatory framework relating to this regime continues to be developed by the IRS and the Treasury Department, and substantial preliminary guidance has been released containing the framework for what are expected to be extensive new regulations. Once these regulations are promulgated and the phased implementation is complete, it is expected that FATCA will affect virtually all multinational enterprises that have direct or indirect connections to the United States to some extent.

In addition, the President and U.S. Congress continue to propose a variety of new anti-avoidance measures, although it is not known whether or if such proposals might be enacted, or in what form.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Yes. There are regulations that require a taxpayer who participates in a "reportable transaction" to file an information return on such reportable transaction with the IRS, generally containing information identifying and describing the transaction and information describing any potential tax benefits expected to result from the transaction. These reporting rules also apply to "material advisors" to the transaction (generally, promoters and advisers who earn fees over a certain threshold amount). Reportable transactions include five categories of transactions: "listed transactions" (certain transactions specifically identified by the IRS in published guidance as having avoidance potential), transactions that generally require the intended U.S. tax treatment be treated as confidential, certain transactions containing contractual protection against the risk of losing intended tax benefits, certain loss transactions, and "transactions of interest" (generally, transactions identified by the IRS that are the same as, or similar to, other reportable transactions). The IRS has published a list of common transactions that are exempt from the reportable transactions requirements because such transactions generally are viewed as having little potential for tax avoidance.

A 25% foreign-owned U.S. corporation or a foreign corporation engaged in a trade or business within the United States generally must make an annual filing of certain transactions it engages in with a foreign related party (defined broadly). In addition, there are requirements that all taxpayers include as an attachment to their income tax returns a number of specific disclosure attachments, where relevant, including disclosure of treaty-based return positions, return positions that are contrary to existing regulations or published guidance, certain return positions that are inconsistent with the return positions taken by counterparties to a particular transaction, and uncertain tax positions which are reflected on the financial statements of large companies with assets that exceed certain thresholds. The rules governing whether and when a taxpayer is required to make some or all of these disclosures are complex, and corporate taxpayers often consult extensively with their advisers and auditors about the nature and scope of such disclosures.

Acknowledgment

The authors would like to acknowledge the assistance of their colleague Martin T. Hamilton (mhamilton@proskauer.com; +1 212 969 3964) in the preparation of this chapter.

Stuart L. Rosow

Proskauer Rose LLP
Eleven Times Square
New York, NY 10036-8299
USA

Tel: +1 212 969 3150
Fax: +1 212 969 2900
Email: srosow@proskauer.com
URL: www.proskauer.com

Stuart Rosow is a Partner in the Tax Department of Proskauer and a leader of the firm's transactional tax team. He concentrates on the taxation of complex business and investment transactions. His practice includes representation of publicly traded and privately held corporations, financial institutions, operating international and domestic joint ventures, and investment partnerships, healthcare providers, charities and other tax-exempt entities and individuals.

Amanda H. Nussbaum

Proskauer Rose LLP
Eleven Times Square
New York, NY 10036-8299
USA

Tel: +1 212 969 3642
Fax: +1 212 969 2900
Email: anussbaum@proskauer.com
URL: www.proskauer.com

Amanda Nussbaum is a Partner in the Tax Department of Proskauer and a member of the firm's Private Investment Funds Group. Her practice concentrates on planning for and the structuring of domestic and international private investment funds, including venture capital, buyout, real estate and hedge funds, as well as advising those funds on investment activities and operational issues. She also represents many types of investors, including tax-exempt and non-U.S. investors, in connection with their investments in private investment funds.

Proskauer

Proskauer is a global law firm widely recognised for its leadership in a variety of legal services provided to clients worldwide from offices in Boca Raton, Boston, Chicago, Hong Kong, London, Los Angeles, New Orleans, New York, Newark, Paris, São Paulo and Washington, DC. Additional information about the firm, which has extensive experience in all areas of practice important to businesses, not-for-profit institutions and individuals, can be found at www.proskauer.com

Chapter 44

Vietnam

Samantha Campbell

Phan Thi Lieu

Gide Loyrette Nouel A.A.R.P.I.

1 General: Treaties

1.1 How many income tax treaties are currently in force in Vietnam?

Vietnam has entered into income tax treaties with 61 countries around the world, of which 54 tax treaties are currently in force.

1.2 Do they generally follow the OECD or another model?

Though Vietnam is not a member of the OECD, in general Vietnamese tax treaties follow the OECD model with some modifications. In particular, certain provisions (e.g. provisions relating to the definition of permanent establishment or the rights to tax "at source income" rather than "residence" criteria) conform with the United Nations model, which is appropriate for a developing country such as Vietnam.

1.3 Do treaties have to be incorporated into domestic law before they take effect?

Yes. A tax treaty must be incorporated into domestic law before it takes effect. Under the Law on Conclusion of, Accession to, and Implementation of International Treaties, depending on the nature of the treaty, the Vietnamese competent authorities will decide whether to: (i) directly apply the whole or a part of the treaty in cases where the treaty is clear and specific enough for implementation; or (ii) revise, supplement or repeal existing domestic regulations or issue specific legal documents to implement the treaty. In respect of an agreement for the avoidance of double taxation, the Prime Minister must issue a decision to approve the executed agreement prior to its implementation.

1.4 Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

In general, there are no "limitation of benefits" articles applied to almost all double tax treaties which Vietnam signed with other countries. However, in some treaties, there are some provisions relating to this area. For instance, the treaty with the Philippines contains a clause which provides that the competent authorities of the Contracting States may deny the benefits of this treaty to any person, or with respect to any transaction, if, in their opinion, the granting of those benefits, under the circumstances, would constitute an abuse of the treaty according to its purpose. Similarly, the treaty with Hong Kong provides that nothing in the treaty shall prejudice the right of each Contracting Party to apply its domestic laws and measures concerning tax avoidance, whether or not described as such.

1.5 Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

Under Vietnamese regulations, in cases where there is discrepancy between an international treaty and Vietnamese laws in respect of an issue, the regulations of the international treaty shall prevail.

2 Transaction Taxes

2.1 Are there any documentary taxes in Vietnam?

Stamp duty, which is formally referred to as a registration fee in Vietnam, is a tax on the acquisition of certain assets, where the registration of the ownership of that asset is compulsory, e.g. land use rights, boats/ships, aircrafts, cars, motorcycles. Under current regulations, the stamp duty rates vary from 0.5% to 20%, but the duty is capped at VND500 million per asset (approximately US$25,000), except for passenger cars with less than ten seats; yachts and airplanes (where there is no such cap). By way of example, the rate of 0.5% is applicable to house and land; 1% is applicable to boats/ships; and the rate ranging from 10% to 20% is applicable to passenger cars with less than 10 seats (to be determined at the discretion of the local province).

2.2 Do you have Value Added Tax (or a similar tax)? If so, at what rate or rates?

Vietnamese Value Added Tax ("VAT") is applied to all goods and services used for production, trading and consumption in Vietnam. VAT is charged on the selling price (exclusive of VAT) of the goods and services supplied. The standard VAT rate is 10%, and the preferential rates are 5% and 0%. While the rate of 0% mainly applies to export goods and services, the rate of 5% applies generally to essential goods and services such as clean water, books, foodstuffs, medicine and medical equipment, various agricultural products and services, etc. The 10% rate applies to the remaining goods and services.

2.3 Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

VAT exemption is applied to many categories of transactions, including transactions involving the following:

- Certain agricultural products.
- Transfers of land use rights.
- Certain securities activities: securities brokerage; securities self-trading; securities underwriting; securities investment consultancy; securities depository; securities investment fund management; portfolio management; services for market organisations provided by exchanges or securities trading centres; and any other trading activities pursuant to the law on securities.
- Services for market organisations provided by exchanges or securities trading centres comprising approval for listing, listing management, trading management, management of trading members, provision of information relating to listing or trading management and any other relevant services.
- Transfer of capital in limited liability companies; transfer of securities and transfer of capital in any other form (the definition of "other form" is not provided in the VAT regulations).
- Financial derivatives and credit services.
- A number of insurance services (e.g. life insurance, non-commercial insurance).
- Medical services.
- Teaching and training.
- Certain public welfare services.
- Certain cultural, artistic, sport services/products.
- Transfer of technology and software services.
- Imports of machinery equipment and special means of transport used in technology research and development activities and which cannot be produced in Vietnam.

2.4 Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

Input VAT for service/goods purchased to be directly used for the making of VAT taxable supplies are fully creditable. If the output of an enterprise is VAT-exempt (i.e. an enterprise sells goods and services which are not subject to VAT), the relevant input VAT is non-creditable. Input VAT on fixed assets used in manufacturing and performing businesses for both VATable and non-VATable goods and services are however fully credited. As an exceptional case, when the value of a car with less than 10 seats is more than VND 1.6 billion, the input VAT corresponding to the proportion of value which exceeds VND 1.6 billion is non-creditable.

Input VAT is creditable in the month when such VAT input is incurred or within six months. A valid tax invoice must generally be retained to support claims for input tax credits. The tax invoice must state the pre-tax price, the VAT and the total amount payable.

Input VAT is only creditable if:

- the claim is supported by proper invoices for the purchase of goods or services or vouchers;
- payments for goods or services in excess of VND 20 million (approx. US$1,200) must be made by and supported with bank transfer documentation; and
- goods and services are purchased for business-related purposes. In practice, if an expense is viewed as non-deductible for corporate income tax purposes, it is likely that related input VAT is also non-creditable.

2.5 Are there any other transaction taxes?

Prior to 2009, the transfer of land use rights was subject to a tax of 4% on the sale proceeds, which were chiefly calculated based on the land price promulgated by the local provincial People's Committee. This tax on transfer of land use rights, however, is currently not in force.

2.6 Are there any other indirect taxes of which we should be aware?

Special Sales Tax is a type of excise duty which applies to the production or importation of a number of goods and services which are considered as a luxury in relation to the economic conditions of the country and are therefore not encouraged to be consumed or carried out in Vietnam, such as cigarettes, liquor, beer, automobiles of less than 24 seats, airplanes, boats, playing cards, discotheques, massages, karaokes, casinos, and gambling.

Import and export duties generally apply on import and export goods, except for some exemptions. The import duty rates change frequently and are classified into three categories: ordinary rates; preferential rates; and special preferential rates. Exports are however generally encouraged. Therefore, zero rate export duty is applicable to almost all types of export goods except crude oil and minerals.

Other indirect taxes include fuel surcharges, and from early 2012, a new tax on environmental protection.

3 Cross-border Payments

3.1 Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

There is no withholding tax imposed on dividends paid by a locally resident company to a non-resident who is not an individual.

3.2 Would there be any withholding tax on royalties paid by a local company to a non-resident?

Royalties paid by a local company to a non-resident are currently subject to withholding tax which is normally referred to as foreign contractor withholding tax ("**FCWT**") in Vietnam. The FCWT regime applies to foreign contractors and foreign subcontractors doing business in Vietnam or having Vietnam-sourced income on the basis of contracts, agreements or commitments with Vietnamese organisations/individuals. FCWT includes two components; VAT and corporate income tax ("**CIT**"). The royalties, however, are not subject to VAT but are subject to CIT at 10%. The tax treatment/protection may be impacted differently under any relevant double tax treaties ("**DTTs**").

3.3 Would there be any withholding tax on interest paid by a local company to a non-resident?

Any interest paid by a Vietnamese entity to foreign lenders who are not individuals will be subject to withholding tax (under FCWT regime as discussed above) at 10% of CIT on the gross amount of interest paid, unless otherwise stipulated in DTTs. Similarly to royalties, interest is not subject to VAT.

3.4 Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Vietnam does not have thin capitalisation rules. It did previously have a maximum 70:30 debt to equity limit, but this was removed in 2006, and the debt to equity structure of the company will be subject to individual negotiations with and approval of the licensing authority. In practice, this ratio may still apply to foreign invested companies, and Vietnamese authorities may refuse to grant a licence if the charter capital is less than about 20% of the total amount of investment capital, depending on the nature and size of the project. If the offshore loans are in line with the issued business registration certificate/investment certificate, there will be no restriction on the interest so-paid.

Notwithstanding the above discussion, interest expenses shall not be deductible for CIT purposes for a local borrower in the following cases:

- Interest expenses on loans corresponding to the portion of committed charter capital not yet contributed.
- Interest on loans from non-economic and non-credit organisations exceeding 1.5 times the interest rate set by the State Bank of Vietnam at the time the loan is concluded.

3.5 If so, is there a "safe harbour" by reference to which tax relief is assured?

There are no safe harbour rules under Vietnamese law.

3.6 Would any such "thin capitalisation" rules extend to debt advanced by a third party but guaranteed by a parent company?

As discussed in question 3.4, there are currently no "thin capitalisation" general rules in Vietnam.

3.7 Are there any other restrictions on tax relief for interest payments by a local company to a non-resident?

There are no relevant regulations under Vietnamese law.

3.8 Does Vietnam have transfer pricing rules?

Yes. The first detailed transfer pricing guidelines of Vietnam were issued and effective in 2006 and were recently replaced by a new circular issued in April 2010.

The guidelines apply to transactions between related parties, both domestically and internationally, and to transactions between an offshore parent and its subsidiaries, and/or other brother-sister corporations.

There is a comprehensive definition of related parties. The control threshold is much lower than in many other countries (20%) and therefore this significantly increases the number of companies potentially subject to transfer pricing rules in Vietnam.

Although not a member of the OECD, the methodologies generally follow the principles put forward in the revised OECD transfer pricing guidelines and the internationally accepted "arms length principle", but with additional prescriptive requirements. The acceptable methods of determining an arms length price are: (i) Comparable Uncontrolled Price ("CUP"); (ii) Resale Price Method; (iii) Cost Plus; (iv) Comparable Profits Method ("CPM"); and (v) Profit Split.

A declaration of transactions with related parties is required to be completed in a prescribed form, to be filed together with the CIT return in which details of associated transactions and the methodologies adopted must be described.

4 Tax on Business Operations: General

4.1 What is the headline rate of tax on corporate profits?

The headline rate of tax is currently 25%.

The rate applicable to the activities of prospecting, exploration and mining of petroleum and gas ranges from 32% to 50%.

4.2 When is that tax generally payable?

CIT has to be provisionally paid on a quarterly basis no later than the 30th day of the subsequent quarter. The deadline for paying annual finalisation CIT is no later than the 90th day from the end of the fiscal year.

In view of the current economic situation, the Vietnamese government has continued to allow small and medium enterprises to defer the payment of 2011 CIT liabilities as follows:

- provisional CIT for the first quarter of 2011 must be paid by 30 April 2012;
- provisional CIT for the second quarter of 2011 must be paid by 30 July 2012;
- provisional CIT for the third quarter of 2011 must be paid by 30 October 2012; and
- provisional CIT for the fourth quarter and final CIT liabilities for 2011 must be paid by 31 March 2013.

4.3 What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base is the accounting profit in the annual financial statements prepared in accordance with Vietnamese accounting standards, subject to adjustments stipulated by the Law on CIT.

In particular, assessable income shall be equal to the taxable income less exempt income and losses carried forward from previous years. Taxable income is computed by starting with revenue/turnover and deducting allowable incurred expenses. Additional adjustments are made for expenses that are not deductible for income tax purposes. To be deductible for tax purposes, expenses must be supported by proper invoices or receipts.

Taxable income is the difference between total revenue, whether domestic or foreign sourced, and deductible expenditures, plus other additional income.

The following key adjustment items can be noted:

Items increasing the tax base

Generally, adjustments increasing taxable income are mostly related to the difference between accounting and CIT treatment and are typically related to expenses which are disallowed for tax deduction, including:

- incurred expenses not relating to business activities;
- expenses which are not supported by legitimate invoices and source vouchers;
- depreciation of fixed assets which are not correctly calculated in accordance with CIT regulations;
- business management expenses allocated by a foreign parent company to its local branch that exceed permitted levels;

- accruals and provisions which are not actually and fully spent;
- advertisement and promotional expenditures which exceed the deductible cap as provided by CIT regulations;
- employment costs which are non-deductible under CIT regulations (e.g. life/health insurance or any other kind of insurance which are not compulsory under Vietnamese regulations relating to employees);
- unrealised foreign exchange losses due to the revaluation of foreign currency items other than accounts payables at the end of a financial year; and
- interest payments on loans corresponding to the unpaid portion of committed charter capital.

Items decreasing the tax base

- losses carried forward incurred within five years;
- income earned from the performance of technical services directly serving agricultural production;
- after tax dividends;
- interest income from bonds which are tax exempt;
- foreign tax credit claims;
- differences in the recognition of accounting revenues and revenues for taxation purposes; and
- amounts related to science and technology development funding, which can be up to 10% of pre-tax annual income.

4.4 If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

The accounting profit in the annual financial statements should be used along with the adjustments required by CIT regulations (see answer to question 4.3 above) for the determination of the tax base.

Income from the assignment of capital in a Limited Liability Company and the transfer of securities and income from real property transfers are subject to the following specific treatments:

- Assessable income from a capital assignment shall be the excess of the transfer price less the cost base, which is the initial value of the capital contribution portion and any assignment expenses.
- Assessable income from a transfer of securities shall be equal to the selling price less the purchase price of the transferred securities and less any expenses related to the transfer.
- Assessable income from a real property transfer shall be equal to the taxable income less losses carried forward from real property transfer of previous years. Taxable income from a real property transfer shall be equal to revenues from the real property transfer less the initial cost of the real property and less any related deductible expenses.

4.5 Are there any tax grouping rules? Do these allow for relief in Vietnam for losses of overseas subsidiaries?

There are no tax grouping rules or tax group reliefs in Vietnamese law.

Although Vietnamese accounting law provides a possibility for a parent company to prepare consolidated financial statements at the end of annual accounting periods, Vietnamese tax law does not permit a group company to file a consolidated tax return.

There is no relief in Vietnam for losses of overseas subsidiaries. Losses arising from an offshore investment project of a Vietnamese company shall not be permitted to be offset against the Vietnamese taxable income generated by the company for CIT purposes.

4.6 Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No, tax is not imposed at a different rate upon distributed, as opposed to retained, profits in Vietnam.

4.7 Are companies subject to any other national taxes (excluding those dealt with in "Transaction Taxes") - e.g. tax on the occupation of property?

The most relevant Vietnamese taxes (excluding the above mentioned CIT and VAT) are the following:

- personal income tax;
- import and export tax;
- special sales tax;
- foreign contractor withholding tax;
- natural resource tax;
- registration fees (similar to stamp duty in other jurisdictions);
- business licence tax;
- property tax: currently there are no actual property taxes in Vietnam but there are land use fees to be paid to the government by certain users such as foreign invested enterprises; and
- compulsory social insurance/health insurance and unemployment insurance contributions (which may be similar to payroll tax in other jurisdictions).

4.8 Are there any local taxes not dealt with in answers to other questions?

There are no other local taxes.

5 Capital Gains

5.1 Is there a special set of rules for taxing capital gains and losses?

Vietnam does not have a separate capital tax rule. Tax on capital gains is covered under income tax (corporate income tax and/or personal income tax). Further to the discussion in question 4.4 above, generally, the tax treatment of capital gains/capital transfer is subject to particular guidance. For example, the transfer of an interest or shares in a Vietnamese entity by non-resident investors who are not individuals shall be subject to tax as follows:

- 25% CIT on gains when transferring an interest in a limited liability company. The gains will be defined as the excess of the sale proceeds less the cost base (i.e. initial value of capital contribution for first sale) and transfer expenses.
- 0.1% CIT on the sale proceeds in the case of a transfer of listed shares or the transfer of shares in a public company registered for trading at a securities trading centre.

5.2 If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

The tax rate of 25% is commonly applicable to income from capital assignment and transfer of securities generated by residents who are not individuals (see answer to question 5.1 for tax treatment of capital gains generated by non-residents). Income from capital assignment or securities transfer is however not entitled to tax incentives (e.g. CIT preferential tax rate or CIT exemption/reduction).

5.3 Is there a participation exemption?

There is no participation exemption in Vietnam.

5.4 Is there any special relief for reinvestment?

Since 2004, there has been no special relief for reinvestment in Vietnam.

6 Local Branch or Subsidiary?

6.1 What taxes (e.g. capital duty) would be imposed upon the formation of a subsidiary?

There are no taxes imposed on the formation of a subsidiary.

However, registration fees must be paid for the establishment of a subsidiary in Vietnam in certain sectors, in particular, banking, securities or insurance.

6.2 Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

No, both a Vietnamese resident subsidiary and a Vietnamese branch of a non-resident company would pay CIT on taxable income generated in Vietnam as well as on taxable income arising outside Vietnam (which relates to its operation, in case of a Vietnamese branch of a non-resident company).

6.3 How would the taxable profits of a local branch be determined?

The taxable profits of a local branch must be determined in the same way as other independent entities in Vietnam as discussed above. A local branch can however claim a tax deduction on the management expenses which are allocated to the branch by its overseas head office up to the level allowed by CIT regulations.

6.4 Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax in Vietnam.

6.5 Would a branch benefit from tax treaty provisions, or some of them?

A branch registered in Vietnam is not a Vietnamese tax resident, and may not benefit from a corresponding tax treaty. Moreover, a branch of a non-resident company is considered a permanent establishment of such non-resident company in Vietnam, which may sometime take away the treaty protection of the Vietnamese double tax treaties for such non-resident companies.

6.6 Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

No withholding tax or other tax would be imposed to the remittance of profits by the branch.

7 Anti-avoidance

7.1 Does Vietnam tax profits earned in overseas branches?

Vietnam imposes 25% on income earned from overseas direct investment (including from overseas branches). Foreign tax credit (to the extent that the credit claimed is not in excess of the tax payable under Vietnamese regulations) and tax sparing against Vietnamese tax payable is allowed.

7.2 Is tax imposed on the receipt of dividends by a local company from a non-resident company?

Vietnam does not have tax regulations which solely govern the treatment of dividends received by a local company from a non-resident company. The regulatory legal framework on indirect investment overseas in general, and the tax treatment of income from indirect investment overseas (or passive income such as dividends) in particular, is unclear. Generally, income from overseas investment received by a local company shall be taxed at 25% as discussed in question 7.1 above.

7.3 Does Vietnam have "controlled foreign company" rules and if so when do these apply?

There is no CFC rule in Vietnam.

8 Anti-avoidance

8.1 Does Vietnam have a general anti-avoidance rule?

There are neither general anti-avoidance rules nor disclosure rules in Vietnam. In practice, there are ways for the tax authorities to deal with tax avoidance, such as regulations on transfer pricing, and the application of fixed prices issued by the authorities for a number of assets/goods/products such as land, imported goods, etc. to determine tax liabilities. In general, Vietnamese laws address the issue of preventing tax avoidance by applying heavy monetary penalties and other administrative measures to deal with violations on tax.

8.2 Is there a requirement to make special disclosure of avoidance schemes?

Please refer to question 8.1.

Samantha Campbell

Gide Loyrette Nouel A.A.R.P.I.
18 Hai Ba Trung, District 1
Ho Chi Minh City
Vietnam

Tel: *+84 8 3823 8599*
Fax: *+84 8 3823 8598*
Email: *samantha.campbell@gide.com*
Web: *www.gide.com*

Samantha Campbell is an English-qualified solicitor and the Resident Partner in charge of GLN Vietnam's practice. Before joining GLN in Vietnam, Samantha was at top-tier U.S. law firm Sullivan & Cromwell LLP, in London for nine years, prior to which she practised at a leading English law firm. Samantha's experience includes advising on numerous international finance transactions, including general bank lending work (secured and unsecured), capital markets issuances, asset-based financings, acquisition financings, debt restructurings and derivatives matters. Her practice has an emphasis on highly structured project development and financing matters including the negotiation of project documents with host governments, state-owned companies and other counterparties. In addition, Samantha has considerable experience of cross-border joint venture arrangements, private acquisitions and divestitures and commercial transactions.

Phan Thi Lieu

Gide Loyrette Nouel A.A.R.P.I.
18 Hai Ba Trung, District 1
Ho Chi Minh City
Vietnam

Tel: *+84 8 3823 8599*
Fax: *+84 8 3823 8598*
Email: *lieu.phanthi@gide.com*
Web: *www.gide.com*

Phan Thi Lieu is a member of the Ho Chi Minh City Bar and heads the GLN's tax practice in Vietnam. Lieu holds a LL.B and a master's degree in economic law from the Ho Chi Minh City University of Law. Her expertise focuses on tax advice and compliance, tax planning, tax due diligence, enterprise restructuring and consortium taxation and the application of double tax treaties. Prior to joining GLN, Lieu was Deputy Manager of Tax & Legal at PriceWaterhouseCoopers Vietnam for five years, followed by one year at Ernst & Young in the position of Tax Manager.

GLN
Gide Loyrette Nouel
A.A.R.P.I.

Founded in Paris in 1920, Gide Loyrette Nouel (GLN) is a leading international law firm with 650 lawyers, including 100 partners. Operating out of 19 offices worldwide, GLN provides specialist quality services in the most complex areas of national and international business and finance law.

GLN was among the first international law firms licensed to set up a formal branch office in Vietnam. The team comprises 20 western and Vietnamese lawyers operating from its two offices in Hanoi and Ho Chi Minh City. GLN Vietnam forms an integral part of the Firm's Asia practice, with offices in Beijing, Shanghai and Hong Kong and activities extending across China, Japan, South Korea and South-East Asia.

GLN Vietnam has some of the best tax capabilities in the market. The experienced and knowledgeable team is able to assist clients with the Vietnamese and international tax and customs issues inherent in all their transactions including corporate restructuring, tax issues connected with M&A and finance matters and tax disputes.

NOTES

NOTES