Taxation of Business Operations in France, Germany and the United Kingdom

A Brief Overview
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A Brief Overview
Preface

We understand that business operations conducted by a foreign investor can be quite complex. *Taxation of Business Operations in France, Germany and the United Kingdom* examines the specific tax requirements of each country in detail. We hope you find the book both interesting and useful.

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Taxation of Business Operations in France

1. Business Overview

1.1. Legal Overview

A business may be conducted in France through a company, a branch or other entities such as *Groupements d'intérêts économiques* (GIE).

Companies can be formed as:

- limited liability companies, *e.g.*, *sociétés anonymes* (SA), *sociétés par actions simplifiées* (SAS), and *sociétés à responsabilité limitée* (SARL);
- limited partnerships, *e.g.*, *sociétés en commandite par actions* (SCA);
- partnerships, *e.g.*, general partnerships, *sociétés en nom collectif* (SNC) and *sociétés en commandite simple* (SCS), civil companies (sociétés civiles) or *sociétés en participation* (SEP - non-registered partnerships).

1.2. Tax Overview

1.2.1. Taxation of Companies

Certain entities are automatically subject to corporate income tax. Among these entities, the most important are limited liability companies, limited partnerships and certain partnerships. SCS are subject to corporate income tax with respect to the profits of certain of their partners, so-called *associés commanditaires*. SEP are subject to corporate income tax with respect to the profits of partners not jointly and severally liable for the debts of partners whose names have not been disclosed to the French tax authorities.

Other entities are generally considered as tax transparent. Assuming their partners are French, the profits of these entities are taxed in the hands of the partners and the losses are transferred to the partners in proportion to the percentage owned in the entity and according to the tax status of each partner. These other entities may, however, elect to be subject to corporate income tax.

In addition, corporate income tax is levied on profits realized by branches of foreign corporations located in France.

Note that, for the purpose of the U.S. “check-the-box” legislation, a French entity incorporated as an SA does not qualify, as opposed to a French entity incorporated as an SAS or an SARL.

An overview of the taxation of corporate groups is provided in Section 2.
1.2.2. Taxation of Individuals

Individuals are subject to individual income tax and wealth tax under the rules summarized in section 3 below.

1.2.3. Other Taxes

The French tax system provides for several other direct and indirect taxes. Among those taxes, the most important are withholding taxes (on dividends, royalties and interest), VAT and registration duties. The scope and mechanism of these other taxes are summarized in section 4 below.

2. Taxation of Companies

2.1. Corporate Income Tax

2.1.1. Territoriality Rules

As opposed to most foreign corporate income tax systems that impose income tax based on worldwide income (e.g., US, UK or German tax systems), French corporate income tax is assessed on income derived from enterprises engaged in business operations in France and on income taxable in France under a tax treaty. Profits and income realized by enterprises operating outside France are thus exempt from French corporate income tax.

Similarly, an enterprise subject to corporate income tax in France cannot normally deduct losses realized in a foreign activity in computing its taxable income.

Tax law does not define what constitutes “an enterprise operating in France”. According to case law and administrative guidelines, the concept refers to the performance, in a usual manner, of an activity that may:

- be performed through an establishment that is both permanent and autonomous (such as a branch, shop, factory, mine or building site) where decisions are made; or
- be performed through a dependent agent; or
- result from the performance of operations deemed to involve a complete commercial cycle (purchase and resale of goods, provision of services distinct from the head office’s business).

These criteria apply unless a tax treaty provides otherwise.

Conversely, French enterprises are normally not subject to corporate income taxation in France on profits realized through a foreign permanent establishment or a dependant agent operating abroad, or when they are involved in business operations which can be deemed to constitute a complete commercial cycle distinct from the other activities carried on in France.

As an exception to the above territoriality rules, French companies authorized by the tax authorities may opt to determine their taxable base by consolidating either (i) all income realized by their
French and foreign 50%-owned subsidiaries (bénéfices consolidés or consolidated income regime) or (ii) all income realized by their enterprises both in France and abroad (bénéfice mondial or worldwide income regime). However, the tax authorities rarely grant the option to apply these two regimes.

2.1.2. Rates

Corporate income tax rates include a flat ordinary rate, a reduced rate and “surcharges” (i.e., the surcharge tax and the additional social surcharge).

(i.) Corporate income tax is due at the ordinary rate of 33.33%. This rate is increased by a 3% surcharge tax, resulting in an effective rate of 34.33% in 2004.

Large companies — with a turnover of more than €7,630,000 — are also subject to an additional social surcharge of 3.3% levied on the aggregate corporate tax exceeding €763,000.

Overall, the maximum corporate income tax rate amounts to 35.43% in 2004.

Small and medium-sized companies — i.e. with a turnover of less than €7,630,000 — may be taxed, on the first €38,120, at a reduced rate of 15% increased by the 3% surcharge. The maximum corporate income tax rate for these companies amounts to 15.45% in 2004.

(ii.) Certain incomes and gains, such as gains on the sale of participating shares, are taxed at a reduced rate of 19% under certain conditions. Notably, the company must book in a special reserve the amount after tax of the capital gain at the end of the tax year following the year of the gain. Increased by the 3% surcharge tax, the effective reduced rate amounts to 19.57% in 2004.

In addition, for companies subject to the additional social surcharge of 3.3%, the maximum reduced corporate income tax amounts to approximately 20.20% in 2004.

2.1.3. Determination of CIT

2.1.3.1. Taxable Income

According to the French Tax Code (FTC) the tax is due on “the net profits arising from all operations including sales of assets”.

Net profits are defined as “the difference between the net asset value of the company at the beginning and at the end of the fiscal year, reduced by the amount of additional capital contributions and increased by income distributions”. For the purposes of determining such net profits, the net asset value of the company is equal to the excess of the total net assets over the total liabilities of the company, depreciation, deductions and deductible tax reserves. (Attention should be paid to the fact that revaluations are allowed only in very specific circumstances and that the above principles are normally based on book values.)
Companies are therefore subject to corporate income tax not only on industrial and commercial profits but also on earnings from stock exchange transactions, dividends, capital gains, partnership income received, etc.

The taxable income is subject to corporate income tax at the ordinary rate.

Capital gains deriving from the sale of qualifying participating stock which have been held for two years or more (i.e., long-term gains) may, however, benefit from the reduced rate of 19% (plus surcharges) referred to in section 2.1.2 (ii), provided that the net gains (not including the surcharges) are credited to a special reserve account. This rule is known as the “long-term capital gain regime”.

Stock qualifies as participating stock (“titres de participation”) under French accounting standards if the stock is useful to the business conducted by the company holding the stock. In this respect, stock representing more than 10% of the capital is presumed to meet that requirement. Stock may also qualify as participating stock under French tax law if the stock is held by parent companies referred to under section 2.2.1.5 or acquired as a result of a cash public offer or an exchange public offer in which the acquisition price is €22.8 M or more.

Royalties paid in consideration for the use of patents and certain other industrial property rights may also benefit from the reduced corporate income tax rate of 19% (plus surcharges).

2.1.3.2. Tax Credits
Tax credits attached to income received by the company (tax credits on dividends, interest, etc.) may be offset against the corporate income tax charge.

2.1.3.3. Tax Losses
Article 89 of the Finance Law for 2004 provides for a new regime of carry-forward tax losses. Ordinary tax losses incurred by companies subject to French corporate income tax could only be offset against profits realized during the five following fiscal years under the previous regime. Under the new law, such losses may now be carried forward during an unlimited period of time.

This measure applies not only to tax losses incurred in respect of fiscal years opening as from 1 January 2004 but also to tax losses which remain available at the close of fiscal years ending as from 31 December 2003.

As a counterpart, the Finance Law for 2004 repeals the previous regime applicable to deferred depreciation allowances ("amortissements réputés différés") which could be carried forward for an unlimited period of time.

As a result of such modifications, companies subject to corporate income tax will now be able to carry forward all their tax losses during an unlimited period of time.
A change in the company’s business activity will trigger a loss of its carry-forward tax losses. Companies may also elect to a carry-back regime that authorizes entities subject to corporate income tax to book a receivable equal to one-third of the taxable income of the three fiscal years preceding the one during which the losses were incurred with a maximum amount equal to one-third of the tax losses.

The carry-back receivable can be used by the company to pay corporate income tax for the five following years and the excess, if any, is reimbursed.

2.1.3.4. IFA

The French Tax Code provides for an annual minimum lump-sum corporate tax (impôt forfaitaire annuel, IFA) based on turnover. The company may offset the amount of the IFA paid against corporate income tax during the two fiscal years following the year of payment.

2.2. Distributions

2.2.1. Dividends Paid by French Companies

Dividends paid by a French company are distributed out of income which, in principle, has been subject to corporate income tax at the ordinary rate (see section 2.1.2).

Article 93 of the Finance Law for 2004 provides for a new regime with respect to the taxation in France of distributions made by French and foreign companies.

Under the new regime, distributions made by French companies as of 1 January 2005 will no longer carry the avoir fiscal or trigger the payment of the précompte. The timing of the cancellation of the avoir fiscal will, however, be different for individual and corporate shareholders. In addition, the cancellation of the précompte will only be effective as of 2006 since Article 95 of the Finance Law for 2004 introduces a 25% special temporary tax on distributions realized by French companies in 2005.

Prior to the reform, dividends benefitted from an avoir fiscal (tax credit) equal to:

- 10% of the dividend when paid to French resident companies other than parent companies as defined under section 2.2.1.5.; or
- 50% of the dividend when paid to French resident individuals or above-mentioned parent companies.

In order to prevent or mitigate double taxation of the income distributed, the amount of the dividend increased by the avoir fiscal was subject to corporate income tax (or to individual income tax for individual recipients) and the avoir fiscal was then deducted from the income tax due by the taxpayer.
Dividends paid out of profits that had not been subject to the ordinary corporate income tax rate, or that were realized more than five years before the distribution, were subject to a \textit{précompte mobilier} (equalization tax) equal to 50\% of the net dividend amount.

Correlatively, dividends distributed to non-parent companies (\textit{i.e.} dividends which carry a tax credit limited to 10\%) were entitled to an additional credit of 80\% of the \textit{précompte mobilier} effectively paid to the French treasury.

\subsection*{2.2.1.1. French Resident Individual Shareholders}

Dividends distributed to French resident individuals in 2004 will continue to carry the \textit{avoir fiscal}. As of 1 January 2005, the \textit{avoir fiscal} will be cancelled, but as a counterpart, the taxable basis of the dividends will be reduced by 50\%\textsuperscript{1}. Unlike the \textit{avoir fiscal}, the 50\% deduction will apply not only to distributions qualifying as “dividends” under French company law but, more generally, to all profits distributed to shareholders as a result of a regular decision of the shareholders’ meeting, including, in particular, exceptional distributions of retained earnings or distributions made in the frame of a share buyback for the portion of the repurchase price corresponding to retained earnings.

In addition, the 50\% deduction will apply not only to distributions by French companies but also to distributions by foreign companies provided that they are established in a country protected by a tax treaty with France or in an EU member State.\textsuperscript{2} Pursuant to preliminary oral comments made by the French tax authorities, which will need to be confirmed, tax credits corresponding to the withholding tax levied at source should be fully offsettable against the French income tax due on the dividend reduced by the 50\% deduction. As a result, French resident individuals holding equity stakes in foreign companies will be the main beneficiaries of this new regime since dividends received from the latter did not benefit from any particular rebate under the previous regime.

\subsection*{2.2.1.2. French Resident Corporate Shareholders}

The \textit{avoir fiscal} attached to dividends distributed to French resident corporate shareholders, including parent companies, will no longer be available as of 1 January 2005. As a result, unlike individual shareholders, corporate shareholders will no longer benefit from any \textit{avoir fiscal} with

\textsuperscript{1} Dividends eligible for the 50\% deduction will also benefit from a tax-free allowance of the same amount as the one available under the former regime. In addition, individual shareholders will be entitled to a tax credit equal to 50\% of the dividend received (before application of the above deduction and tax-free allowance) but limited to a threshold of €115 for singles and €230 for jointly taxed couples. This tax credit is aimed in particular at compensating the loss of the \textit{avoir fiscal} for shareholders who hold their shares in a Plan d’Epargne en Actions (\textit{i.e.} specific savings plans organized under French law).

\textsuperscript{2} As of 2009, the benefit from the deduction will be subject to the condition that the foreign distributing companies are established in a country protected by a tax treaty with France which includes an administrative assistance provision.
respect to dividends distributed by French companies as of 2004. In addition, distributions made in 2004 may still be subject to the *précompte* which will only be cancelled as of 1 January 2005.

On the other hand, the situation of parent companies will be slightly improved since the *avoir fiscal* will no longer have to be taken into account for the determination of the 5% lump sum of charges and expenses on which they are currently taxable (see section 2.2.1.5).

As regards the redistributions by parent companies of French source dividends, the amount before tax received by their French shareholders should be roughly the same due to the cancellation of both the *avoir fiscal* and the *précompte* (except for the redistributions which will be made in 2005 and thus be subject to the special 25% tax described below). On the other hand, the redistributions of foreign-source dividends should be subject to a much more favorable tax treatment due to the cancellation of the *précompte*, which was only very partially compensated by the imputation of foreign tax credits.

### 2.2.1.3. Non-Resident Recipient

Non-French resident individuals who are currently entitled to a transfer of the *avoir fiscal* under a tax treaty should still benefit from a refund of the *avoir fiscal* with respect to dividends distributed in 2004 (to be refunded after 15 January 2005). No refund will be available with respect to dividends distributed as of 1 January 2005. As of this date, it is unclear whether the amount subject to French withholding tax on dividends could be reduced by the 50% deduction which applies to French resident individuals. Subject to contrary comments from the French tax authorities, however, the initial is to consider that the benefit of the deduction should not be available to non-French tax residents.

Non-French resident corporate shareholders should not be entitled to a refund of the *avoir fiscal* attached to dividends distributed by French companies in 2004. Dividends distributed as of 1 January 2005 will no longer benefit from any *avoir fiscal* and thus will not give rise to any refund.

It is uncertain whether companies — which were entitled to a refund of the *précompte* pursuant to applicable tax treaties — will still benefit in 2005 from a refund of the *précompte*, if any, paid by the French distributing company with respect to dividends distributed in 2004. Dividends distributed as of 1 January 2005 will no longer be subject to any *précompte* and thus will not give right to any refund.

French withholding taxes on dividends are addressed under section 4.1.

### 2.2.1.4. Temporary Special Tax

In order to finance the costs of transition to the new tax regime, Article 95 of the Finance Law for 2004 introduces a 25% temporary special tax (the “special tax”) imposed on profits distributed in 2005.
The special tax is very similar to the *précompte*: it applies to sums distributed out of profits realized more than five years before the distribution or which have not been subject to the ordinary corporate income tax rate. But as opposed to the *précompte*, which applies only to distributions of “dividends”, the special tax will apply to all kinds of distributions made by French companies whether or not made pursuant to an ordinary shareholders’ meeting.

The distributing company will be allowed to claim a credit in three equal installments for the amount of the special tax paid against its French corporate income tax liability during the three following fiscal years, and to receive a refund of any excess. No tax credit may be claimed against the special tax except for parent companies which may offset the *avoirs fiscaux* and foreign tax credits attached to dividends received during the five preceding fiscal years and still available.

### 2.2.1.5. Parent-Subsidiary Tax Regime
Qualifying corporate shareholders may elect for the parent-subsidiary tax regime in order to benefit from a dividend exemption.

To qualify for this regime, the parent company must be subject to corporate income tax and hold an interest representing at least 5% of the share capital of the distributing company.

Dividend received by the parent company is fully exempt from corporate income tax. As a counterpart, the parent company must include in its taxable income an amount equal to 5% of the dividend distributed or, if lower, the actual amount of its costs.

### 2.2.2. Foreign-Source Dividends
A French tax corporation or individual resident receiving foreign-source dividends must include the net dividend received into its taxable base and may be allowed, under a tax treaty, to offset the amount of the withholding tax paid abroad against the income tax due.

Such dividends may also benefit from an exemption under the parent-subsidiary tax regime (see section 2.2.1.5).

### 2.3. Tax Consolidation
The tax consolidation regime is used as an incentive tool in tax group optimization schemes and, in particular, in transactions such as LBOs.

#### 2.3.1. Overview
Subject to strict conditions, French entities subject to corporate income tax may elect to create a “tax unit”.

Unlike the consolidated income and the worldwide income regimes mentioned under section 2.1.1, the tax consolidation regime only includes French subsidiaries. It is also different from the consolidation for accounting purposes.
The tax consolidation regime is optional. In substance, it allows the aggregation of tax profits or losses within the group at the level of the parent company.

*Vis-à-vis* the French tax authorities, the parent company is the sole entity liable to pay the corporate income tax due by the tax unit.

### 2.3.2. Requirements

The regime applies under the following conditions:

- the parent company and its subsidiaries (usually referred as the “members” of the tax unit) must be subject to corporate income tax in France;
- the parent company must own at least 95% of its subsidiaries, either directly or indirectly through companies that are also members of the tax unit;
- the parent company must not be directly held for more than 95% by a company subject to French corporate income tax;
- the election to benefit from this regime must be made prior to the end of the third month of the first fiscal year and is made for a period of five years (automatically renewed); and
- each subsidiary included in the tax unit must also notify the tax authorities of its agreement.

Finally, the parent company may freely decide to include or exclude certain of its subsidiaries from the tax unit within the given year election period.

### 2.3.3. Consolidated Tax Result

Each member of the tax unit determines its own taxable income under ordinary rules, as if it did not belong to such tax unit. Then, the taxable profits or losses of each member are aggregated, with adjustments in order to eliminate any distortions resulting from intra-group transactions.

The tax losses of a company that existed prior to its entry in the tax group could not be offset against the profit of the tax group. These tax losses could be offset only against the profits of this company.

The main adjustments relate to:

- dividends received from a member of the tax unit if they do not benefit from the parent-subsidiaries exemption regime (see sections 2.2.1.5 and 2.3.4);
- director’s fees;
- reserves booked by a member of the tax unit in connection with claims it has against other members or shares it holds in the capital of other members;
- intra-unit forgiveness of debts as well as direct or indirect subsidies granted among the members (e.g., pursuant to transactions which are not at arm’s length); and
- gains or losses on intra-unit sales of assets, etc.
Losses incurred by a member of the tax unit are automatically transferred to the parent company for the computation of the consolidated tax result. As a result, members of the tax unit are no longer entitled to carry over their own former tax losses on profits realized during the tax consolidation except for those losses incurred prior to entering the tax unit.

2.3.4. Dividend Distributions Inside the Tax Unit
The election has the following consequences on the distributions among the members of the unit:

- Dividends distributed by members of the tax unit to other members and paid out of profits realized during the tax consolidation period are not subject to the précompte and do not carry any avoir fiscal.
- Dividends distributed by members of the tax unit to other shareholders (non-members), as well as intra-unit dividends paid out of profits realized before the tax consolidation period, are subject to ordinary tax rules, which means that they may be subject to the précompte and carry the avoir fiscal.

2.3.5. End of the Tax Unit
A tax unit ceases to exist upon (i) the acquisition of more than 95% of the parent company by another company subject to French corporate income tax or (ii) the merger between the parent company and the subsidiaries.

The tax consequences of the dissolution of a tax unit generally relate to the intra-unit operations that have been neutralized from a tax standpoint during the tax consolidation period (e.g. intra-unit subsidies, depreciation reserves, gains or losses resulting from intra-unit sales of assets, etc.). In certain circumstances, the dissolution may trigger a double taxation, if not scheduled in advance.

2.4. Anti-Avoidance Measures
French tax law provides for two general anti-avoidance principles. The abnormal acts of management concept allows the tax authorities to reassess companies with respect to management decisions that are considered contrary to the interest of the business. The abuse of law theory allows the tax authorities to reassess companies as well as individuals on the ground that a legal act may be artificial or tax-driven only.

Anti-avoidance measures in the French tax code also include CFC rules, transfer pricing rules and thin capitalization rules.

2.4.1. CFC Rules
The French system of taxation of controlled foreign corporations (CFC) is an important exemption to the French territoriality rules pursuant to which companies are subject to French corporate income tax only upon the income derived from a business conducted in France.
A French company may become subject to corporate income tax on a prorata share of the income realized by a foreign entity, whether or not such income is actually distributed, if:

- the French company (i) holds — directly or indirectly — 10% or more of the share capital of the foreign entity, (ii) holds a shareholding interest in the foreign entity with an acquisition price of at least €22.8 M, or (iii) runs a permanent establishment located outside France; and
- such foreign entity or permanent establishment benefits from a privileged tax regime (the existence of a privileged tax status is presumed if the tax applicable in the foreign country is less than one-third of the corporate income tax which would be applicable in France).

As an exception, CFC rules do not apply if the foreign entity is mainly engaged in commercial or industrial activities that are predominantly carried out in its local market.

The compatibility of these provisions with tax treaties that do not expressly allow the tax authorities to apply French CFC rules have been challenged. The main tax treaties concluded by France that expressly allow France to apply its CFC rules are treaties with the U.S., Canada, Mexico, Japan, South Africa, Switzerland, Norway and Spain.

In addition, the compatibility of the French CFC rules with the regulations of the European Union (EU) and particularly the freedom of establishment and circulation is also challenged.

2.4.2. Transfer Pricing Rules

French transfer pricing rules allow the tax authorities to recast transnational transactions between related parties on arm’s length terms and to adjust French taxation accordingly, with special emphasis on transactions that involve companies that benefit from a favorable tax regime.

The concept of related parties is broad and encompasses legal control as well as de facto control.

In principle, the French tax authorities must prove the dependence or control, and the unjustified advantages granted to a foreign entity. In practice, however, the tax authorities may request the taxpayer to provide explanations and documents regarding the taxpayer’s transfer pricing policy, provided that they have enough information to presume a transfer of profits.

When a transaction involves a company which benefits from a privileged tax status (see section 2.4.1), the burden of proof is shifted on the taxpayer. The tax authorities may presume a transfer of profits and the taxpayer can rebut that presumption only by proving that the transaction is bona fide and that the amount paid or due is not exaggerated or abnormal.

The French tax authorities generally use the traditional transfer pricing methods recognized by the OECD (i.e., comparable uncontrolled-price, resale price and cost-plus methods) rather than methods based on the reference to profits.
Taxpayers may also seek to obtain from the tax authorities the issuance of an advanced pricing agreement in order to secure their position.

### 2.4.3. Thin Capitalization Rules

French tax law does not provide for any specific thin capitalization rules, except with respect to loans granted by direct shareholders of a French borrowing company.

Interest paid on sums placed at the disposal of a French company by shareholders (a) having legal or de facto control of the management, or (b) holding more than 50% of the economic or voting rights of the company, is deductible only to the extent of a sum which, for all such shareholders, does not exceed one and a half times the amount of the share capital.

This debt-to-equity ratio does not apply to interest on loans granted by French companies to their subsidiaries when the lender qualifies as a parent company (see section 2.2.1.5). As a result of this particular exception, this limitation generally only applies in respect of loans granted by foreign shareholders since such shareholders cannot qualify as parent companies pursuant to French tax law. The compatibility of these rules with the regulations of the European Union (EU) and particularly the freedom of establishment and circulation is currently challenged.

### 2.5. Acquisitions — Share Deal vs. Asset Deal

This section focuses on tax issues that may be raised when structuring a corporate acquisition of a target business run by a French company (i.e., asset deal vs. share deal).

The following is based on a fact pattern whereby both the seller and the purchaser are entities subject to French corporate income tax.

#### 2.5.1. Asset Deal

An asset deal occurs when a purchaser acquires the intangible assets (goodwill, clientele, patents, trademarks, etc.) and tangible assets (properties, equipment, etc.) of a target corporation. Employees attached to the business sold are transferred to the purchaser.

##### 2.5.1.1. Registration Duties

An asset deal triggers the payment of registration duties at a rate of 4.8% on the transfer price or the fair market value of the target business transferred, whichever is higher (such basis may be increased by the value of certain liabilities transferred) (see section 4.4.2). However, registration duties do not apply to the transfer of inventories, receivables and cash.

##### 2.5.1.2. Corporate Income Tax

The seller is subject to corporate income tax at the standard rate of 35.43% or at the reduced corporate income tax rate of 20.20% on any capital gain realized as a result of the sale of its assets. Any tax losses may be offset against such capital gain.
For the purchaser, the acquisition allows a step-up in basis of the acquired assets (implying positive tax consequences in terms of depreciation allowances for depreciable assets and future capital gains).

2.5.2. Share Deal
In a share deal, the purchaser buys the shares of a target corporation from the target's shareholders.

2.5.2.1. Registration Duties
Provided that the target company is not a real estate company and is incorporated as a stock company (e.g., SA or SAS), a share deal triggers a significantly reduced amount of registration duties at a rate of 1% capped at €3,049 per transaction (see section 4.4). By contrast, acquisition of shares of a real estate company or shares of other companies than stock companies (e.g., SARL) requires the payment of registration duties at the rate of 4.80% without any ceiling.

2.5.2.2. Corporate Income Tax
The target shareholders recognize gain or loss on the sale of their shares measured by the difference between the amount realized and their basis in the shares. The gain realized upon the sale of the shares, if any, is taxed as ordinary income at the standard corporate income tax rate, unless the sale can benefit from the reduced rate of corporate income tax of 20.20% (see section 2.1.2).

For the purchaser, a share deal does not raise any particular corporate income tax issue provided that the acquisition is not immediately followed by a restructuring which would be only tax driven (such as an immediate merger of the target company and the purchaser).

2.5.3. Funding of the Acquisition

2.5.3.1. Deductibility of Interest Expenses
(iii.) The interest paid to shareholders in consideration for loans to a company are deductible from the taxable income of such company (a) only if the capital of the company is fully paid in and (b) to the extent of a rate equal to the annual average rate of floating rate loans granted by financial establishments for a minimum term of two years.

(iv.) As mentioned above, French tax law does not provide for any specific thin capitalization rules except with respect to loans granted by direct shareholders of the French borrowing company (see section 2.4.3).

(v.) The level of indebtedness of the acquiring company must also be analyzed in light of the abnormal act of management concept, i.e. the burden of the debt must not be too heavy considering the financial position of the company (see section 2.4).
Moreover, in the case of deals realized by members of a tax unit, the deductibility of interest expenses born by the tax unit may be limited if the seller may be considered as having a legal or de facto control of the purchaser (Amendement Charasse).

2.5.3.2. Withholding Tax
Proceeds from loans contracted abroad may be exempt from withholding tax under certain conditions (in particular, a loan agreement must be signed before the funds are delivered to the French borrowing company) (see section 4.1).

2.6. Reorganizations

2.6.1. Overview
French tax law provides for a favorable tax regime in order to facilitate corporate restructuring. This regime is consistent with the provisions of the EC Merger Directive dated 23 July 1990.

(i.) Basically, the favorable tax regime applies to mergers and assimilated operations (such as straight liquidations).
In brief, provided certain conditions are met and certain commitments are taken by the absorbing corporation, the absorbing corporation will not report any gain or loss upon the receipt of assets from the absorbed corporation and the absorbing corporation's basis in the assets acquired from the absorbed corporation will be the same basis as in the absorbed corporation's hands.

Shareholders of the absorbed corporation (whether companies or individuals) may also benefit from a favorable tax regime, i.e. they will have no taxable gain or loss and their basis in the shares of the absorbing corporation will be the same basis they previously had in their shares of the absorbed corporation.

In addition, subject to prior approval of the French tax authorities, existing ordinary tax losses of the absorbed corporation may be transferred to the absorbing corporation. The approval is automatic if certain prerequisites are met. Notably, the reorganization must be motivated by sound business reasons, the business generating the losses must be pursued for a certain period of time, and the amount of the transferable tax losses must not exceed the original book value or contribution value, whichever is higher, of the transferred fixed assets (excluding participations).

(ii.) Contributions of assets in exchange for shares may also benefit from the favorable tax regime, provided additional conditions are met.

Notably, the transferred assets must be either a “complete and autonomous branch of a business” or a substantial interest in another company’s share capital (i.e., the level of such
interest must be at least 30% and the beneficiary of the contribution must obtain the status of main shareholder of the underlying company).

In addition, the contributing company must hold the shares received in exchange for a three-year period and take certain commitments with respect to the computation of future capital gains on the transfer of the shares received in the contribution.

(iii.) Split-ups are the last type of reorganizations that may benefit from the favorable tax regime provided additional conditions are met. In a split-up, the corporation transfers all of its assets to two or more new corporations in return for stock, which is then distributed to the shareholders of the parent corporation in return for all the parent stock. The split-up effectively liquidates the original parent corporation.

The additional conditions to be met to benefit from the favorable tax regime are the following:

- the distributing company must transfer to the beneficiary companies separate branches of business, which requires the prior existence of two distinct businesses within the distributing company; and
- the distributing company’s shareholders must commit to keep the shares received in the split-up for a three-year period (except for certain minority shareholders).

2.6.2. Cross-Border Reorganizations

Cross-border reorganizations may benefit from the same favorable tax regime as mergers, contributions of assets or split-ups involving French corporations, provided the characteristics of the transaction fit the corresponding French tax definition. The transaction must be realized between companies established in the EU or in countries that have signed with France a tax treaty which includes an administrative assistance clause.

In a cross-border reorganization, a prior ruling from the French tax authorities must be obtained in order to benefit from the favorable tax regime. Since 1 January 2002, however, such ruling is automatically granted if the two following conditions are met:

- the reorganization is motivated by sound business reasons; and
- capital gains that benefit from a deferral of taxation as a result of the French favorable tax regime remain taxable in France following the reorganization.

2.7. Investment Funds

2.7.1. Overview

Investors can make their investments through a vehicle equivalent to the UCIT, so-called "Organismes de Placement Collectif en Valeurs Mobilières" (OPCVM).
In order to benefit from a favorable tax regime, most French OPCVMs take the form of a Société d’Investissement à Capital Variable (SICAV) which is a stock company with a variable capital, or a Fonds Commun de Placement (FCP) which can be defined as co-ownership of securities without legal personality.

French law also authorizes specific investment vehicles such as:

- Employee-participation funds or FCPE (Fonds Communs de Placement d’Entreprises) whose purpose is to manage employees’ savings;
- Securitization funds or FCC (Fonds Communs de Créances);
- Venture capital funds or FCPR (Fonds Communs de Placement à Risques) investing in newly created or already existing ventures;
- Innovative venture capital funds or FCPI (Fonds Communs de Placement dans l’Innovation) investing in innovative companies; and
- Venture capital companies (Sociétés de Capital Risque) and individual venture capital companies (SUIR) whose principal purpose is to invest in unlisted securities.

### 2.7.2. French Venture Capital Funds

In addition to legal requirements, specific criteria must be met in order for the investor to benefit from a favorable tax regime.

From a legal standpoint, the fund must meet the following conditions to qualify as an FCPR:

- The fund must be operated by a management company with sufficient financial resources;
- The assets of the fund must be at least equal to €380,000 at the time of the constitution and €160,000 during the investment period;
- At the end of the fiscal year following the year of constitution of the fund, more than 50% of the assets of the fund must be invested in French or European securities not traded on a regulated market (“FCPR Qualifying Investments”);
- Redemption of the shares must be effected according to their realization value;
- The fund may not advertise or offer its shares for sale to the public; and
- The composition of the assets of the fund is subject to specific diversification rules.

In addition, for the purpose of determining FCPR qualifying investments, the portfolio companies taken into account in the computation of the 50% investment threshold must (i) have their registered office in one of the member states of the EU, (ii) carry out an industrial, commercial or craft activity (which includes companies carrying out a real estate, a noncommercial or an agricultural activity) and (iii) be subject to corporate income tax.
2.7.2.1. French Corporate Investors

French corporate investors are taxed only when profits realized by the FCPR are effectively distributed to them, and the tax regime applicable depends on the source (French or foreign) and the type of income realized (dividends, interest on bonds, etc.).

Capital gains realized on the sale or redemption of shares of the FCPR are normally subject to corporate income tax at the ordinary rate of 33.33% (plus surcharges) (see section 2.1.2). However, capital gains may benefit from the reduced rate of 19% (plus surcharges) under the long-term capital gains regime if the fund’s assets are composed of at least:

- 50% of FCPR Qualifying Investments for tax purposes; and
- the shares sold or redeemed were held for at least five years by the corporate investor.

2.7.2.2. French Individual Investors

(i) French individual investors holding ordinary shares of an FCPR (“A” Shares) may benefit from an exemption from the income and capital gains realized by the FCPR under the following conditions:

- The individual investors must commit to hold the shares for at least five years. In the absence of such commitment, the income realized by the fund may benefit from the tax regime of common FCP;
- The income of the FCPR during the five-year period must be immediately reinvested in the fund; and
- The individual investors do not own or have owned during the five years preceding the acquisition of the FCPR’s shares (alone or with relatives) more than 25% of the rights in the income of one of the companies held in portfolio by the fund.

When the sale or redemption occurs within the five-year period or the fund does not meet the conditions applicable to qualifying investments for tax purposes, the capital gain realized on the transfer of the FCPR’s shares is taxable at the rate of 26% (including additional social contributions, explained in sections 3.1.4 and 4.6.3).

(ii) Recent administrative guidelines set as a principle that capital gains relating to “carried interest” shares (“B” Shares) attributed to the members of the deal team of the FCPR are subject to individual income tax according to the regime applicable to the type of income realized. However, the reduced rate of 26% (including additional social contributions) may apply when the holder is a member of the deal team at the date of subscription or acquisition of the shares and (a) the “B” Shares are acquired in consideration for cash, (b) a specific category of shares is created for that purpose (i.e., all of them are subscribed at the same price and given equal rights), (c) members of the deal team do not hold any other shares in the fund that may
entitle them to an exemption from income tax and, (d) members of the deal team receive a normal remuneration for their services.

2.7.2.3. Non-Resident Investors

Distributions made by an FCPR to non-resident investors are subject to the following rules:

- A withholding tax is due at a rate of 25% (or a lower treaty rate) on the portion of the distribution representing French-source dividends. Tax treaty provisions may, in certain cases, provide for the transfer of the avoir fiscal to the non-resident investor;
- A withholding tax applies at a rate varying from 15% to 45% depending on the nature of the investment (or a lower treaty rate) on the portion of the distribution representing French-source fixed investment income;
- No French tax is due with respect to the portion representing foreign-source income; and
- Capital gains realized by non-resident investors on the disposal or redemption of their shares in the FCPR are not subject to tax in France.

2.8. Stock Options and BCE

Stock options and Bons de Créateurs d’entreprises (BCE) granted to French beneficiaries may benefit from a favorable tax and social regime.

2.8.1. Stock Options

Beneficiaries of stock options could benefit from a favorable tax regime regardless of whether the options are granted by a French or a foreign company.

The gain realized by the beneficiaries of stock options on the sale of the shares acquired upon exercise of the option is split between:

- the “acquisition gain” equal to the difference between the value of the shares at the time of the exercise of the option and the exercise price; and
- the “sale gain” equal to the difference between the value of the shares at the time of the exercise of the option and the sale price.

2.8.1.1. Acquisition Gain

Provided that (i) the shares acquired upon exercise of the options are registered and not bearer shares and (ii) the beneficiaries keep these shares during a period of four years from the date the options are granted until the date of the sale of the shares, the acquisition gain is taxed as a capital gain. The rate of taxation is currently equal to 40% (including additional social contributions, explained in section 4.6.3) for the yearly portion of the acquisition gain which does not exceed €152,500, and to 50% (including additional social contributions) for the yearly portion exceeding the €152,500 threshold.
The acquisition gain is only taxable if the total amount of sales of securities realized by the taxpayer and his household exceeds, during the said year, €15,000 (see section 3.1.4).

In addition, the acquisition gain may benefit from a more favorable tax treatment if the shares acquired as a result of the exercise of the option are held after the period of four years for a minimum of two years before they are sold. In such case, the yearly portion of the acquisition gain not exceeding €152,500 is taxable at a rate of 26% (including additional social contributions) instead of the 40% rate. The yearly portion of the acquisition gain exceeding €152,500 is subject to tax at the rate of 40% instead of 50%.

Provided the requirements mentioned above are met, the acquisition gain is not subject to any employer’s or employee’s social security contributions.

If either of the two conditions mentioned above is not met, the acquisition gain is taxed as a salary pursuant to the progressive rates of income tax and the gain is subject to social security contributions.

2.8.1.2. Sale Gain
The sale gain is always taxed at the rate of 26% (including additional social contributions) to the extent that the total amount of sales of securities by the taxpayer and his household exceeds, for the year of the sale, the above-mentioned €15,000 threshold. In addition, the sale gain is not subject to social security contributions.

2.8.2. BCE
Only French companies may issue BCE. These companies must comply with the following conditions:

- They must be stock companies registered with the Trade Register for less than 15 years;
- Their shares must not be listed on a regulated stock-exchange market at the time the BCE are issued (other than a growth stock market of the EU, such as the French New Market);
- They must be subject to French corporate income tax;
- They must not have been created as a result of a consolidation, reorganization, extension or takeover of pre-existing activities. However companies created by the employees of a pre-existing company as a result of taking over its activities in order to develop them may issue BCE; and
- At least 25% of their share capital must be held, and have been held since their date of creation, by individuals or companies owned by individuals. Shares held in the issuing company by certain entities or companies (such as FCPR, FCPI, etc.) are not taken into account when determining whether the 25% threshold is met, to the extent such entities and companies do not have a dependence link with the issuing company.
BCE may be granted only to the managers and the employees of the issuing company. Unlike stock-options, they cannot be granted to managers and employees of another company even if it belongs to the same group as the issuing company.

The price at which the shares of the company may be acquired pursuant to the exercise of the BCE must be at least equal to the issue price set forth upon the last share capital increase during the last six months preceding the issuance of the BCE.

Subject to the above, a capital gain realized upon the sale of the shares acquired as a result of the exercise of the BCE, which is equal to the difference between the sale price and the subscription price, is taxable at the rate of 26% (including additional social contributions) to the extent that the beneficiary has been employed by the company for at least three years on the date of the sale of the shares. Otherwise, the capital gain is taxable at the rate of 40% (including additional social contributions).

As mentioned above, the capital gain is only taxable if the total amount of the sale of securities by the taxpayer and his household exceeds, for the year of the sale, the €15,000 threshold.

In any case, the capital gain realized upon the sale of the shares is not subject to any employee’s or employer’s social security contributions.

3. Taxation of Individuals

3.1. Individual Income Tax

3.1.1. Territoriality Rules

Individuals whose tax domicile is located in France, as well as individuals whose tax residence is not located in France but who have realized French-source income, are subject to individual income tax.

Unless otherwise provided by a tax treaty, an individual is considered a resident of France for French individual income tax purposes if:

- he has his home, or his principal place of abode, in France;
- he is engaged in a business activity in France; or
- the center of his economic interests is in France.

Individual residents of France are subject to income tax on their worldwide income, whereas non-residents are subject to income tax only on their French-source income.
3.1.2. Taxable Base
The individual income tax base is the net income of various categories of income: real estate income, industrial and commercial income, income received by corporate executives, agricultural income, employment income, income from independent personal services, investment income and capital gains. The net income of each category is determined with reference to specific rules.

The total amount of the net income from each category constitutes the gross taxable base for individual income tax purposes (which under specified conditions may be decreased by certain tax-deductible losses). The net taxable base is obtained by deducting from the gross taxable base certain expenses (e.g. social security contributions, interests paid on certain kinds of loans, alimonies, etc.) and certain deductions.

3.1.3. Rates
Individual income tax is levied on the net taxable base at progressive rates. The rates vary from 0% up to 48.09% (plus the 10% additional social contributions, see section 4.6.3).

The family status of the taxpayer may limit his individual income tax. Indeed, the taxable base of a taxpayer is divided into a number of shares depending on the number of members in his household and his family status (single, married, widowed or divorced). Then, individual income tax progressive rates are applied and the resulting amount is multiplied by the number of shares allocated to the taxpayer in order to determine the gross individual income tax. The net amount of individual income tax payable by the taxpayer is obtained by deducting investments, donations to charities, political contributions, etc.

3.1.4. Capital Gains and Interest Income
Certain individual income may benefit from a reduced rate of taxation:

- Gains on shares, bonds, and similar securities of domestic or foreign entities may benefit from a flat rate of taxation of 16% plus additional social contributions (see section 4.6.3), resulting in a 26% effective rate, if the aggregate sales in the tax year exceed €15,000.
- Interest may be subject to a final withholding tax at a rate of 16%, plus additional social contributions (see section 4.6.3), resulting in a 26% effective rate.

3.1.5. Non-Resident Taxpayers
Individuals who are non-residents for tax purposes are subject to individual income tax only with respect to French-source income as defined by domestic tax law or tax treaties signed by France. However, the taxable base of non-resident taxpayers domiciled in a non-treaty country who have the use of a dwelling house in France may not be lower than three times the rental value of such house.
3.1.6. **Anti-Avoidance Measures**
As for companies, anti-avoidance measures are applicable for individuals (such as the abuse of law, the CFC rules, etc.).

3.2. **Wealth Tax**
Wealth tax is paid by individuals whose net wealth exceeds a threshold level, currently equal to €720,000. This threshold is determined on the basis of the net wealth of all members of the taxpayer’s household.

3.2.1. **Territoriality Rules**
Taxpayers are subject to wealth tax on a worldwide basis if they are residents of France for tax purposes. Otherwise, they are subject to wealth tax only with respect to their assets located in France, apart from financial investments which are expressly exempt.

These provisions apply unless provided otherwise by tax treaties.

3.2.2. **Rates**
Wealth tax rates are progressive and range from 0% to 1.8% depending on the net taxable wealth.

3.2.3. **Taxable Base**
The tax is assessed on all properties owned by the taxpayer, his spouse, children and members of his household on 1 January of each year. However, some properties are exempt from wealth tax; e.g. assets used by taxpayers for their business activities (including, under certain conditions, shares of companies), works of art, etc.

4. **Other Taxes**

4.1. **Withholding Taxes**
Under domestic law, unless otherwise provided by a tax treaty, withholding taxes may be levied on dividends, royalties, interests and considerations for certain services paid to non-residents:

- **Dividends** – Distributions to non-resident shareholders are subject to withholding tax at a rate of 25%.
  
  Dividends paid by a qualifying French subsidiary to its qualifying parent company resident of another EU member state may be exempt (EC Parent-Subsidiary Directive).

- **Royalties** – Withholding tax is due at the rate of 33.33%.
  
  Royalties paid by a qualifying French subsidiary to its qualifying parent company resident of another EU member state may be exempt.

- **Interest** – Withholding tax is due at a rate of 16%.
Interest paid by a qualifying French subsidiary to its qualifying parent company resident of another EU member state may be exempt.

Moreover, interest on loans contracted abroad, bank deposits, state bonds issued after 1 October 1984, corporate bonds issued after 1 January 1987 and certain negotiable debt instruments traded on a regulated market may be exempt from withholding taxation under certain conditions.

- **Compensation for services** – Income received or realized in France by non-residents is subject to a withholding tax whenever they relate to independent personal services that are either (i) performed in France when the recipient of such income has no permanent professional establishment in France or (ii) used in France.

  The withholding tax rate is presently 33.33%, reduced to 15% for services of an artistic or sporting nature.

- **Wages, pensions, annuities** – Non-residents are liable to a withholding tax on this income, at a rate of 0%, 15% or 25%.

These withholding taxes are not always final, which means that the foreign taxpayer may have to file a tax return in France (for example in the case of employment income).

A schedule summarizing the withholding tax rates applicable under certain tax treaties signed by France is provided in the Appendix.

### 4.2. Value Added Tax (VAT)

VAT is a multiple-stage non-cumulative general turnover tax that applies to goods and services destined for consumption in the EU territory. VAT domestic rules are derived from the provisions of the Sixth EU Directive dated 17 May 1977 as amended by subsequent Directives. As a result, VAT rules applicable in France are generally consistent with VAT rules applicable in other EU member states.

The tax is collected and deducted at each stage of the production process of goods and services until the last stage of this process. Due to the calculation mechanics of the VAT, the global burden is in principle equal to the tax on the final setting price at the end of the economic process when the goods or services are finally used by the final consumer.

VAT is levied in France mainly at a reduced rate of 5.5% (applicable mainly to food, water, books and to specific services such as transportation of passengers) or a normal rate of 19.6% (applicable to all operations which are not subject to the reduced rate).

VAT is assessed on all economic activities, such as the supply of goods and services for consideration, farming, legal, accounting and other professional activities.
Certain goods and services are exempt from VAT.

4.2.1. **Scope**
VAT is assessed on the supply of goods and services rendered for consideration by a “taxable person”. For VAT purposes, a taxable person is any person who independently carries out in any place any economic activity.

In this respect, the FTC expressly applies VAT to imports, to certain purchases from non-VAT liable persons (such as pearls, precious stones, spirits or wine), to real estate construction and self-supply of property. Conversely, the following activities are exempt from French VAT: exports, supply of goods within the EU, as well as international transports, certain financial operations, sales of second-hand goods and certain “liberal activities” such as insurance and reinsurance, offshore fishing, etc.

Note that there is a threshold reviewed periodically under which a person will not qualify as a taxable person.

4.2.2. **Territoriality Rules**
Goods and services follow different territoriality rules.

The supply of goods is subject to the following rules:

When the goods are delivered in their original condition, the following rules apply:

- if the place of departure of the goods is located within France, French VAT liability is incurred unless the goods are exported or delivered within the EU;
- if the place of departure of the goods is located outside France, the goods do not attract VAT unless taxed as an import or as an intra-EU acquisition in France; and
- if the goods are not transported, French VAT applies if the goods are located in France when they are delivered to the customer.

When the goods are installed or assembled after delivery in France, they are always taxed in France.

The supply of services is normally subject to French VAT when the supplier is established in France.

Two exceptions apply to this rule with respect to services which are materially performed in France and services that are considered as intangibles.

Services materially performed in France may be subject to French VAT when they relate to the rental of transportation means, services on real property, certain transportation services, services rendered in connection with cultural and artistic events, works and services of experts on movable property located in France, or the supply of lodging and meals.
Intangible services notably include the sale of licensing of copyrights, patents, trademarks and similar rights, advertising services, counseling services, the supply of information, banking, financial and insurance services, and services of intermediaries and brokers related to the supply of the above categories. These services are subject to VAT according to the following rules:

- Services supplied by a person established in France are taxable in that country if:
  (i) the customer is established in France; or
  (ii) the customer is established in another EU member state where such customer is not liable to VAT.
- Services supplied by a person not established in France (whether in or outside the EU) are taxable in that country if:
  (i) the customer is liable to VAT in France; or
  (ii) the supplier is not established in the EU and the customer is established in France, while a person not liable to VAT actually used the services in France.

In all other cases, immaterial services are not taxable in France.

In addition, when a person is not established in France but French VAT is due, VAT may have to be paid to the French treasury directly by the French client (under the “reverse charge procedure”).

4.2.3. Taxable Base
The taxable base of VAT for the supply of goods, services and intra-EU acquisitions is the price charged. The price is made up of all sums, values, goods or services received or to be received by the supplier of the goods or the persons rendering the services. As a result, taxes of any kind, except French VAT itself, must be included in the taxable base. Similarly, transportation expenses that the supplier invoices to his client must be included in the taxable base.

4.2.4. Payment of Tax
For the supply of goods, the chargeable event, as well as the liability to the VAT, arises on the date of delivery of the goods.

As regards the supply of services, the chargeable event is the performance of the services. Payment of the tax occurs, however, only when the corresponding price is received from the customer in whole or in part. However, taxpayers may be authorized to collect VAT on a “debit basis”, i.e. when the invoice is issued and not when the price is paid.

4.2.5. Deductions
4.2.5.1. Principles
Taxpayers may deduct VAT incurred in respect of goods and services supplied to them (“input VAT”) from VAT they collect for the French Treasury in respect of their own supplies of goods and services. Under certain conditions, they may claim a refund of any excess from the French Treasury.
VAT is deductible under the following conditions:

- VAT must be incurred by the enterprise for the purchase of goods or services that are used by the enterprise for transactions that are actually subject to VAT;
- The expenses subject to VAT must be incurred for the normal and necessary operations of the business;
- The expense must not be of a type for which VAT is not deductible under an express provision of the FTC; and
- Input VAT deducted must be indicated on an invoice or other acceptable document.

Except expressly otherwise provided for, VAT paid on most taxable goods and services is deductible.

4.2.5.2. Method of Computing VAT Deduction Rights of an Enterprise

The right to deduct or obtain refunds of VAT only applies with full effect to the supplies of goods and services used for purposes of taxable transactions. Enterprises cannot deduct the input VAT linked to goods or services used for the purposes of activities that are outside of the scope of VAT (such as pure holding activities) or expressively exempt from VAT (such as certain financial activities).

As a result, enterprises engaged in taxable and non-taxable transactions must determine the deductible proportion according to the applicable calculation methods, i.e. the "real use method" (input VAT incurred in respect of a good or service is deductible if this specific good or service is used for a transaction subject to VAT) or the "prorata method" (the deduction proportion of input VAT incurred in the purchase of goods and services is determined globally based on the percentage of the turnover realized on activities subject to VAT in comparison to the total turnover of the enterprise).

Often used, the *prorata* method allows a proportional deduction of input VAT. In addition, when an enterprise is engaged in different sectors of activity that are subject to different VAT treatments, it may determine a specific VAT *prorata* percentage for each sector.

VAT may be an actual cost for companies which are not in a position to obtain a full credit or repayment of the VAT. This is typically the case of financial institutions, as most banking services (including financial credits, loans, etc.) are generally exempt from VAT. As a result, under the *prorata* method described above, financial institutions located in France (and in other EU member states) may receive a credit for only a portion of the VAT borne with respect to the goods and services purchased from their suppliers.

4.2.6. Reporting Requirements

Taxpayers must meet the following reporting requirements:
- VAT returns must be filed where the VAT taxable base is declared;
- Invoices must be issued with all mandatory information;
- A special tax return relating to the exchange of goods in case of intra-EU supply or acquisition must be filed; and
- Accounts must be kept for a certain period of time.

4.3. **Other Turnover Taxes or Indirect Contributions**

There are two types of turnover tax other than VAT. Some are taxes for which the rate is determined as a percentage of the turnover of the taxpayer (on forestry products, on publishing, etc.) and others are specific taxes (on cooking oil, meat, beetroots and television advertisements).

Indirect contributions include the following taxes: license rights on bars, beverage taxes, entertainment taxes and taxes on precious metals.

4.4. **Registration and Transfer Duties**

Registration duties are levied when specific transactions are entered into (incorporation, modification of by-laws, transfer or contribution of assets, mergers or similar restructuring, etc.) and also in case of gifts or death.

4.4.1. **Registration Duties to be Paid by Companies**

Registration duties must be paid by companies or their shareholders with respect to certain transactions for which a deed must be registered within a compulsory time period (frequently one month) following the execution date. For example:

- Contributions to capital may be subject to a flat duty of €230, up to 4.8% duty.
- Merger agreements benefit from a special flat duty of €230.
- Transformations of companies are usually subject to a flat duty of €75.
- Except for “real estate companies”, sales of shares of a corporation (SA, SCA or SAS) trigger the application of a 1% registration tax limited to €3,049 per transfer;
  sales of an interest in a “real estate company” or in a partnership (SCS, SNC) or SARL give rise to a registration duty of 4.8% of the sales price or market value, whichever is higher, without any ceiling. A rebate up to €23,000 is applied on the sales of interest in a partnership.
- Dissolutions of companies are subject to a flat duty of €230, while distributions among the shareholders of the remaining assets is, in principle, subject to a 1% share tax (droit de partage); etc.

4.4.2. **Transfer of Goodwill, IP Rights and Real Estate**

Transfer of goodwill and exploited IP rights (except for patents and other assimilated rights) are subject to a tax of 4.8%. The rate is equal to 4.89% for the transfer of real estate assets. Both
4.4.3. Gift and Death Taxes

French death taxes are applicable at the opening of the estate on assets that are (i) owned by a deceased person who is French tax resident, (ii) received by a beneficiary who has been a French tax resident for six years during the last ten years preceding the year during which the beneficiary receives the assets, or (iii) located in France. The definition of residence for death tax purposes is the same as for income tax purposes (see section 3.1.1).

In principle, death taxes are paid by the beneficiary. The rates are the same for all type of assets but vary according to the value of the assets and the relationship between the beneficiary and the deceased person. For transmission to children and between spouses, the rates vary between 5% and 40% (the 40% rate applies on the share of the assets received by a given person for a value in excess of €1,700,000), while between unrelated persons, the tax rate is 60%.

Gift taxes usually follow the rules applicable to death taxes. However, gift taxes may benefit from a reduction depending on the age of the donor.

4.4.4. Stamps Duties

Stamps duties are paid in connection with the recording of certain deeds (transfer deeds, etc.) or other legal proceedings (issuance of a bill of exchange or services of process, etc.). The rate of the applicable stamp duty depends on the situation and type of deed involved.

4.5. Taxes Based on Salaries

4.5.1. Payroll Tax

Payroll tax (taxe sur les salaries) is due by employers and calculated on the basis of salaries paid by the employer increased by any bonus and fringe benefits paid in cash or in kind to or enjoyed by the employee net of social charges. The rates vary between 4.25% and 13.6%.

Each year, employers are subject to payroll tax only to the extent of the percentage of their turnover that was not subject to VAT in the preceding year. If at least 90% of their turnover is subject to VAT, employers are totally exempt.

4.5.2. Other Taxes Based on Salaries

- The “apprenticeship tax” is due at a rate of 0.5% and is based on salaries paid by the enterprise during the preceding year;
- The “continuing professional training tax” is due by entities employing more than ten employees at a rate of 1.5% or 0.25% and is based on salaries paid during the current fiscal year; and
- The “participation in housing construction tax” is due by entities employing more than ten employees at a rate of 0.45% and is based on salaries paid during the preceding year.

4.6. Social Contributions

4.6.1. Social Security Contributions
Employers, employees and independent workers are subject to social security contributions (contributions for illness benefits, family allowance, housing aid, old age pension, unemployment benefit, other supplementary pensions for executives or non-executives, etc.).

The taxable base for employees is the gross wage paid (including fringe benefits and employment-related allowances). Independent workers are subject to social security contributions on their professional income.

The rates and ceilings of each contribution vary according to various factors, such as the position of the person concerned (executive, non-executive) and the sector of activity (employees, independent workers).

Contributions are deductible for income tax purposes under specific rules.

4.6.2. Additional Social Contribution Due by Companies
The social contribution due by companies (so-called ORGANIC) is levied on enterprises (i) whose turnover (VAT excluded) equals at least €760,000 and (ii) which are set up according to one of the listed types of entities (the definition is very broad and encompasses, among others, SA, SAS, SARL, EURL, SCA, SCS, SNC, GIE, public companies, foreign companies subject to corporate income tax in France, financial institutions, cooperatives, etc.).

The tax is levied at a rate of 0.13% and is based on the enterprise’s turnover (note that a threshold may apply).

4.6.3. Additional Social Contributions Due by Individuals
Currently, the maximum global rate of additional social contributions due by individuals is 10%.

4.6.3.1. Generalized Social Contribution
The contribution sociale généralisée (CSG) is levied on all income received by individuals who are French residents for tax purposes. The rate is generally 7.5% (3.8% for pension income) and applies on 95% of the gross income; 5.1% out of the 7.5% CSG is deductible for income tax purposes.

4.6.3.2. Social Security Deficit Contribution
This contribution au remboursement de la dette sociale (CRDS) of 0.5% applies on the same taxable base as the CSG but is not deductible for income tax purposes.
4.6.3.3. Social Levy

The *prélèvement social* of 2% only applies on investment and immovable property income and is not deductible for income tax purposes.

### 4.7. Profit Sharing

French enterprises employing at least 50 employees must implement and manage a profit-sharing plan ("*participation*”) for their employees. Although enterprises are given some latitude, the form of such plan is fixed by law.

The exact terms of the plan must be negotiated under a collective agreement or between the employer and union representatives or the worker’s council. However, when the enterprise fails to implement the plan, the French labor authorities may impose a standard plan.

Amounts contributed by the enterprise to the mandatory profit-sharing plan are deductible for corporate income tax purposes.

All employees are generally plan participants. The sums received by employees pursuant to the profit-sharing plan are exempt from individual income tax provided that the funds are kept in the profit-sharing account for a three or five-year period, depending on the plan. When employees withdraw their interest in the plan prematurely, they lose part of the income tax exemption except under special circumstances, e.g. family events (marriage, divorce) or work-related events (termination of employment, disability).

Funds held in the plan may be invested in the employer’s stock or bonds or in accredited investment funds depending on the stipulations of the plan.

In addition to the mandatory profit-sharing plan, optional schemes also exist (such as stock-option or BCE plans) (see section 2.8), “*plan d’épargne salarial*” (savings capital plans), “*plan d’épargne d’entreprise*”, etc.

### 4.8. Local Taxes

Local taxes are paid to local authorities or to some public agencies. The most important local taxes are the business tax and the 3% real estate tax.

#### 4.8.1. Business Tax

The business tax (*taxe professionnelle*) applies to individuals (except employees) or corporate entities involved in business or professional activities. The taxable base is composed of two elements:

- the rental value of assets used by the enterprise for its activities; and
- 18% of the annual salaries paid by the enterprise. This component was reduced by €914,694 in 2002 and was abolished in 2003.
The taxable base is then reduced by 16%.

The taxpayer pays the business tax in the city or town where the business property is located on 1 January of each year. The tax is calculated by applying to the tax base the annual rate voted by the relevant local governmental authorities.

Before 1 May of each year, the taxpayer must file a return listing the assets constituting the business tax base in each city where the taxpayer has an establishment (i.e., one return has to be filed for each locality).

Article 13-III of the Finance Bill for 2003 provides for an exemption of business tax that may benefit new enterprises engaged in R&D activities in France.

4.8.2. 3% Real Estate Tax
Subject to the exemption below, French and foreign entities owning French real estate must pay an annual tax equal to 3% of the market value of their real estate owned on 1 January of each year. Entities are not subject to the 3% real estate tax if their real estate located in France represents less than 50% of their French assets. In addition, French or foreign companies located in certain treaty countries may be exempted from the 3% real estate tax if:

- they file a special form containing information on the real estate owned and disclosing the identity of each shareholder before 15 May of each year; or
- they make a written commitment, within two months following the acquisition of real estate, to provide the French tax authorities with this information on their request.

4.8.3. Other Real Property Taxes
Taxpayers are subject to the real property tax (taxe foncière), which applies to real estate owners, and to the residence tax (taxe d’habitation) applicable to taxpayers having a real estate at their disposal. Both taxes are levied for the benefit of local governmental entities. The taxes are based on a special rental value determined by the code (lower than fair market value) and the rates vary each year and from one local governmental entity to another.

5. Statute of Limitations
As a general rule, the statute of limitations for individual and corporate income taxes expires at the end of the third year following the year for which tax is due. A longer statute of limitations applies under special circumstances (e.g., fraud).

For registration duties and related taxes, the statute of limitations ends on 31 December of the third year following that during which the tax authorities became aware that registration duties or other taxes were due, e.g., registration of a deed or filing of a return. However, if insufficient information
was provided to the tax authorities regarding a taxable transaction, the statute of limitations expires at the end of the tenth year following the year of the transaction.
**APPENDIX**

Withholding Tax Rates Applicable in Certain Tax Treaties Signed by France

<table>
<thead>
<tr>
<th>Country</th>
<th>Dividends</th>
<th>Interest (%)</th>
<th>Royalties (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individuals / Non-Qualifying Companies (%)</td>
<td>Qualifying Companies (%)</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>15</td>
<td>10(^2)</td>
<td>15</td>
</tr>
<tr>
<td>Canada</td>
<td>15</td>
<td>5(^3)</td>
<td>10/0(^9)</td>
</tr>
<tr>
<td>(see also Quebec)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>0/15</td>
<td>0(^1)</td>
<td>0</td>
</tr>
<tr>
<td>Ireland</td>
<td>15</td>
<td>10(^4)</td>
<td>0</td>
</tr>
<tr>
<td>Italy</td>
<td>15</td>
<td>5(^5)</td>
<td>10/0(^6)</td>
</tr>
<tr>
<td>Japan</td>
<td>15</td>
<td>0/5(^8)</td>
<td>10/0(^9)</td>
</tr>
</tbody>
</table>

---

\(^1\) This treaty provides for the “avoir fiscal” to certain recipients of dividends.

\(^2\) A 10% holding is required.

\(^3\) The 0% rate applies to the extent that such interest is a penalty charge for late payment, is paid to the Central Bank or is paid on certain sale on credit. It also applies to (i) interest on bond, debenture or similar obligation of a state, a political subdivision or a local authority, (ii) interest paid in respect of a loan or a credit made or guaranteed by the Export Development Corporation or a public institution.

\(^4\) The 0% rate applies to copyright royalties, excluding films, to computer software, to patents and know-how and to royalties paid to the government or to an approved organization of Canada.

\(^5\) A one year 50% holding is required.

\(^6\) The 0% rate applies to interest paid in connection with the sale on credit of industrial, commercial, or scientific equipment and merchandise delivered by one enterprise to another enterprise. It also applies if (i) the payer of the interest is that state, one of its political or administrative subdivisions or territorial authorities, (ii) the interest is paid in consideration of a loan granted or guaranteed by the other state, administrative subdivisions or territorial authorities, or a public body of that other state, and (iii) the interest is paid to other institutions or bodies in the framework of an agreement concluded between both states.

\(^7\) The 0% rate applies to copyright royalties of literary, artistic or scientific work (excluding royalties for films, computer programmes and other sound or visual recordings).

\(^8\) The 5% rate applies if the Japanese company has held, directly or indirectly, at least 15% of the share capital of the French company for at least six months before the end of the accounting period for which the distribution takes place. If the above requirements are met, a 0% rate applies when the Japanese company is a “qualified resident” as defined in the treaty.

\(^9\) The 0% rate applies to interest on loans which are granted, guaranteed or derived by the state, a territorial authority, the Central Bank or a public financial institution.
### Appendix

**Taxation of Business Operations in France**

<table>
<thead>
<tr>
<th>Country</th>
<th>Dividends</th>
<th>Interest (%)</th>
<th>Royalties (%)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Individuals / Non-Qualifying Companies (%)</td>
<td>Qualifying Companies (%)</td>
<td></td>
</tr>
<tr>
<td><strong>Luxembourg</strong></td>
<td>15</td>
<td>5(^{10})</td>
<td>10(^{11})</td>
</tr>
<tr>
<td><strong>Netherlands</strong></td>
<td>15</td>
<td>5(^{9})</td>
<td>10/0(^{12})</td>
</tr>
<tr>
<td><strong>Quebec (Canada)</strong></td>
<td>15</td>
<td>10(^{1})</td>
<td>10/0(^{13})</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
<td>15</td>
<td>5/10(^{15})</td>
<td>0</td>
</tr>
<tr>
<td><strong>Spain</strong></td>
<td>15</td>
<td>0(^{1})</td>
<td>10/0(^{16})</td>
</tr>
<tr>
<td><strong>Switzerland</strong></td>
<td>15</td>
<td>0(^{1})</td>
<td>0(^{18})</td>
</tr>
<tr>
<td><strong>United-Kingdom</strong></td>
<td>15</td>
<td>5(^{1})</td>
<td>0</td>
</tr>
<tr>
<td><strong>United-States</strong></td>
<td>15</td>
<td>5(^{1})</td>
<td>0</td>
</tr>
</tbody>
</table>

---

10 A 25% holding is required.
11 A 33.33% withholding tax applies to interest paid to a "1929 holding".
12 The 0% rate applies to interest (i) paid under a financing contract or a contract for deferred payment relating to the sale of industrial, commercial or scientific equipment or installations or the carrying out of public work, (ii) interest paid on a loan made by a banking establishment, and (iii) if such interest is paid following a formal request for payment or a legal action as penalty for late payment.
13 The lower rate applies to certain interests listed in the treaty.
14 The 0% rate applies to copyright royalties, excluding films, and to royalties paid to the government or to an approved public body of Quebec.
15 The 5% rate applies if the recipient company (i) has invested in the French company a cumulative amount of not less than 500,000 FRF on the date the investment is made and (ii) is subject to tax in Russia but is exempt from tax on the dividend received. The 10% rate applies if one of these conditions is met.
16 The 0% rate applies to interest (i) paid by the other contracting state or one of its territorial authorities, (ii) by an enterprise of Spain to an enterprise of France in the course of a business, (iii) in connection with the sale on credit of industrial, commercial or scientific equipment or (iv) on any loan of whatever kind granted by a credit institution.
17 The 0% rate applies to remuneration in any kind paid for the use of, or the right to use a copyright of literary or artistic work, excluding films and any sound or picture recording (see also the Protocol).
18 A different rate applies if the Swiss recipient is controlled by a non-Swiss resident.
19 The lower rate applies to copyright royalties, including films, etc. and to computer software. The term "royalties" means payment of any kind received as a consideration for the use of, or the right to use, (i) any copyright of literary, artistic, scientific work or any neighboring right, (ii) any patent, trademark, design or model. The term "royalties" also refers to gain derived from the alienation of any such right or property described in this paragraph that is contingent on the productivity, use or further alienation thereof.
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Taxation of Business Operations in Germany

1. Business Overview

1.1. Legal Overview

The legal form of a business operation conducted by a foreign investor in Germany depends on a variety of individual circumstances. These circumstances include the degree of market penetration already achieved, the prospective scope of operation, the long-term strategy and, last but not least, tax considerations. An enterprise may start doing business in Germany not only via commercial agents or distributors, but also by opening a branch office or forming a German company.

German civil law provides for the following types of companies:

- limited liability corporations, e.g., Gesellschaft mit beschränkter Haftung (GmbH), Aktiengesellschaft (AG) and Kommanditgesellschaft auf Aktien (KGaA);
- limited partnerships, e.g., Kommanditgesellschaft (KG); and
- general partnerships, e.g., Gesellschaft bürgerlichen Rechts (GbR) and Offene Handelsgesellschaft (OHG).

1.2. Tax Overview

German tax laws are just as elaborate and complex as can be expected in a country justly or unjustly famous for its bureaucratic perfectionism. Furthermore, German tax laws are subject to rapid changes these days.

Some characteristic features of the main German taxes are briefly summarized below. In addition to domestic tax laws, the application of these rules to a foreign business in Germany will in many cases be modified by provisions in one of the numerous double taxation treaties which Germany has concluded with other countries, as well as standards set by the European Union.

1.2.1. Taxation of Companies

The income of corporations is subject to corporation income tax (Körperschaftsteuer, CIT), whereas partnerships are transparent for personal income tax (Einkommensteuer, IT) and CIT purposes. Therefore, partnerships are not subject to income tax at the partnership level. Thus, a corporate partner will have to pay CIT on income derived from a partnership, and an individual partner will have to pay IT on such income. Furthermore, a solidarity surcharge (Solidaritätszuschlag) is levied on the CIT or IT due.
CIT is levied annually on the worldwide income of German resident corporations, subject only to specific exemptions and exclusions under any relevant double taxation treaty, whereas non-resident corporations are subject to CIT with their income from defined German sources only.

Furthermore, withholding tax might be levied on certain specific income (see section 5.1).

While the imposition of CIT and IT depends on the legal form and the domicile of the relevant taxpayer, trade tax (Gewerbesteuer) is levied, in principle, on all businesses in Germany, irrespective of the legal form of the business operation. Consequently, a partnership itself is subject to trade tax on the profit generated by the partnership.

An outline of the taxation of companies is set out in section 2. Particular tax regimes will be highlighted in section 3.

1.2.2. Taxation of Individuals
Individuals are subject to IT and a solidarity surcharge according to the rules summarized in section 4 below.

1.2.3. Other Taxes
The German tax system provides for several other direct and indirect taxes. Among those taxes, the most important are value added tax (Umsatzsteuer, VAT) and real estate transfer tax (Grunderwerbsteuer). The scope and mechanism of these and other taxes is summarized in section 5 below.

2. Taxation of Companies
The following comments focus on tax rules applicable to corporations and partnerships.

2.1. Corporate Income Taxation

2.1.1. Territoriality Rules
German resident corporations and German resident corporate partners of partnerships are, in principle, subject to tax on their worldwide income. However, Germany’s right to tax is limited by double taxation treaties which have been concluded with almost 90 foreign countries, and also by European regulations such as the EC Parent-Subsidiary Directive.

Double taxation treaties provide for different methods to prevent double taxation of German resident taxpayers on business activities outside Germany. Under the exemption method, the income derived from foreign sources which was already taxed is exempt from taxation in Germany. Under the credit method, the foreign income is included in the calculation of taxable income, but foreign income tax is credited against the IT or CIT due. Corporations are considered German residents when they maintain their head office or their seat in Germany.
As set out above, non-resident companies will be subject to German taxation with income from German sources only, i.e., income attributable to a permanent establishment in Germany.

2.1.2. Rates
The corporate income tax rate is 25% regardless of whether the income is distributed or retained. Additionally, a solidarity surcharge at a rate of 5.5% is levied on the CIT amount due resulting in an effective tax rate of 26.375%. The same rates apply in the case of income received by a corporation as a partner in a partnership.

2.1.3. Determination of Taxable Income

2.1.3.1. Taxable Income
Under the Income Tax Act (Einkommensteuergesetz, ITA) and the Corporate Income Tax Act (Körperschaftsteuergesetz, CITA) the CIT base is calculated in accordance with German tax accounting principles.

The taxable income is ultimately derived from the financial statements, which are prepared according to German GAAP prescribed in the German Commercial Code (Handelsgesetzbuch, CC). However, the financial statements are adjusted in accordance with specific provisions as set out in the ITA and the CITA. This may result in a tax balance sheet considerably deviating from the commercial financial statements.

2.1.3.2. Tax Losses
CIT losses may be carried back one year up to the amount of €511,500. From 2004 onward, losses may still be carried forward without any limitation, but loss carry-forwards may be set off against profits up to €1 million without limitation; only 60% of the profits beyond this threshold may be set off against loss carry-forwards. Consequently, 40% of the profits (exceeding €1 million) will be taxed (concept of minimum taxation). However, since no time limit has been introduced the residual losses may be entirely utilized in subsequent years.

2.1.4. Trade Tax
In principle, German-source business income is subject to trade tax (Gewerbesteuer, TT). TT is levied annually on the income determined for purposes of CIT (see section 2.1.3.1). However, such income computation is subject to modifications, such as the disallowance of one-half of the interest on long-term debt paid by the company, i.e., one-half of such interest is added back to the trade tax base. The rate is determined by the municipality in which the company operates, within limits set by federal statute. The TT rates vary between approximately 13% and 20%. TT qualifies as a deductible expense for purposes of determining the profits that are subject to CIT.
2.1.5. Capital Gains and Losses

In general, capital gains are treated as ordinary income. However, capital gains derived from sales of shares in a subsidiary corporation are tax-exempt at the level of a corporate shareholder. On the other hand, 5% of the capital gains are deemed non-deductible business expenses. As a result only 95% of the capital gains are tax-exempt. This is, however, not true for capital gains realized upon a sale of so-called tainted shares (shares received upon a tax-neutral contribution of a business operation or separable part of a business operation, *einbringungsgeborene Anteile*), which are treated as ordinary income if the sale takes place within a seven-year holding period.

Specific rules may apply to banks and financial holding companies. Capital gains derived from sales of shares are not tax-exempt and are treated as ordinary income in the hands of life and health insurers as well as pension funds.

Capital losses are not deductible if a capital gain would have been exempted from taxation. Therefore, losses deriving from sales of shares can be deducted by life and health insurers as well as pension funds. The same is true for banks and financial holding companies provided a capital gain would have been subject to tax.

2.1.6. Dividends

Dividends are tax-exempt at the level of a corporate shareholder. This holds true for domestic and foreign source dividends. However, 5% of the dividends received are deemed non-deductible business expenses. Thus, *de facto* only 95% of the dividends received are tax-exempt. In case of foreign source dividends the foreign entity has to qualify as a corporate entity by German standards, *i.e.*, the foreign rules and regulations governing the status of the relevant entity have to be similar to the German concept of corporations. Again, specific rules may apply to banks and financial holding as well as insurance companies.

As regards withholding taxes, please see section 5.1.

2.2. Partnerships

German partnerships are treated as tax transparent for CIT and IT purposes so that the individual partners are taxable on their share of partnership income. Consequently, for corporate income tax purposes, an investment by a foreign corporation via a German partnership is, in principle, treated similarly to a direct investment, *i.e.*, the partners are treated as if they maintained a permanent establishment in Germany. The profits generated by the partnership are subject to CIT/IT in Germany.

Due to the transparency principle the partners are taxed on the income generated by the partnership regardless of whether profits are actually distributed. Consequently, the distribution of profits is not a taxable event. As regards foreign partners, Germany does not levy any form of
“branch profit tax” or comparable substitute for a dividend withholding tax. Therefore, the partnership is not obligated by German tax law to withhold taxes in the case of distributions.

Unlike German corporations, partnerships are not automatically deemed to generate business income due to their legal form. However, German partnerships are subject to trade tax, unless (i) the activities of the partnership are restricted to the pure management of assets (Vermögensverwaltung) and (ii) the partnership is not deemed to be engaged in a commercial activity (gewerbliche Prägung). In principle, this will be the case if a partnership has a corporation as general partner only.

2.3. Tax Consolidation/Fiscal Unity

Fiscal unities (Organschaften) are established for various reasons and should always be considered in multi-tier structures.

2.3.1. Overview

Under a fiscal unity arrangement, participating entities are basically treated as one taxable person, and income of the subsidiaries is allocated to the parent. A fiscal unity allows the aggregation of taxable profits or losses of the group at the level of the parent company. Such fiscal unity may be established for purposes of CIT, TT and VAT. In principle, the establishment of a fiscal unity is optional.

Profits and losses realized by the subsidiary will automatically be transferred to the parent company for purposes of income taxation. Consequently, subsidiaries are not entitled to utilize corporate losses while the fiscal unity is in place. Losses which had been suffered at the level of the subsidiary prior to the establishment of the fiscal unity can be carried forward to an assessment period after dissolution of the fiscal unity only.

2.3.2. Requirements

The main requirements of a fiscal unity are as follows:

- The parent entity has to be a commercial enterprise (gewerbliches Unternehmen) including the German branch (permanent establishment) of a foreign company. Cross-border consolidation, however, is not available;
- The subsidiary must be a German tax-resident corporation;
- The parent must hold the majority of the shares (voting rights) in the subsidiary from the beginning of the financial year of the subsidiary (“financial integration”). If a German branch acts as parent company, the shares have to be attributable to the branch (business assets of the branch); and
The parent and the subsidiary must enter into a profit and loss transfer agreement (Ergebnisabführungsvertrag) according to which all profits and losses generated by the subsidiary will be transferred to the parent. The minimum term of the transfer agreement is five years.

2.3.3. Fiscal Unity Tax Result
The taxable income of each subsidiary is, in principle, determined according to the rules described above (2.1.3.1). Subsequently, the taxable profits or losses of the subsidiaries will be allocated to the parent company.

2.3.4. Dividend Distributions Within the Fiscal Group
Profits realized during the existence of the fiscal unity are automatically allocated to the fiscal parent company. Therefore, such profits cannot be distributed as dividends. However, the transfer of profits generated before the establishment of the fiscal unity but not yet distributed, will be treated according to the ordinary tax rules for dividend distributions outside of fiscal groups.

2.3.5. End of the Fiscal Unity
All requirements for a fiscal unity have to be met throughout the subsidiary’s taxable year. Consequently, if only one requirement for a fiscal unity ceases to be met, the fiscal unity dissolves for the whole taxable year. If the initial five-year period has not yet elapsed, any failure to maintain the financial integration or the profit and loss transfer agreement will result in a termination of the fiscal unity from its creation.

2.4. Anti-Avoidance Measures
German tax law provides for general anti-avoidance rules (abuse-of-law concept) and anti-avoidance measures for specific situations.

As a general rule, taxpayers may choose any legal form and structure to operate and finance their business activities. When a structure or transaction is chosen merely to generate tax benefits, however, it may be viewed as abusive. If a structure or transaction is regarded as abuse of law, it will be taxed as if it were based on an appropriate legal structure.

Among the anti-avoidance measures of German tax law, CFC rules, guidelines for transfer pricing agreements and thin capitalization rules must be considered.

2.4.1. CFC Rules
German controlled foreign companies (CFC) regulations prevent tax saving schemes under which passive income is derived by subsidiaries incorporated in low-tax jurisdictions (tax haven countries) by shareholders that are subject to unlimited taxation in Germany. This is accomplished by allocating undistributed “passive” income of a CFC to the German shareholders. Thus, the German
shareholders may become subject to taxation on such income even in the absence of any distribution from the CFC.

Furthermore, so-called passive investment income (Zwischeneinkünfte mit Kapitalanlagecharakter) — i.e., income that results from the holding of, and the management for the purposes of retaining and enhancing the value of, liquid funds, account receivables, securities, shares and similar assets — may be attributed to a German resident shareholder provided certain requirements are met.

2.4.2. Transfer Pricing Rules

In multi-tier structures, especially if companies exist in different jurisdictions, income allocation is crucial. An international group of companies will try to reduce its overall tax burden, whereas the tax authorities of the jurisdictions involved want to secure the internal tax revenues. In Germany, several tax rules regulate the allocation of income. Furthermore, double taxation treaties may provide for additional rules. The basic concept of both domestic and treaty rules is the arm’s length principle.

Transfer pricing rules will be applied to transactions between related parties. The concept of related parties is broad and encompasses legal control as well as de facto control.

2.4.2.1. Domestic Principles

As regards transfer pricing methods, the German tax authorities prefer the traditional methods recognized by the OECD (i.e., comparable uncontrolled price method, resale price method and cost plus method) over the allocation of the global profit of the relevant group. In general, German companies are obliged to obtain and provide sufficient evidence for their determination of transfer prices. In particular, in the event of cross-border transactions, comprehensive documentation is necessary to meet those obligations and to avoid negative tax consequences and possible surcharges.

2.4.2.2. Advance Pricing Agreement (APA)

In 1999, the OECD released an update to the OECD Transfer Pricing Guidelines for multinational enterprises and tax administrations. Subsequently, the United States and some other countries introduced advance pricing agreements (APAs), i.e., legally binding contracts between taxpayers and tax authorities to apply a certain transfer pricing method for a set time and set transactions. In Germany, however, the tax authorities are presently not authorized to conclude APAs. German tax case law provides for private letter rulings by the tax authorities in special situations. When issuing a private letter ruling, the tax authorities do not investigate the facts and are only bound to the ruling with regard to the set of the facts provided by the taxpayer. Nevertheless, the Federal Ministry of Finance has recently published a draft that provides for special private letter rulings regarding transfer pricing issues. So far the draft has not been finalized, and it is not certain whether it will be released at all.
Though the European Commission expressed the importance of APAs to remove tax obstacles on the EC domestic market, the EU Joint Transfer Price Forum, which was introduced by the European Commission, agreed during its first meeting in 2002 to attribute only low priority to the concept of APAs.

### 2.4.3. Thin Capitalization Rules

As of 2004, German thin capitalization rules have been intensified. In a change from the past, thin capitalization rules apply to the funding of a corporation by foreign and domestic shareholders. In addition, partnerships falls into the scope of the amended rules, provided a corporation is directly or indirectly holding 25% of the partnership. Shareholder funding in this respect means direct financing by the shareholder, indirect financing through an affiliated person of the shareholder, or financing by a third, unrelated party having recourse to the shareholder or an affiliated person of the shareholder.

Interest payments on such shareholder loans are treated as dividends and added back to the companies’ taxable base for CIT and TT purposes provided that, *inter alia*:

- the shareholder holds directly or indirectly more than 25% of the capital;
- the loans exceed the debt/equity ratio of 1.5:1;
- the interest payments exceed €250,000; and
- a third party test is not met.

Additionally, an anti-avoidance provision regarding leveraged share deals within a group of companies has been introduced according to which interest payments on shareholder loans are not deductible if the loan was granted in connection with the acquisition of a participation in another corporation and the seller and the lender are either shareholder of the corporation or an affiliated person of the shareholder or an independent third party to the shareholder party having recourse to the shareholder or an affiliated person of the shareholder.

The new thin capitalization rule leads to a lot of ambiguities and is, therefore, heavily discussed. However, a circular recently issued by the German tax authorities clarified at least some of the raised questions.

### 3. Highlight on Certain Particular Tax Regimes

#### 3.1. Acquisitions — Share Deal vs. Asset Deal

This section focuses on tax issues which are relevant in structuring a corporate acquisition in Germany. In particular, the pros and cons of asset deals and share deals under German tax law shall be discussed.
This overview is based on a fact pattern whereby both the seller and the purchaser are entities subject to German corporate income tax.

3.1.1. **Asset Deal**

3.1.1.1. **Corporate Income Tax**

The seller is subject to corporate income tax at standard rates on any capital gain realized as a result of the disposal of assets (see section 2.1 above). Losses, if any, may however be offset against such capital gain. In addition, any such capital gain is subject to trade tax at a rate determined by the municipality (see section 2.1.4).

The taxable amount is the sale price less the basis of the assets (acquisition costs diminished by depreciation allowances) at the time of sale. The taxation of capital gains realized on the sale of certain assets (e.g., German land or buildings) may be deferred and the tax burden can be reduced effectively if a reinvestment reserve (*Reinvestitionsrücklage*) is created and if certain other requirements are met (roll-over relief). If no reinvestment is made within a certain time period, however, the above-mentioned capital gain (plus 6% thereon per year) will be subject to tax.

For the purchaser, the acquisition allows a step-up of the basis in the acquired assets (implying positive tax consequences in terms of depreciation allowances — for depreciable assets — and future capital gains). A residual value will be considered goodwill of the business. For tax purposes, goodwill must be depreciated over a period of 15 years.

3.1.1.2. **Other Taxes**

An asset deal will be subject to VAT unless the assets qualify as a going-concern business or a part of such business. In case of real estate, VAT will, in general, not be levied provided that the seller does not opt for VAT.

If and to the extent real estate is transferred, real estate transfer tax is levied at a rate of 3.5% (see section 5.3.1).

3.1.2. **Share Deal**

3.1.2.1. **Corporate Income Tax**

Of the capital gains realized pursuant to a share deal, 95% are exempt from corporation tax and trade tax irrespective of the size and holding period of the shareholding (unless the shareholder has made tax-effective depreciations on the shares in the past).

This tax exemption, however, does not apply if credit institutions and financial services institutions dispose of shares held in the trading book in accordance with the German Banking Act (*Kreditwesengesetz*, GBA). The same holds true for shares held by financial enterprises within the meaning of the GBA (including holding companies) and life and health insurers as well as
pension funds. The tax exemption does not apply to shares derived from a contribution of assets below their fair market value (*tainted shares*, see section 2.1.5).

For the purchaser, a share deal does not raise any particular corporate income tax issues. The acquisition, however, does not imply positive tax consequences in terms of depreciation allowances at the level of the purchaser. Thus, from a tax point of view, the purchaser will favor an asset deal while the seller will prefer a share deal.

3.1.2.2. Other Taxes

A share deal will not be subject to VAT provided that the seller does not opt for the application of VAT.

If more than 95% of the shares of a company holding real estate located in Germany are sold, such sale is, in principle, deemed a constructive sale of real estate and subject to real estate transfer tax (see section 5.3.1).

3.1.3. Funding of the Acquisition

3.1.3.1. Deductibility of Interest Expenses

Business expenses directly associated with tax-free income are not deductible for income tax purposes (Section 3c ITA). For corporate income tax purposes, however, interest expenses incurred in relation with tax-free income are, in general, deductible. On the other hand, 5% of the dividends received are deemed non-deductible business expenses. Thin capitalization rules have to be kept in mind as well.

For trade tax purposes, 50% of the interest paid on long-term debts for business operations associated with the funding, acquisition or expansion of the business are added back to the trade tax base. An inverse exception to this rule exists for financial institutions.

3.1.3.2. Withholding Tax

See section 5.1.

3.2. Reorganizations

3.2.1. Overview

German tax law provides for a favorable tax regime in order to facilitate corporate restructurings. The Transformation Tax Act (*Umwandlungssteuergesetz*, **TransTA**) addresses, in particular, the following issues:

- The transformation tax regime applies to mergers (*Verschmelzungen*), contributions (*Einbringungen*) and similar operations.

Provided that (i) the hidden reserves of the transferred assets remain subject to German corporate income tax at the level of the purchasing company and (ii) shareholders of the target company
receive only shares in exchange, no capital gains will be realized upon such transaction due to a rollover of book values. Existing tax losses may be transferred. Contributions of assets in exchange for shares may also benefit from the favorable tax regime, provided additional requirements are met.

However, the benefit of this tax regime is somewhat limited. So-called “tainted” shares may only be sold without any capital gains taxation after a period of seven years. For this purpose, tainted shares are shares in a corporation granted as consideration for a contribution of a business or of business units or interests in a commercial partnership and contributed without taxation of hidden reserves.

- Spin-offs and split-ups (Spaltungen) are another type of reorganization that may benefit from the favorable tax regime, provided additional conditions are met.

The assets transferred to the purchasing company as well as the remaining assets of the target company in case of a spin-off must each represent a separable “business unit” (which requires, in principle, the prior existence of two distinct going-concern businesses). In principle, interests in a commercial partnership and a 100% interest in a corporation are considered a business unit for transformation tax purposes.

The spin-off or split-up of a company may not be carried out in a tax-neutral manner if the company is reorganized solely in preparation of a future sale.

- Finally, under the TransTA a company may carry out a conversion (Formwechsel) into a new legal structure with a different tax regime in a tax-neutral manner, i.e., from a partnership into a corporation or vice versa. There are, however, specific anti-avoidance rules to be complied with.

### 3.2.2. Cross-Border Reorganizations

The transformation tax regime is basically in line with the provisions of the EU Merger Directive dated 23 July 1990. However, the EU Merger Directive has not yet been fully implemented in Germany. The favorable tax regime provided by the TransTA is only applicable to specific transactions.

### 3.3. Investment Funds

#### 3.3.1. Overview

As from 2004, the new Investment Tax Act (Investmentsteuergesetz) replaces the tax sections of the former Foreign Investment Act (Auslandinvestitionsgesetz) and the Capital Investment Companies Act (Gesetz über Kapitalanlagegesellschaften). The Investment Tax Act provides for a revision of the tax principles applicable to investment funds. Most importantly for tax purposes, foreign and domestic funds are, in principle, treated equally. The tax treatment depends on the funds and/or
the investor, respectively, meeting specific reporting duties and disclosure requirements with respect to the tax basis. In general, taxation of investors is based on the principle of transparency. Only if the relevant requirements are not met may penalty taxation for non-transparent ("black") funds be triggered.

3.3.2. Income Tax Treatment of German Private Equity Funds

In principle, neither the Investment Act nor the Investment Tax Act deals with German private equity and venture capital funds. Usually, private equity funds are structured as non-commercial partnerships. Such partnership can be either a civil law partnership (Gesellschaft bürgerlichen Rechts) or a limited partnership (Kommanditgesellschaft) with a GmbH as non-managing general partner and a managing limited partner taxed according to general principles of taxation.

3.3.2.1. Classification of Commercial or Non-Commercial Partnership

The classification of a private equity fund as non-commercial tax-transparent partnership has two main advantages. First, the fund is not subject to trade tax. Second, capital gains deriving from the sale of a target company by the fund are tax-free at the level of an individual investor, provided that the investor, indirectly via the fund, does not hold or has not held at any time during a five-year period prior to disposal, 1% or more of the stated capital of the target company, or provided that the disposal does not occur within one year after acquisition. Dividends, however, are subject to tax under the half income system, i.e. half of the dividends are taxed in the hands of the individual investor.

If the activities of a private equity fund qualify as commercial activities or if the partnership interests are held as part of the business assets (Betriebsvermögen), the earnings and profits of the partners of the fund will be treated as income from a commercial trade or business. As a result, half of the amount of all capital gains and dividends would be taxed in the hands of individual investors at ordinary rates.

Regardless of the qualification of the private equity fund as commercial or non-commercial, 95% of the capital gains and dividends are, in principle, exempt from corporation tax in the hands of a corporate investor.

As regards the status of private equity funds as tax-transparent non-commercial vehicles, the German Ministry of Finance issued a Circular. This Circular outlines, inter alia, the German tax authorities' position on the qualification of a private equity fund as non-commercial or commercial. According to the Circular and subject to certain assumptions, funds may be structured as look-through non-commercial vehicles for tax purposes if the following conditions are fulfilled:

- The fund must largely be financed with equity. However, governmental grants and short-term bridge loans are left out of consideration;
- The fund must not maintain its own management organization for the management of investee companies. Office space and working staff are allowed to the extent they are necessary to administer private equity holdings as a passive investor;
- The fund must not make use of its market experience for the account of a third party. The managers, however, are permitted to make use of their know-how and practical experience within the due course of their business for the fund;
- The fund must neither offer securities to the general public nor deal with securities for a third party’s account. Moreover, the fund’s investments must not be made on a short-term basis, i.e., the fund shall maintain its shareholdings for a period of three to five years;
- Capital gains may not be reinvested, but shall be distributed in accordance with the fund’s regulations; and
- The fund must not participate in the management of the target companies. However, it is allowed to assume supervisory board function or to reserve veto rights over certain management activities provided the management retains the authority for entrepreneurial decisions.

Although a certain legal security was achieved by the tax authorities’ decree, it is pertinent to note that the overall picture of the fund’s activities determines the qualification, i.e. even if the requirements are fulfilled, German tax authorities have the discretion in assessing the case.

3.3.2.2. Income Tax Treatment of the Carried Interest

The carried interest is regarded as compensation for services, but, nevertheless, provides for the application of the half income system on the carried interest. Therefore, 50% of the carried interest shall be taxed.

3.4. Stock Options

There is no specific tax regime for stock options granted to German beneficiaries. As a result, general income tax provisions are applicable.

3.4.1. Grant of Options

There is no income tax levied upon the grant of employee stock options (except under rare exceptional circumstances, e.g., in case of tradable option rights). In addition, pursuant to German tax law, there is no right on the side of the option holder to elect to be taxed at the date of grant instead of being taxed on any difference between the purchase price of the shares and their fair market value on the date of purchase.

3.4.2. Exercise of Options

The capital gain realized upon exercise of a non-tradable option is deemed to be a benefit in kind and is subject to the progressive income tax rate (see section 4) plus a solidarity surcharge on the income tax due. The capital gain realized upon exercise of an option is determined by the
difference between the fair market value of the shares at the time the option is exercised and the
purchase price (exercise price). The fair market value is defined on the basis of a specific appraisal
formula for unlisted shares of corporations.

In principle, wage tax has to be withheld by the employer company like any benefit paid in relation
to the employment status. The same applies if a foreign company grants the options to employees
of its German subsidiary. The German subsidiary will be released from its withholding obligations
only if it did not know that such benefit was granted to its employees by its parent company.

Additionally, social security contributions have to be paid on the difference between the purchase
price and the fair market value at the time the options are exercised. Such contributions must also
be deducted by the employer and paid to the competent authority, up to the relevant maximum
amount provided for in German social security laws.

Sometimes, a stock option plan might provide for the possibility of early exercise of unvested
options in connection with a repurchase option by the company during the vesting period in order
to allow US employees to opt for early taxation. In such case, in principle, the early exercise has
similar tax consequences in Germany as described above provided that the employees have all
rights usually held by shareholders including a (restricted) right to transfer the shares.

In order to ensure compliance of a stock option plan with German tax law, it might be advisable to
obtain a tax ruling for wage tax purposes in advance.

3.4.3. Sale of Shares
Capital gains from the sale of shares held by employees are generally subject to tax provided that
either (i) the shareholder (or the predecessor in the case of a transfer of shares without
consideration), at any time during the five years preceding the sale, has held or holds directly or
indirectly a participation of 1% or more of the stated capital of the company, or (ii) the sale takes
place within one year after acquisition of the shares (there is a limit of €512, however, for each
calendar year up to which the total gains from private transactions are tax exempt).

To the extent that capital gains are subject to German income tax, 50% of such capital gains are
subject to the progressive income tax rate plus a solidarity surcharge of 5.5% thereon.

3.4.4. Dividends
In principle, 50% of the gross dividends received by the employee are subject to income tax at the
progressive rate plus a solidarity surcharge. Investment income received by the employee —
including dividends and interest after deduction of half the income-related expenses, i.e., the actual
amount of expenses in connection with the dividends or the standard amount for income-related
expenses of €51 (€102 for married couples filing jointly) — is exempt from tax up to the maximum
amount of the tax-free savings allowance of €1,370 (or €2,740 for married couples filing jointly).
4. **Taxation of Individuals**

4.1. **Territoriality Rules**

All individuals who have their tax domicile or habitual place of abode in Germany are, in principle, subject to tax on their worldwide income (unlimited tax liability). However, Germany’s right of taxation is limited by double taxation treaties with foreign countries.

As regards German resident taxpayers with business activities outside of Germany, double taxation treaties provide for different methods to prevent double taxation. Either income derived from foreign sources which was already taxed is exempt from taxation in Germany (exemption method; such income, however, can be taken into account for calculation of the income tax rates), or foreign income is included in the calculation of taxable income but foreign income tax is credited against the personal income tax due (credit method).

All individuals without tax domicile in Germany, but who have realized defined German-source income, are subject to individual income tax with such income only (limited tax liability).

Except as otherwise provided by tax treaties, the following income is considered German-source income under German tax law:

- Commercial income allocable to a permanent establishment or permanent representative in Germany;
- Income derived from independent and dependent personal services that are performed in Germany;
- Dividends paid by a company resident in Germany;
- Interest, the principal of which is secured by German real property or paid over-the-counter; and
- Income derived from real estate located in Germany.

4.2. **Rates**

Personal income tax is levied on the net taxable base. IT rates are graded progressively according to the amount of taxable income, calculated after deduction of various allowances. The lowest rate is currently 16%, but will be reduced to 15% in 2005. The marginal rate is currently 45% (on the part of the taxable annual income of more than €52,152 for singles, €104,304 for married couples filing tax returns jointly, see section 4.4), but will be reduced to 42% in 2005.

The marital status of the taxpayer limits the progressiveness of personal income tax if a married couple files tax assessments jointly.

In order to meet the cost of the German unification, a surcharge to IT (and to CIT), the so-called *Solidaritätszuschlag* (solidarity surcharge), was introduced with effect from 1995. The surcharge...
amounts to 5.5% of the relevant IT (or CIT) bill. No time limit has been set for levying this surcharge, so it can be expected to remain in place for the foreseeable future.

4.3. Taxable Base
Personal income tax is payable on individual income of seven different categories further specified by law. Among those categories, the most important are commercial income, income from independent professional services, wages and salaries, income from capital investments and income from letting and leasing. The net income of those categories is determined by reference to two basic rules. For commercial income, for example, profits or losses are determined according to specific tax accounting rules (profit income – Gewinneinkünfte). By contrast, for wages, salaries, income from capital investment and income from letting and leasing, income is determined as the surplus of receipts over income-connected expenses (surplus income – Überschusseinkünfte).

The total amount of the net income from each category constitutes the gross taxable base for individual income tax purposes. Therefore, negative income from one category is deducted from positive income from another category.

4.4. Capital Gains and Interest Income
Capital gains realized by a private individual upon disposal of shares in a corporation are subject to tax in any of the following situations:

- The shareholder holds, or has held at any time during a five-year period prior to disposal, 1% or more of the stated capital of the corporation.
- The shareholder disposes of the shares within one year after acquisition of the shares.

Capital gains are tax exempt if the total gains from private transactions (private Veräußerungsgeschäfte) in the respective calendar year amounts to less than €512; and

- The shares stem from a tax-neutral contribution in kind and are being disposed of within a period of seven years after such contribution.

4.5. Non-Resident Taxpayers
As set out above, individuals who are non-residents for tax purposes are subject to personal income tax only with respect to German-source income as defined by domestic tax law or tax treaties concluded by Germany.

4.6. Anti-Avoidance Measures
As for companies, anti-avoidance measures are applicable for individuals (abuse of law, CFC rules, etc.).
5. Other Taxes

5.1. Withholding Taxes

Unless otherwise provided by a double tax treaty, withholding taxes may be levied on dividends, interests, royalties, wages and considerations for certain services paid to non-residents:

- **Dividends** – Dividends distributed to resident or non-resident shareholders are subject to a withholding tax (WHT) at a rate of 20% (25% if WHT is borne by the debtor). Withholding tax is final for non-resident shareholders.

  Dividends paid out by a qualifying German subsidiary to its qualifying parent company resident in another EU member state are tax exempt (EC Parent/Subsidiary Directive). Double taxation treaties typically reduce the rates to 15% for individuals as shareholders and 5%, 10% or 15% for parent corporations owning at least 10% or 25% of the shares in the subsidiary. Foreign shareholders may have to claim the treaty benefits in a refund procedure.

- **Interest/Royalties** – Interest payable by a German company on debt obligations is subject to withholding tax at a rate of 30% if the claim is securitized (verbrieft) or paid via a German bank account (42.85% if WHT is borne by the debtor). The respective withholding tax provisions, however, only apply if the recipient of the interest payment is subject to tax in Germany. As set out above, limited tax liability of recipients which are not tax resident in Germany is, in principle, restricted to interest, the principal of which is secured by German real property, or to interest that is paid over the counter. Interest that stems from convertible bonds or bonds carrying profit-sharing rights is subject to withholding tax a rate of 25% (33 1/3% if WHT is borne by the debtor).

  If a non-resident subject to limited tax liability receives royalties from German sources, withholding tax is due at a rate of 25%. No deductions for business expenses or income-connected expenses are allowed.

  However, according to the EC Interest/Royalties-Directive withholding taxes on interests and royalties paid between associated companies shall be abolished. Although in Germany the Directive has not been transposed into national law yet, a Circular issued by the German tax authorities states that the Directive is, in general, applicable without being implemented. Therefore, no withholding taxes are triggered in case of interest or royalties payments made between associated companies of different member states provided the companies fall into the scope of the Directive. However, with regard to interest payments some exceptions may apply as the Directive provides for some exceptions.
• **Services** – Income received or realized in Germany by non-residents is subject to withholding tax provided that they relate to the presentation, performance or exploitation of activities as an artist, professional athlete, author, journalist or broadcaster in Germany. The withholding tax rate is 25%. Again, no deductions for business expenses or income-connected expenses are allowed.

• **Wages** – Personal income tax on income from dependent personal (employment) services is levied by way of withholding tax.

Wage tax (Lohnsteuer) is payable by employers (for the benefit of the employees) which are tax resident in Germany. Wage tax is calculated on the basis of salaries paid by the employer (including any bonus and fringe benefits paid in cash or in kind to, or enjoyed by, the employee). The employer is liable for withholding wage tax. The calculation of wage tax is based on a standardized and simplified method. Each employee receives a wage tax card (Lohnsteuerkarte) from the resident’s registration office that shows his or her wage tax category (Steuerklasse) and possible wage tax allowances (Freibeträge).

If the regular salary of the employee is not sufficient for the employer to deduct wage tax and pay such tax to the competent tax office, the employer has to request the employee to pay the tax to the tax office directly. The employer will inform the tax office of such request. Only upon such information will the employer be released from its withholding obligations.

In principle, German withholding tax is credited against the (corporate) income tax bill of a domestic taxpayer. A schedule summarizing the withholding tax rates applicable under certain double tax treaties signed by Germany is provided for in the Appendix.

### 5.2. Value Added Tax

Value added tax (VAT), i.e., German turnover tax (Umsatzsteuer), is levied on all payments for goods delivered and services rendered in Germany as well as on payments for imported goods. As an exception, however, some goods and services are exempt from VAT. The VAT rate is currently 16%. A reduced rate of 7% is applicable to certain preferred goods and services. No VAT is levied on exported goods and services (including legal services) to foreign residents, again subject to exceptions.

Due to the harmonization of European VAT laws, the German system of VAT is consistent with the VAT systems in other European Union countries. At each level of a production or distribution chain, the sole value added is taxed so that all goods and services bear a uniform tax burden at the consumer level. This is achieved by allowing each company or business to deduct all “input tax” it pays on goods and services received by it from the VAT it invoices in respect of goods delivered and services rendered by it. The sole balance of VAT billed is effectively paid over to the revenue
authorities. If the amount of VAT paid is higher than the amount billed, the excess is refunded by the revenue authorities. Thus, no VAT burden remains with a company or other business. VAT is a true consumer tax.

For further reference, please see section 4.2 of the French section of this booklet.

5.3. Transfer Taxes

5.3.1. Real Estate Transfer Tax
Real estate transfer tax (Grunderwerbsteuer) is levied on all acquisitions of real estate located in Germany (including the acquisition of 95% of the shares in a company owning real estate, and the direct or indirect transfer of at least 95% of the interests in resident or non-resident partnerships holding real estate located in Germany to new partners within a period of five years). Real estate transfer tax is also charged on mergers and de-mergers of companies holding real estate located in Germany. The 3.5% rate applies to the purchase price, subject to certain exceptions. Where there is no consideration payable for the real estate, e.g., in the case of a share transfer or a merger of companies, the tax is 3.5% of the value of the real estate assessed on the basis of the German Evaluation Act (Bewertungsgesetz). This value is generally significantly lower than the fair market value.

5.3.2. Inheritance and Gift Tax
Inheritance and gift tax (Erbschaftsteuer and Schenkungsteuer) is levied on inheritance and gifts when they accrue. The law distinguishes three tax classes according to the degree of relationship between the deceased person/donor and the heir/recipient. Different tax rates and tax-free allowances apply to each class. The tax-free allowances vary from €307,000 for the surviving spouse (who may be entitled to a further tax exemption of up to €256,000, depending on the capitalized value of pension to which he or she becomes entitled on the spouse’s death) to only €5,200 for persons who are not or only distantly related to the respective deceased person/donor.

The applicable tax rates range from 7% to 17% for an inheritance/gift of no more than €52,000, to between 30% and a maximum of 50% for an inheritance/gift in excess of €25,565,000.

A number of exemptions apply to various types of assets. In particular, business assets of up to €225,000 are not subject to inheritance or gift tax, and any excess value of business assets is taken into account at a rate of 65% only.

Assets are evaluated in accordance with special statutory provisions. Substantial changes in this area have been introduced following a decision by the Federal Constitutional Court (Bundesverfassungsgericht), which held that the application of different valuation methods to real estate on the one hand and movable and other assets on the other hand is unconstitutional.
Current valuation methods still appear to be not entirely consistent with the principles introduced by the Court. As a result, new valuation techniques might be introduced in the future.

5.4. Wealth Tax

Wealth tax (Vermögensteuer) has not been levied since 1996.

5.5. Local Taxes

Local taxes are paid not to the federal state or the regional states (Länder) but to the local municipalities. Among the most important local taxes are trade tax and real estate tax.

5.5.1. Trade Tax

As set out above, trade tax is levied annually on all types of commercial enterprises doing business in Germany, including partnerships and permanent establishments of non-resident companies. Taxable profits are determined on the basis of the commercial profits as determined for corporate or personal income tax purposes, subject to considerable modifications. In principle, trade tax qualifies as a deductible expense for purposes of determining the profits subject to corporate or personal income tax.

The trade tax rate is determined by the municipality in which the business operates, within limits set by federal statute.

5.5.2. Real Estate Tax

Local authorities annually levy real estate tax (Grundsteuer) on the value of all domestic real property assessed in accordance with elaborate statutory provisions. These values are far below the fair market value. The effective tax rate is approximately 1.5% but depends on the intended use of the real estate and is calculated using a multiplier which varies from municipality to municipality.

5.6. Social Contributions

5.6.1. Social Security Contributions

Employers are obligated to withhold social security contributions (contributions for statutory health insurance, nursing care insurance, social security pension insurance and unemployment insurance) from wages and salaries.

The amounts withheld depend on the gross wages (including fringe benefits, etc.).

Such contributions are applicable to wages and salaries up to maximum amounts known as social security ceilings ("Beitragsbemessungsgrenze"). The rates and ceilings of each contribution vary by insurance, state and in time. For 2004, the rates and ceilings for the West German states are as follows:
<table>
<thead>
<tr>
<th>Insurance</th>
<th>Rate</th>
<th>Ceiling</th>
</tr>
</thead>
<tbody>
<tr>
<td>Health</td>
<td>approx. 14%</td>
<td>€41,850 p.a.</td>
</tr>
<tr>
<td>Nursing Care</td>
<td>1.7%</td>
<td>€41,850 p.a.</td>
</tr>
<tr>
<td>Pension</td>
<td>19.5%</td>
<td>€61,800 p.a.</td>
</tr>
<tr>
<td>Unemployment</td>
<td>6.5%</td>
<td>€61,800 p.a.</td>
</tr>
</tbody>
</table>

Social security contributions are, in principle, borne half by the employer and half by the employee. The employee’s share of the contributions is partly deductible for income tax purposes according to specific rules.

### 5.6.2. Additional Social Contributions Borne by Companies

Every company in Germany is member of one of the 35 German statutory accident insurance institutions (*Berufs genossenschaften*), each responsible for a particular branch of industry.

In 2001, contributions paid by companies to the industrial statutory accident insurances added up to €8.8 billion. This corresponds to an average contribution of 1.31% of all wages and salaries.
### APPENDIX

**Withholding Tax Rates Applicable Under Certain Tax Treaties Signed by Germany**

<table>
<thead>
<tr>
<th>Country</th>
<th>Dividends</th>
<th>Interest (%)</th>
<th>Royalties (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individuals / Qualifying companies (%)</td>
<td>non-qualifying companies (%)</td>
<td></td>
</tr>
<tr>
<td>Belgium$^1, 2$</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Canada</td>
<td>15</td>
<td>5$^3$</td>
<td>10 / 0$^4$</td>
</tr>
<tr>
<td>France$^1$</td>
<td>15</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>Ireland$^1, 2$</td>
<td>10</td>
<td>15$^6$</td>
<td>0</td>
</tr>
<tr>
<td>Italy$^1$</td>
<td>15</td>
<td>15</td>
<td>10 / 0$^7$</td>
</tr>
<tr>
<td>Japan</td>
<td>15</td>
<td>15</td>
<td>10 / 0$^9$</td>
</tr>
<tr>
<td>Luxembourg$^1$</td>
<td>15</td>
<td>10$^{10}$</td>
<td>0</td>
</tr>
<tr>
<td>Netherlands$^1$</td>
<td>15</td>
<td>10$^{10}$</td>
<td>0</td>
</tr>
<tr>
<td>Russia</td>
<td>15</td>
<td>5$^{11}$</td>
<td>0</td>
</tr>
<tr>
<td>Spain$^1$</td>
<td>15</td>
<td>10$^{10}$</td>
<td>10</td>
</tr>
<tr>
<td>Switzerland$^2$</td>
<td>15 / 30$^{12}$</td>
<td>5 / 0$^{13}$</td>
<td>0</td>
</tr>
<tr>
<td>United Kingdom$^1, 2$</td>
<td>15</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>United States</td>
<td>15</td>
<td>5$^{3}$</td>
<td>0</td>
</tr>
</tbody>
</table>

---

$^1$ Dividends are paid free of withholding tax if they fall under the Parent/Subsidiary Directive.

$^2$ These treaties provide for reduced rates in case of dividends only if dividends are paid from profits subject to corporation tax under the so-called half-income system.

$^3$ A 10% stockholding is required to benefit from this reduced rate.

$^4$ The 0% rate applies to (i) interest paid on certain sales on credit, (ii) interest on bonds, debentures or similar obligations of a state, a political subdivision or a local authority, (iii) interest paid to the Export Development Corporation or a public institution and (iv) interest paid to an entity founded solely for the purpose of tax-free pension funding or pension administration.

$^5$ The 0% rate applies to copyright royalties (excluding films), computer software, patents and know-how.

$^6$ The increased rate requires a 25% stockholding.

$^7$ The 0% rate applies to interest paid in connection with certain sales on credit of industrial, commercial, or scientific equipment and merchandise delivered by one enterprise to another enterprise. It also applies if (i) the payer of the interest is a state, one of its political or administrative subdivisions or territorial authorities or (ii) the interest is paid in consideration of a loan granted by the other state, administrative subdivisions or territorial authorities.

$^8$ The 0% rate applies to copyright royalties of literary, dramaturgical, musical or artistic work (including royalties for films and other sound or visual recordings).
The 0% rate applies to (i) interest on loans which are granted or guaranteed by the state or a territorial authority (Land) provided that the loan has been issued in the other state or (ii) interest derived by the central bank or a public financial institution.

A 25% stockholding is required.

The 5% rate applies if (i) the recipient company holds at least 20% of the interests and (ii) the respective share capital amounts to not less than DM 160,000.

The 30% rate applies to income from dormant partnerships, participation rights, profit-sharing loans and bonds if the respective expenses of the debtor are tax deductible.

A 20% stockholding is required for either rate. The 0% rate has been introduced by a recent revision of the tax treaty. This revision is still subject to ratification.
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Taxation of Business Operations in the United Kingdom

1. Business Overview

1.1. Legal Overview
A business may be conducted in the UK in the framework of a company, a European economic interest grouping (EEIG) incorporated under the laws of the United Kingdom. (The law, other than tax law, is different in Scotland from that applicable in the rest of the United Kingdom.) Business can also be carried on in the United Kingdom through a branch of any such entities set up under a legal system outside the UK.

Companies incorporated under English law can be limited liability companies or unlimited liability companies. Partnerships incorporated under English law can be limited liability partnerships or unlimited liability partnerships. A form of entity known as a limited liability partnership, with a separate legal existence (LLP), has been introduced into law recently. Generally, partnerships will not have any legal corpus separate from the partners themselves although certain limited liability partnerships are separate legal entities.

1.2. Tax Overview

1.2.1. Taxation of Partnerships
Whether or not a partnership is a limited liability partnership or an unlimited liability partnership it will generally be transparent for tax purposes. An LLP will lose its tax transparency in limited circumstances, generally when it ceases its activities on a formal winding up. Broadly, the profits of the partnership will be apportioned among the partners in partnership shares. The partners will be liable to tax in relation to profits arising from the partnership.

1.2.2. Taxation of Companies
Corporations are separate legal entities and will be liable to tax. Corporations, including a corporate partner in a partnership, are liable to corporation tax on both income and capital gains. Corporations can, in limited circumstances, be liable to income tax and not corporation tax.

1.2.3. Taxation of Individuals
Individuals are liable to income tax and capital gains tax on income and capital gains respectively.
1.2.4. Taxation of EEIGs
An EEIG is treated effectively as a partnership for tax purposes and is also transparent for tax purposes. EEIGs are not common in the UK as partnerships offer similar commercial advantages.

1.2.5. Other Taxes
The UK tax system provides for a number of other direct and indirect taxes. The most important of these are VAT, stamp duty and stamp duty reserve tax (SDRT), and stamp duty land tax (SDLT), and the liability of a taxpayer to withhold an amount on account of tax (withholding tax).

2. Corporation Tax

2.1. Corporation Tax on Profits

2.1.1. Territorial Rules
Under UK tax law, corporation tax is assessed on UK resident companies, irrespective of where the income or capital gain arises, and on companies trading in the UK through permanent establishment here (a company which is not liable to UK corporation tax may be liable to income tax on UK source income). However, to the extent that a corporation liable to UK corporation tax is also subject to tax on the same income or capital gains in another jurisdiction, relief from double taxation will be applicable either under an appropriate double taxation treaty or under UK domestic law.

A company will be resident in the UK if it is established under the laws of the UK (including Scottish law) or if it is centrally managed and controlled in the UK, save where it is treated as resident in another jurisdiction under the terms of a double taxation treaty with the UK. A company will be centrally managed and controlled in the jurisdiction where decisions that would usually be taken by the board of directors are made, even if made otherwise than in board meetings. Prior to the Finance Act 2003, whether a company was trading in the UK through a branch or agency (rather than a permanent establishment) determined, subject to the terms of a double taxation agreement, whether it was liable to corporation tax. There is considerable case law authority as to what constitutes trading in the UK through a branch or agency. These cases will to some extent still be relevant to determining whether a company is trading in the UK through a permanent establishment. However, this case law relates more to 19th century trading situations and is not always easily applicable to modern commerce. The general principle is that a person will be trading in the UK as opposed to with the UK if the activities from which the profits of the trade arise are undertaken in the UK. If the contracts would give rise to profits, for example in connection with the sale (not the purchase) of goods undertaken in the UK, then the whole of the profits of the business may be liable to UK corporation tax. However, even if contracts are not concluded in the UK, if the
trader performs its obligations under the contract in the UK, this may constitute trading in the UK for these purposes.

This position is subject to the terms of any relevant double taxation treaty. However, if a person is trading in the UK through a UK permanent establishment (as defined under UK law) they are likely under the terms of any relevant double taxation treaty with the UK to be treated as carrying on business in the UK through a UK permanent establishment (as defined in that treaty) which will invariably be the test as to whether they are liable to UK taxes in respect of their business profits.

2.1.2. Rates
Corporation tax is generally charged at the rate of 30% on a company’s chargeable profits. However, reduced rates of corporation tax are applied to “small” groups of companies. The rate of corporation tax varies from 0% (where the total income of the company’s or the group of which it is a member, is £10,000 or less) increasing to 19% (at £50,000 to £300,000) and thereafter increasing to 30% (at £1.5 million). Profits that would not otherwise be liable to corporation tax at the rate of at least 19% become liable to corporation tax at that rate if they are distributed to non-corporate shareholders.

The rate of corporation tax is the same for income profits and capital gains. However, in the case of capital gains the chargeable capital gain is the actual capital gain but after relief for inflation (known as the indexation allowance). The calculation of chargeable capital gains for individuals is different. In certain circumstances capital gains are deemed to be income under specific statutory provisions and are taxed as income.

2.1.3. Determination of Corporation Tax
2.1.3.1. Taxable Profits
The basis of calculating income liable to tax (corporation tax and income tax) depends on the type of income involved. Income is classed within different “schedules”. The schedules are mutually exclusive so that if income falls in one schedule it cannot be taxed under another schedule. Not only do the separate schedules contain separate rules for calculation of the income liable to tax but they also have different rules as to when the income is brought into account for tax purposes.

As to trading income, the general position is that the profits of a trade arising in any tax year are liable to tax. However, there is no statutory definition of profits for these purposes. Generally, the profits liable to tax in any one year are the profits as calculated for commercial, i.e. accounting, purposes, subject to any overriding legal principles or specific statutory provisions. The inter-relationship with general commercial principles and overriding principles of law has been the subject of a number of cases, in particular over recent years. Determining the extent to which general legal principles override the accounting calculation of profits is a very complex area of
law. As regards deductions that are entitled to be taken into account in calculating trading income, there is a specific provision against taking into account any capital expenditure generally. However, specific statutory provisions provide for deductions for certain items of capital expenditure, for example, capital (depreciation) allowances on plants and machinery and certain types of buildings.

Capital gains are generally taxed when a gain is realised, namely when there is a disposal or deemed disposal of a capital asset. The amount liable to corporation tax on capital gains will generally be the disposal proceeds less any allowable costs, e.g. the cost of acquisition and the indexation allowance. There is an important exemption for capital gains realised by corporations on the disposal of “substantial shareholdings” discussed in section 2.5.2.2.

When the income chargeable under the various schedules of tax is calculated, the amount of such income, together with any chargeable capital gains, is added together to arrive at “total profits”. In calculating the profits liable to corporation tax certain deductions known as “charges on income” (e.g. certain royalties and certain interest payments together with “annual payments”) are allowable against such total profits as reduced by all other relief, (e.g. carried forward losses) other than “group relief” (see section 2.3.1). For example, certain interest payments which are not deductible in calculating income under any particular schedule of charge may be deductible against total income. Also, various types of losses will be allowable against total income.

2.1.3.2. Tax Credits
Relief is available for tax credits against the company’s liability to corporation tax. Such tax credits include UK taxes withheld from payments made to the company together with taxes payable outside the UK for which double taxation relief is available under UK tax law or any relevant double taxation treaty.

2.1.3.3. Tax Losses
The basis upon which tax losses can be utilised by offsetting them against taxable profits depends upon the type of loss involved. The most generous relief applies to trading losses. Such losses may be offset against other profits, including capital gains, in the same year and the prior year. Additionally, trading losses may be carried forward indefinitely to offset against trading profits arising in respect of the same trade. Charges on income “incurred for trading purposes only” can to the extent that they are not utilised against profits generally in any year, in certain circumstances be carried forward for offset against profits in subsequent years. Capital losses may be carried forward and offset against future capital gains.
2.2. Distributions

2.2.1. Dividends Paid by UK Companies
Dividends paid by a UK resident company are distributed from income which, in principle, has been subject to corporation tax at the ordinary rate (see section 2.1). Such dividends are exempt from corporation tax in the hands of the recipient of the dividend.

2.2.1.1. Advanced Corporation Tax (ACT)
Previously on the payment of a dividend by a UK resident company it was required to account for an amount of ACT. Such ACT was creditable against the liability of the company to pay corporation tax on its profits in any fiscal year. ACT has now been abolished and therefore dividends of a UK resident company can be paid without the company becoming liable to pay any tax in respect of such dividend. However, there are special relieving provisions in respect of surplus unutilised ACT paid by companies before the abolition of ACT. Such provisions enable the surplus ACT to reduce the company’s liability to corporation tax.

2.2.1.2. Parent-Subsidiary Tax Regime
As UK resident companies are generally exempt from UK corporation tax on dividends from other UK resident companies there is no need for a special regime for dividends paid by a UK resident subsidiary to its UK resident parent.

2.2.1.3. Non-Resident Recipient
Where dividends are paid by a UK resident company to non-residents there is no liability to UK tax on that dividend. However, relief may be applicable under an appropriate double taxation treaty to enable the recipient of the dividend to obtain a repayment from the UK tax authorities attributable to part of the corporation tax paid by the company paying the dividend. Any such credit will be calculated by reference to the tax credit available to a UK resident individual in respect of the receipt of a dividend from a UK resident company. The rules relating to taxation of such dividends in the hands of UK resident individuals have in recent years been changed with the effect of reducing the tax credit available to non-residents under any applicable double taxation treaty often to zero. It would now be rare for a non-UK resident to be able to reclaim a repayment of tax from the UK tax authorities in respect of the receipt of a dividend from a UK resident company.

2.2.2. Foreign Source Dividends
Any dividend from a non-UK resident company received by a UK resident company will be subject to corporation tax. However, credit will be available in respect of any tax withheld from that dividend. Additionally, if a UK resident company holds shares in the non-UK resident company which carry voting rights at least equal to 10% of the total voting rights of the non-UK resident company, then a further credit is available in respect of any tax equivalent to UK corporation tax payable by the dividend-paying company in its own jurisdiction. For these purposes the UK
resident company is deemed to receive a gross dividend equal to the profits generating the dividend, with credit being given for the foreign corporation tax on those profits and any withholding tax, subject to the usual limitations (the total tax credit cannot be more than the amount of UK corporation tax which would be payable on the same amount of income). The UK tax treatment of dividends paid by companies resident in other European member states to UK resident companies may be unlawful under European law in that the taxation of those dividends are treated less favourably. This is a new and developing area of law.

2.3. Tax Consolidation – Group Relief

There is no system in the UK for electing for groups of companies to be consolidated generally for tax purposes. Rather, there are specific provisions that enable certain types of losses and excess charges on income, which do not technically give rise to losses, to be offset against profits of other members of the same tax group. Losses arising in relation to disposals of capital assets cannot, however, be offset against capital gains realised by another member of a tax group. However, capital assets can be transferred between members of a tax group without crystallising any capital gain liable to corporation tax. This can enable effective utilisation of capital losses in other group members. Capital assets can be transferred between group members and then the transferee can dispose of the capital asset with an in-built capital gain and utilise its capital losses available for relief against taxable capital gains. The definition of tax group differs depending upon the type of relief or offset concerned. Further, the manner in which income losses can be offset depends upon the type of loss concerned. The rules relating to the different types of reliefs are complex. However, the main reliefs arise in relation to utilisation of losses incurred in carrying on a trade and the regime for transfer of capital assets among trade members. Only these reliefs are discussed.

2.3.1. Group Relief and Consortium Relief for Trading Losses

Where a company suffers a tax loss in its trade or has excess charges on income in any accounting period (the surrendering company), such loss or excess deductions can be offset against the total profits (income profits and any taxable capital gains) of another member of the same tax group (the claimant company or consortium) arising in the same period of time in which the trading loss or excess charges arose. This is the case even though the company surrendering the loss or excess charges could have used them to reduce its other taxable profits. Where the accounting periods of the two companies concerned do not coincide, so that the accounting period of the surrendering company in which losses arise corresponds to parts of two accounting periods of the claimant company, the profits for each of those accounting periods of the claimant company are apportioned, on a just and reasonable basis, to determine the profits of the corresponding period against which the losses of the surrendering company may be offset. In the case of a claim for relief between a company and a member of a consortium, the proportion of any loss that may be surrendered to a consortium member will be equal to the consortium member’s percentage share in the consortium.
Similarly, the profits of a claimant company against which the losses of a consortium member can be offset will be limited by the same percentage. This compares with surrenders between members of the same group of companies where the whole of any loss of a surrendering company may be surrendered against the whole of the profits of a claimant company.

2.3.2. Requirements
The claimant company and the surrendering company must (i) both be members of the same group of companies (the parent and all its 75% subsidiaries), or (ii) one of them must be a member of a “consortium” and the other:

- a trading company which is owned by the consortium and which is not a 75% subsidiary of any company;
- a trading company which is a 90% subsidiary of a holding company which is itself owned by a consortium (and again which is not a 75% subsidiary of any company other than that holding company); or
- a holding company which is owned by a consortium (and which is not a 75% subsidiary of another company).

A consortium exists where at least 75% or 90% (as appropriate) of the share capital of the trading company or holding company, is owned by at least 20 companies, each of which owns at least 5% of the share capital.

A company will be a 75% subsidiary of another company if that other company owns directly or indirectly more than 75% of the nominal share capital (other than shares carrying a right to a fixed rate of dividend).

Both in relation to determining whether a company is a member of a group of companies or is owned by a consortium there are anti-avoidance provisions which prevent artificial groups being established. Broadly, in addition to satisfying the test as to the beneficial entitlement of the required percentage of the nominal value of share capital, there are also requirements that the parent company of the group or consortium member must be entitled to the appropriate percentage directly, or indirectly, of the relevant company’s profits available for distribution and of the capital of the company available on a winding up of the company available in each case to “equity holders”. The definition of equity holders for these purposes is broadly drawn to include persons who in economic terms hold equity and can include certain loan creditors.

For tax on capital gains purposes, a group consists of a parent company and each of its subsidiaries and sub-subsidiaries, and so on, satisfying the following test. The parent must own directly at least 75% of the ordinary share capital of each of its subsidiaries and each of those subsidiaries must own at least 75% of the ordinary share capital of the sub-subsidiaries and so on. In addition, the parent company must be entitled, as regards to each member of the group, directly or indirectly to more
than 50% of the profits available for distribution and capital assets available on a winding up of the company in each case available to “equity holders”.

2.4. Anti-Avoidance Measures

There are various specific statutory anti-avoidance provisions applicable to specific situations. Additionally, anti-avoidance principles have been developed by the courts which can result in certain “pre-ordained series of transactions” being looked at together to determine the transaction to which any particular piece of legislation is then applied. These principles are complex and a detailed analysis of them is beyond the scope of this summary.

Among the statutory anti-avoidance measures contained in United Kingdom statutory provisions are the CFC rules and transfer pricing rules. There are no specific thin capitalisation rules but the principles of thin capitalisation may apply to transfer pricing issues and the availability of relief under double taxation treaties.

2.4.1. Controlled Foreign Companies Rules

Under general principles, the profits of non-UK resident subsidiaries which are owned by UK companies would only become liable to UK taxation when those profits were distributed to the UK shareholders or where the UK shareholders realised a capital gain on disposal of the subsidiary. In order to avoid UK resident companies establishing non-UK resident subsidiaries with a view to artificially generating profits in those non-UK resident subsidiaries, the CFC legislation was enacted to result in certain income profits (not capital gains) of non-UK resident companies being deemed to be paid to certain of the UK resident corporate shareholders of such companies.

A subsidiary can only be a controlled foreign company if it is controlled by one or more UK resident companies and is resident in a jurisdiction where its profits are subject to a “lower rate of taxation”. A company will be subject to a lower rate of taxation if the tax on its income profits is less than 75% of the tax on the same profits that would have been payable if the non-UK resident company were subject to UK corporation tax on those profits. To the extent that profits of the non-UK resident company are attributed to its UK resident corporate shareholders, in assessing the UK corporation tax arising to those shareholders, in respect of the profits treated as distributed, credit will be given for any taxation suffered by the non-resident company on those profits.

Notwithstanding that a company may be a controlled foreign company, no distribution of its income profits will be deemed to be made to its UK resident corporate shareholders if one or more of the following exemptions apply:

- Where the non-UK resident company pursues an acceptable distribution policy;
- Where the non-resident company is engaged in exempt activities;
- Where the public quotation condition is satisfied;
Where the chargeable profits of the non-resident company are *de minimis* (currently £50,000 per annum); or

Where the company is resident in certain specified jurisdictions.

Additionally, there is a general exemption that no apportionment will be made under the controlled foreign companies’ legislation to the extent that the non-UK resident company does not undertake its activities with a view to avoiding UK taxation.

The acceptable distribution policy test is satisfied if 90% of the non-UK resident profits are paid by way of dividend to persons resident in the UK broadly within 18 months of the end of the accounting period in which they arise.

In order to satisfy the exempt activities test the non-UK resident company must comply with the following three conditions:

- There must be a business establishment in its territory of residence;
- What it does must be “effectively managed” in its territory of residence; and
- It must not do certain things which are prohibited, for example making investments.

However, a holding company may satisfy this test where, for example, its subsidiaries satisfy all of these three tests.

In order to satisfy the public quotation condition, the shares of the control foreign company must be listed in and dealt with on a recognised stock exchange situated where that company is resident and broadly where 35% of the voting power of shares is held by members of the public.

### 2.4.2. Transfer Pricing Rules

These rules apply to impose market value in respect of transactions between certain parties where the transaction is undertaken otherwise than at arms length. The legislation applies to impute arms length pricing between parties to a transaction irrespective of whether all the parties involved are subject to UK corporation tax in respect of the relevant transaction. The transactions must be between parties where broadly one controls the other or both are under common control, or must be a series of transactions involving third parties in addition to such controlled parties. For these purposes control is defined as having rights by means of shareholding voting rights or under other documents regulating the company, which enable the controlling person to secure that the affairs of the company are conducted in accordance with its wishes. Additionally, there are specific provisions extending the control test to joint venture situations where each of two persons holds at least 40% of such rights.

The transfer pricing legislation is fairly new and therefore has not been tested before the courts. There are various questions about the ambit of the provisions, particularly in the context of the
legislation being expressed to be interpreted, where appropriate, in accordance with the OECD commentary on the OECD double taxation medal treaty.

One important issue arising is the situation of a loan where the transfer pricing rules apply because of the necessary “control” connection between the lender and borrower or between the guarantor and borrower. In that case not only can the transfer pricing rules apply to restrict the interest deductible for tax purposes by the borrower because the rate of interest is accessible but can also apply to restrict the deductibility of interest on that part of the loan which would not have been made by a third party lender without any guarantee.

2.4.3. Thin Capitalisation Rules

UK law does not provide for any specific thin capitalisation rules. Rather, the issue of thin capitalisation arises under any provision where the tax treatment to be imposed is to be determined by reference to the position which would have existed had the transaction been undertaken on arms length terms between third parties.

In the context of the making of a loan to a UK taxpayer, in order for the borrower to obtain a full deduction for the interest payable on that loan and/or to enable the borrower to pay the interest without any UK withholding tax, the financial position of the borrower may be relevant in determining this amount. This is because the deductibility/payment gross issue may depend upon the interest that would have been payable on the amount of money that a third party would have been prepared to loan the borrower. In this connection the debt-to-equity ratio and the income-versus-interest payable ratios will be relevant. The main circumstances in which the issues arise are:

- Under the transfer pricing legislation issues of debt-to-equity ratios and income cover may arise as discussed at Section 2.4.2.
- Interest payable by a UK resident corporate borrower to any non-UK resident person will be, under UK law, subject to UK withholding tax. Relief may be available under an appropriate double taxation treaty. However again, there would generally be a limitation in the treaty where, for example, even though the loan is made by a third party non-UK resident bank the loan is guaranteed by a company connected with the borrower. The ability to rely on the treaty to enable interest to be paid gross will be limited to the interest on a loan which would have been made by the third party bank without any guarantee from the connected party. Again, debt-to-equity ratios and income-versus-interest payable will be relevant. However, the Finance Act 2004 introduced provisions which, if the necessary election is made, should ensure that a withholding tax obligation will not apply to interest which is not deductible by reason of the application of transfer pricing rules.
2.5. **Acquisitions – Share Deal vs. Asset Deal**

This section focuses on tax issues which may arise when structuring a corporate acquisition of a target business run by a UK resident company (*i.e.* asset deals and share deals).

The following is based on a fact pattern whereby both the seller and the purchaser entities are subject to UK corporation tax in respect of the business acquired.

2.5.1. **Asset Deal**

An asset deal is an acquisition of a business which comprises intangible assets (clientele, patents, trademarks, …) and tangible assets (properties, equipment, …). Employees attached to the business sold may transfer to the purchaser.

2.5.1.1. Stamp (Transfer) Duties

Stamp duty on all transfers of assets, other than on land or in respect of instruments relating to stock or marketable securities or bearer instruments, will be abolished. Thus in the context of an asset sale all assets — other than land (assuming no shares or securities are compressed in the assets) — can be transferred without any stamp duty liability. Where land is transferred the transfer tax applicable will be stamp duty land tax (*SDLT*). *SDLT* will apply whether or not a transfer is affected by an instrument. (Transfer taxes other than in respect to UK shares and securities are, under the regime to be replaced, only payable on transfers affected by instruments.) For commercial property the rate of *SDLT* is zero on transfers where the value is up to £150,000, 1% where the value does not exceed £250,000, and 3% where the value does not exceed £500,000. On values greater than £500,000 the rate is 4%.

2.5.1.2. Corporation Tax

The sale of assets by the seller may result in a taxable capital gain to the extent that the capital gain-based cost (including the indexation allowance) is less than the sales proceeds. Such taxable capital gain would be subject to corporation tax at 30%. Additionally, any asset sale could trigger a claw back of capital allowances available in relation to the acquisition of plant and machinery and certain types of buildings. The tax charge would arise on the difference between the sale price and the tax written-down value of the asset.

For the purchaser, the acquisition price will constitute the base price for the purposes of tax on capital gains. Additionally, if the assets qualify for capital allowances the purchaser should generally be able to obtain such allowances by reference to the purchase price.

2.5.2. **Share Deal**

A share deal is a sale of shares of a company.
2.5.2.1. Stamp (Transfer) Duties
The rate of stamp duty in relation to the transfer of shares and securities is 0.5% on the cash and certain other types of consideration. Also agreements to transfer UK securities may be liable to SDRT at the rate of 0.5%.

Where shares in a company are sold, the sale will trigger a charge to stamp duty or SDLT where the company holds shares or securities or land which were transferred to it within the prior three years and such transfer was exempt from stamp duty or SDLT by reason of the transfer being between companies in the same group of companies.

2.5.2.2. Corporation Tax
The sale of shares in a company where the seller has a “substantial holding” in that company (broadly, at least 10% of the ordinary shares in that company and of the income available for distribution and assets available for distribution in a winding up of the company) will be exempt from corporation tax on capital gains and any capital loss will not be an allowable loss. The sale of a company will generally not trigger any tax charge in the company itself, save where the company has in the preceding six years acquired an asset from another member of its tax group (where the company will have inherited the transferors tax-based cost of that asset). The tax charge where a company leaves the group will be on the basis that the company will be deemed to have sold and acquired the asset transferred to it at the time of the transfer of the asset and at the market value of the asset at the time of that transfer. It is important to ensure that any purchaser is indemnified in respect of such tax charge in the company. Alternatively, it is possible to elect that the seller’s group and not the company should be liable for that tax.

The purchaser will be treated for tax purposes as acquiring the shares for the purchase price paid. However, the purchaser will effectively acquire a company with assets which may have in-built tax charges attached to them, for example in-built capital gains and potential liabilities to claw back of capital allowances.

2.5.3. Funding of the Acquisition
2.5.3.1. Deductibility of Interest Expenses
Clearly the ability to obtain deductions for interest and make payments of interest without withholding tax is a major issue in relation to any acquisition. In the context of a non-UK group acquiring a UK company, as opposed to a UK asset purchase, the question arises as to whether the purchaser should be a UK resident company or not. A non-UK resident company will not be within the charge to UK corporation tax on any capital gain realised on the sale of shares in a UK resident company. However, if the substantial shareholder exemption (see section 2.5.2.2) were available to a UK resident purchaser there would not be liability to UK corporation tax on any capital gain in any event. Dividends paid by a UK resident company are not subject to any withholding tax or
other taxes payable by that company. The tax effect of the funding of the acquisition would be determined by the rules in the jurisdiction of the purchaser. Thus, it would seem appropriate (unless there are other issues for the purchase) for the acquisition of any UK resident company to be made by a non-UK resident company where the substantial shareholder exemption might not apply. However, if the UK resident company acquired is funded at the date of acquisition by the vendor group, or by third parties, and part or all of that funding is to be re-financed on sale of the company, issues may arise on purchase in relation to interest payments to be made by the company being acquired on the refinancing where the purchaser is not a UK resident company. These issues will be the deductibility of interest payments and withholding tax on interest payments. These issues are discussed in section 2.4.3. Where assets rather than a company are acquired, then whether or not the purchaser of the assets is a UK or non-resident company, it will still be within the charge to corporation tax in respect of the ongoing business where that business continues to be undertaken in the UK. In those circumstances the purchaser will be making payments of interest in relation to any funding to acquire the business. The issues relating to deductibility of interest and payment of interest subject to withholding tax discussed in sections 2.4 and 4.1 will apply equally here.

2.6. Reorganisations and Mergers

2.6.1. Overview

UK tax law provides for a favourable (substantially neutral) tax regime in order to facilitate corporate restructurings, mergers and demergers. It should be noted that in relation to any form of reorganisation there is no concept in the UK of two corporate entities merging into one so that mergers involve transfers of businesses and/or transfers of the shares in one group into another group or possibly the shares in the two groups being transferred under a new holding company.

As referred to above, the UK does not tax non-UK resident companies on any capital gains arising from disposals of shares in UK resident companies. Thus, in the case of non-UK resident shareholders any disposal or alteration in their shareholding, as a result of any form of reconstruction, merger or demerger, will not come within the UK tax net and therefore any special exemptions will not be relevant. Thus, the discussion below in relation to the various favourable tax treatments of shareholders relates to UK resident shareholders. However, the reliefs for the company which is the subject of the reorganisation may apply where the shareholders include new non-UK residents. The discussion below assumes that the Substantial Shareholder exemption discussed at section 2.5.5.2 does not apply.

In addition to granting relief to shareholders in circumstances of reconstructions, mergers and demergers, the beneficial tax regime covering these situations applies to prevent tax charges
arising in the transferee company or anywhere assets are transferred from one company to another as part of the overall transaction.

2.6.2. Reconstruction of Stock
A restructuring of a company’s stock generally involves no change to the ownership of the total stockholding of the company but rather a change in the way that stockholding is held. Thus, for example, on the issue of bonus stock to stockholders the number of shares of stock held by any particular stockholder may be increased but, in substance, there will be no change in the stockholder’s stockholding. In these circumstances, stockholders are not treated as making any disposal of their original stockholding and the cost of that stockholding is then spread for tax purposes over the total new stockholding. Rights issues will generally fall within these reorganisation provisions provided that substantially all stockholders have been offered the new rights even though all stockholders may not take up such rights.

2.6.3. Mergers of Companies
A merger may be affected by a company or a group acquiring a company or another group (by acquiring the parent company) in consideration of the purchasing company issuing stock to the stockholders of the company acquired. In such circumstances, the stockholders of the company acquired will not be treated as disposing of their original stockholding but rather their new stockholding in the acquiring company will be treated as their original stockholding. This will be the case provided that (i) the acquiring company acquires at least 25% of the ordinary stock of the company “acquired”, (ii) or the acquiring company acquires stock under a general offer to all stockholders of the company acquired, or (iii) the acquiring company acquires the majority of the voting power in the “acquired” company. The provisions that treat new securities effectively as the original securities also apply where the securities being exchanged or issued are debt securities as well as equity securities, although one of the three conditions set out above must still be satisfied. However, there are special rules that apply to debt securities because generally any gain or loss on those securities is taxed as income and not as capital gain when held by a company. Additionally, certain securities held other than by companies are exempt from capital gains tax and a provision is needed to deal with the situation where chargeable securities are exchanged for exempt securities and vice versa. These provisions ensure that any capital gain effectively rolled into a debt security is calculated but not crystallised when the debt securities are issued in exchange and crystallises when the debt securities are disposed of.

2.6.4. Reconstructions of Mergers by Transfers of Businesses
The reconstruction of a group or a merger may sometimes involve the transfer of a business or businesses from one or more companies to another company or companies in consideration of the issue of stock by the acquiring company to the shareholders of the company transferring the business. In these circumstances the company transferring the assets as part of the transfer of the
business will not suffer a tax charge but rather the acquiring company takes over the tax position of the company transferring the business. Further, the new total stockholding of the stockholders to whom the acquiring company issues stock are treated for tax purposes as the original stockholding in the transferor company held by them, whether or not that stock remain in existence.

2.6.5. Demergers
Where one or more businesses are carried on by a company or a group of companies and the stockholders wish to demerge those respective businesses, where one set of stockholders will end up owning stock in a company with one or more or part of the businesses and another set of stockholders will end up with stock in another company holding part or one or more of the prior businesses, then generally the tax position of the stockholders and the companies involved will again be neutral as in the case of reconstructions and mergers as discussed above.

2.6.6. General
Generally, the relieving positions discussed above will apply whether any company acquiring shares is a UK company or a non-UK company. However, where transfers of businesses and assets are involved, in order for the tax position to be neutral in respect of that transfer, the acquiring company will be required to be a UK resident company.

All the reliefs discussed in this section are subject to a specific anti-avoidance provision with a clearance procedure.

2.7. Investment Funds

2.7.1. Overview
There are various forms of investment funds which attract favourable tax regimes both for the fund itself and the investors of the fund. Apart from these special types of funds, investment companies carry no special favourable tax treatment. There are special rules for dealing with expenses of investment companies and excess expenses arising in any year. They differ from, and are more restrictive than, the rules applicable to trading companies.

The specialist investment funds which attract a favourable tax regime are investment trusts, venture capital trusts, unit trusts and open-ended investment companies.

2.7.2. Investment Trusts
An investment trust is a company in which the shares are not closely held (in broad terms, not controlled by five or fewer persons), which is approved by the Inland Revenue and which satisfies the following conditions:

- that the investment trust is resident in the UK;
that the investment trust's income consists wholly or mainly of eligible income (income derived from shares or securities or rental income from certain lettings of residential property);
- that no holding by the investment trust in another company (a group of companies is treated as a company for these purposes) represents more than 15% by value of the holder’s investments (but excluding holdings in other approved investment trusts or non-approved investment trusts which should be approved but for the fact that their shares are not quoted on a recognised stock exchange);
- that the ordinary shares of the investment trust are quoted on a recognised stock exchange;
- that the investment trust's memorandum and articles of association prohibit the distribution by way of dividend of profits on realisation of investments; and
- that the investment trust does not retain in any accounting period more than 15% of its eligible investment income.

An approved investment trust will be completely exempt from tax on capital gains realised on its investments. Further, eligible rental income will be taxed at a lower rate than the usual rate of corporation tax. There are special rules that apply in relation to loan securities and derivative contracts held by an investment trust to determine what profits are capital gains and what profits are income for the purposes of determining which capital profits are exempt from tax.

2.7.3. Unit Trusts

A unit trust is a collective investment scheme under which the property in question is held in trust for the participators. If a unit trust is an “authorised unit trust” (authorised under the terms of the relevant legislation) it will be treated as a company resident in the UK for tax purposes. Any capital gains realised by an authorised unit trust will not be liable to tax. Its income will be liable to corporation tax generally although if it receives dividend income from a UK company, that income will be exempt in the same way as applies to UK resident companies generally. As with investment trusts there are special rules applicable to loan securities and derivative contracts to ascertain what profits are capital gains and what are incomes. There are special rules for determining how authorised unit trusts can distribute their income profits, either as interest or distributions, and there are complicated special rules for determining the tax treatment of the recipients of income distributions from such unit trusts.

2.7.4. Open-Ended Investment Companies

Broadly, open-ended investment companies are taxed in the same way as authorised unit trusts. The difference between an authorised unit trust and an open-ended investment company is that the latter is formed as a company rather than a trust. Their form is more acceptable to investors outside the UK.
2.7.5. Venture Capital Trusts

Venture capital trusts are companies that benefit from a favourable tax regime and offer individual investors beneficial tax treatment in respect of their investment in the venture capital trust. This favourable tax regime is intended to encourage investments in small unquoted trading companies.

The tax regime applicable to the venture capital trust itself is based very closely on the investment trust regime discussed in section 2.7.2. Capital gains are exempt from tax. There are special rules for determining when the profits on loan securities and derivative contracts are capital or revenue for these purposes.

The individual investors in a venture capital trust benefit from four types of tax relief:

- Income dividends paid will be exempt from tax.
- Gains on the disposal of ordinary shares in a venture capital trust will be exempt from tax.
- Income tax relief against the investor’s general income will be available at the higher rate of income tax in respect of the monies subscribed for eligible shares in the venture capital trust (eligible shares means new ordinary shares in the venture capital trust which in the period of three years from the date of issue carry no preferential rights to dividends or assets in a winding up and no right to be redeemed).
- Capital gains on holdings on an investment trust which are not exempt (ordinary shares are exempt) can be deferred if the disposal proceeds are re-invested in a venture capital trust.

The tax relief for an investor in respect of the receipt of dividends and capital gains on ordinary shares will be limited to investments made by that investor in any year with a market value when acquired of no more than £200,000.

A venture capital trust must not be a closely held company (controlled by five or fewer persons) and must be approved by the Inland Revenue. Approval will only be given if the conditions are satisfied as follows:

- income of the venture capital trust must be derived wholly or mainly from shares or securities;
- at least 70% by value of the investments must be shares or securities in “qualifying holdings” and 30% by value of qualifying holdings must be represented by holdings of “eligible shares”;
- no holding in a company (a group of companies is treated as a company for these purposes) other than in a venture capital trust or one which would qualify as one if its shares were quoted on a recognised stock exchange represents more than 15% by value of the investments held;
- the ordinary shares in the venture capital trust are listed on the London stock exchange; and
- the company does not retain more than 15% of its income derived from shares and securities.

The above conditions must be satisfied throughout each accounting period of the venture capital trust.

Qualifying holdings for these purposes are, broadly, shares or securities of unquoted trading companies, whether or not resident in the UK for tax purposes, which must have been issued to the venture capital trusts. Eligible shares are, broadly, irredeemable ordinary non-preferred shares.

The shares and securities which can be “qualifying holdings” must be in a company that exists wholly for the purposes of carrying on a “qualifying trade” wholly or mainly in the UK or be a parent company of such a trading company. All trades will be qualifying trades other than certain specified non-qualifying trades. These non-qualifying trades are, broadly, various financial trades including trades and derivatives, insurance, leasing, property, farming, woodlands, leasing or licensing, hotels and nursing homes.

Venture capital trusts may make investments up to £1 million in total in unquoted trading companies in any one year toward the 70% requirement, provided that the gross assets of the company or group in which the relevant investment is made do not exceed £15 million prior to the investment or £16 million immediately afterwards. This latter limitation has caused concern in the venture capital/investment trust industry and is likely to limit the appeal of venture capital trusts that sponsor.

2.8. Stock Options

There is no special tax regime for stock options save in relation to those applicable to individuals acquiring stock options by reason of their directorship or employment. Generally, where an option is exercised the option will be treated as the acquisition of the asset for an amount equal to the price paid for the option and on the exercise of the option.

2.8.1. Acquisition Gain

Where a director or employee of a company is offered stock options by reason of his office or employment there will be no charge to income tax on that grant.

The exercise of an option by a director or employee will give rise to a charge to income tax, and national insurance contributions if the shares acquired are “readily disposable assets.” (See section 4.4). (There are certain approved schemes which enable an employee to obtain shares at an under value without being liable to income tax on acquisition. These schemes allow only a limited value of shares to be acquired and only apply where the price payable for shares under an option is at least equal to the value of the shares at the time the option is granted.) The amount on which tax
will arise will be equal to the market value of the shares acquired less any payment for the shares and/or all stock options.

Any profit arising on the sale of shares acquired by a director or employee would generally be liable to capital gains tax and not income tax. The profit for these purposes will be equal to the difference between the disposal proceeds and the market value of the shares on the date of acquisition. In calculating that part of the capital gain liable to capital gains tax, “taper relief” will be available. Taper relief has the effect of reducing the effective rate of capital gains tax (the top rate of 40%) to one-quarter of that rate (10% in the case of a 40% taxpayer) where the maximum relief is available in the case of business assets. Shares acquired under stock options will generally be business assets for these purposes.

There are extensive anti-avoidance provisions to prevent directors and employers obtaining the favourable capital gains tax treatment on disposals of shares acquired under stock options. Broadly, these provisions apply to tax part of any capital gains as income if the value of the shares has been artificially manipulated to increase that value. However, they can also apply in other circumstances, for example where the employer can require the director or employer to sell the shares back to the employer on leaving. There are provisions enabling an election to be made so that on acquisition of the shares a limited change to income tax arises, in which case any further increase in value of the shares will be taxed as capital gains.

3. Taxation of Individuals

3.1. Individual Income Tax

3.1.1. Territorial Rules

The liability of UK income tax of individuals depends on their residence and domicile status. Domicile here has a special meaning which is generally not applicable under other systems of law. (However, the UK government is considering making changes to the tax position of non-UK domiciled individuals, including treating long-term UK residents as UK domiciled for tax purposes.)

The concept of domicile is different from that of residence and a person has a domicile in the jurisdiction in which an individual has their “permanent home”. Permanent home in this respect does not mean a physical home in which the individual is resident but rather the country which is “home”. The place of domicile will generally be the country in which the individual intends to reside permanently or eventually rather than the jurisdiction in which an individual may reside, even long-term, for example for the purposes of work. Thus, if an individual has a domicile in one country but comes to live in the UK, even for a long period of time, he will not necessarily acquire a UK domicile. Generally, if the individual intends to leave the UK, for example on retirement, he will
retain his original domicile. However, if the person with a domicile outside the UK comes to live in the UK with the intention of remaining here permanently he will require a UK domicile. The consequences of a person’s domicile are relevant to his liability to income tax, capital gains tax and inheritance tax in connection with non-UK income, gains and assets, as discussed below.

There are two categories of residence. A person can be resident and/or ordinarily resident in the UK. A person’s residence status will depend on all the facts and circumstances of his individual position. Residence is not defined by status; the relevant principles that determine a person’s residence status have been determined over a long period of time in cases which have come before the courts. An individual is ordinarily resident in the UK, broadly, if he is resident here year after year. Residence is a status determined more by the circumstances existing in any particular year. An individual may be resident under the local laws of more than one jurisdiction, including the UK. In that case his liability to UK taxes will depend on the terms of any relevant double taxation treaty.

As a matter of law a person’s residence status (resident and/or ordinarily resident) is generally determined for a particular year. However, in practice if a person has been resident in the UK but then leaves the UK in circumstances where he is going to live long-term abroad, and where he does not continue to spend on average 91 days or more in the UK, he will be treated as ceasing to be resident or ordinarily resident from the day after his departure from the UK. As regards a person leaving the UK to work abroad he will be considered to cease to be resident or ordinarily resident in the UK if he plans to work abroad for a period including a complete tax year. Similarly, if a person has been residing permanently outside the UK and comes to live in the UK he will only be considered resident in the UK from the time he arrives here. Where a person has previously not been resident in the UK and does not come to the UK to live here on anything other than a temporary basis without a view to establishing his residence in the UK he will not be resident in the UK during that temporary period unless he is physically present in the UK for 183 days or more in the tax year. If he comes to the UK with the intention of remaining here for over three years he is likely to become resident and ordinarily resident in the UK from the time he comes to the UK.

Subject to special rules applicable to individuals who are not ordinarily resident or not domiciled in the UK an individual will generally be liable to income tax on their worldwide income. Subject to rules applicable to non-UK domiciled individuals an individual will be liable to tax on his worldwide capital gains if he is resident and/or ordinarily resident in the UK. Non-UK resident individuals may be liable to UK income tax if they are trading in the UK through a permanent establishment here, if they work here or if they have other UK source income. However, there are extensive exemptions from UK income tax on UK source income other than from trading or an employment arising to non-UK resident individuals. As a general rule, UK source income (other than trading income and employment income) will not be liable to UK income tax unless it is levied by withholding tax or the non-resident has an agent in the UK connected with the UK source.
income. There is no liability to UK capital gains tax arising merely by reason of an asset being a UK asset. In relation to employment income, a person resident, ordinarily resident, and domiciled in the UK will be liable to UK income tax on all his worldwide employment income. If a person is not resident in the UK, or if resident is not ordinarily resident in the UK, he will be liable to UK tax in respect of income from employment in which the duties are performed in the UK. Where a person is not domiciled in the UK and his earnings would otherwise be liable to UK income tax they will not be so liable if he performs the duties of the employment wholly outside the UK for a non-UK resident employer. In that case the earnings are only taxed in the UK if remitted to the UK.

A non-UK domiciliary who would otherwise be liable to income tax on non-UK source income or capital gains tax on non-UK assets will only be liable to such UK tax to the extent that the income or gains are remitted to the UK.

3.1.2. Rates

Personal income tax is levied on the net taxable income at progressive rates. Taxable income between certain income bands are taxed at different rates, the lowest rate of income tax being 10% on annual taxable income up to £2,120, 22% on taxable income between £2,120 and £31,400 and 40% on taxable income in excess of £31,400.

In calculating taxable income, various reliefs are available. Each individual has a personal relief annually of £4,615. Additional reliefs apply depending on the number and age of a person’s children.

3.1.3. Taxable Base

As with corporation tax, different categories of income falling within different “schedules” are taxable in accordance with the rules of those schedules. These include trading and professional income, employment income, income from capital investments and income from letting and leasing. For trading and professional income, the income for any year is generally determined by the accounting profit save for the extent where specific rules apply to supersede the accounting treatment, for example capital allowances (depreciation allowances) in respect of capital expenditure on certain assets. However, income from wages, salaries, investments and income from letting and leasing will generally be determined by reference to actual receipts less allowable expenditures.

Once the amount of income from each “schedule” is calculated they are added together. Generally only losses arising from trading activities will be allowable against other classes of income. Additionally, certain expenses, for example interest on certain qualifying loans, which are not generally deductible in calculating income under any particular schedule, other than possibly in relation to trading income, will then be deducted in calculating income.
3.1.4. Capital Gains

Generally, capital gains are treated as income for the purposes of calculating the appropriate rate of capital gains tax, when added together with income, applicable to that gain. Capital gains are taxed at the top income tax rate, assuming for the purposes of determining that rate that the chargeable capital gain is income. However, in calculating any chargeable capital gain a reduction may be made for taper relief. In the case of non-business capital assets the amount of the gain which will be liable to capital gains tax will decrease 5% after two years, reducing at the rate of 5% each year to a maximum reduction of 40% after ten years. However, any period of ownership prior to April 1998 will be ignored for these purposes.

In the case of business assets, the part of the gain liable to capital gains tax will be reduced by 50% after the asset has been held for one complete year and 75% if held for at least two years. Again, any period prior to April 1998 will be ignored for these purposes. An asset will be a business asset if it is used:

- in a trade or business carried on by the individual or a partnership of which he is a member;
- for the purposes of a qualifying company; or
- for the purposes of employment of the individual;

An asset could also be a qualifying asset if it is shares held by an individual in a qualifying company.

A trading company or a holding company of a trading group will be a qualifying company by reference to an individual if one or more of the following conditions are met:

- the company is unlisted;
- the individual is an officer employee of the company or a company connected with it; or
- the voting rights of the company are exercisable as to not less than 5% by the individual.

Other types of companies will be qualifying companies by reference to an individual if the following conditions are met:

- the individual is an officer or employee of the company or a company connected with it; and
- the individual did not have a material interest (broadly more than 10% of the shares) in the company or a company controlling it.

3.1.5. Non-Resident Taxpayers

As set out above, individuals who are not resident for tax purposes in the UK are subject to income tax only with respect to certain UK source income.
3.1.6. Anti-Avoidance Measures
As for companies, anti-avoidance measures are applicable for individuals. In addition to the general principles of tax avoidance there are numerous anti-avoidance provisions contained in the legislation applicable to certain specific circumstances.

3.2. Inheritance Tax
Inheritance tax is applicable to certain gifts of assets made during a person’s life if that person dies within seven years of the day of the gift, and is also applicable to the assets held by a person on death. Non-UK resident domiciliaries are not liable to inheritance tax on non-UK assets. However, for these purposes the general definition of domicile is amended so that a person will be treated as domiciled in the UK for inheritance tax purposes if he has been resident in the UK for at least 17 out of the previous 20 years.

On a person’s death the gifts made within the prior seven years and the value of his assets on death are added together. However, some relief is available in respect of gifts made prior to death in terms of a reduced rate of tax. Where the total value of assets on death does not exceed £280,000, no inheritance tax is due, after which inheritance tax is payable at 40%.

There are various reliefs from inheritance tax relating to specified classes of assets, e.g. farms.

4. Other Taxes

4.1. Withholding Tax Under UK Law
Withholding tax is levied on “annual payments”. (The rules to establish whether a payment is an annual payment are complex and have been developed over many years by case law.) Broadly, annual payments are repeated payments made which are not trading receipts in the hands of the payee, certain royalties and certain interest payments.

There is no withholding tax on dividends. Where withholding tax applies it is levied currently at 20%. The obligation to withhold may be mitigated or eliminated by a relevant double taxation treaty. The income tax liability of directors and employees is also deducted from their wages prior to payment.

Issues relating to withholding tax on interest issues arise frequently. For UK withholding tax to apply, interest must have a UK source. Generally a payment by a UK company will be at UK source.
but various factors are relevant in determining whether interest has a UK source. If a loan is secured on UK property or guaranteed by a UK person, this could lead to the interest on the loan being UK source even if the borrower is not a UK resident company. Subject to certain exemptions, withholding tax will apply where “annual” interest (interest on a loan likely to be outstanding for a year or more) is paid by or through a company and, irrespective of who pays the interest, if interest is paid to a non-UK resident person. The exemptions from withholding tax, apart from any relief applicable under any relevant double taxation treaty are as follows:

- the interest is payable by a bank in the ordinary course of its banking business;
- the interest is payable on an advance from a bank carrying on a bona fide banking business in the UK (which includes a UK branch for a non-UK resident bank) and where the recipient of the interest (including any transferee of the loan) is within the charge to UK corporation tax as respects to that interest; and
- the interest is payable in circumstances where the payer reasonably believes that the recipient of the interest is within the charge to UK corporation tax in respect of the interest.

In this case, if it turns out that the payer’s reasonable belief was incorrect and the recipient is not within the charge to corporation tax in respect of the interest the payer will have to account for the tax to the UK tax authorities even though it has paid the interest gross.

A schedule summarizing the withholding tax rates applicable under certain tax treaties entered into with the UK is contained in the Appendix.

4.2. **Value Added Tax (VAT)**

VAT is levied and payable generally to the UK tax authorities by persons making supplies of goods or services in carrying on business (“output tax”) whether corporations, individuals or partnerships, although they pass the cost of the VAT on to their customers. VAT is currently the only tax applicable throughout the EU and the domestic rules of each territory derive ultimately from the provisions of the 6th EU directive. As a result, in a number of respects, VAT rules are similar throughout EU member states although there are certain exceptions to this, for example where a member state is given discretion as to the application or rate of VAT applicable. The current general rate of VAT is 17.5%. A reduced rate of 5% applies to goods and services. Certain services (including legal services) do not attract VAT when provided to certain persons outside the UK.

The way VAT operates is similar to that in other EU member states. It is paid at each level where a taxable supply (not an exempt supply) is made by a taxable person (broadly, somebody carrying on a business whose turnover exceeds stated limits). However, the person paying an amount of VAT on a supply to him (“input tax”) can claim a credit or repayment for that VAT if the goods or services are supplied to him for the purposes of his taxable business (not for an exempt business).
each period of account the difference between the input tax and the output tax is calculated and a net amount paid or rebated to the taxpayer. In this way, the real burden of VAT is borne by the non-business person who ultimately receives the benefit of the various goods and services which have been delivered in the chain leading to a product purchased by the consumer.

4.3. Stamp Duty and Stamp Duty Reserve Tax
The liability for Stamp Duty and SDRT is discussed in sections 2.5.1.1 and 2.5.2.1 in connection with transfers of business (company and asset transfers).

4.4. Payroll Taxes

4.4.1. Pay As You Earn (PAYE)
PAYE is the means by which most taxes on employment income, including earnings of directors, are collected. The employer is liable to deduct and account for such taxes to the Inland Revenue on each payment of earnings. Benefits are not, however, generally liable to PAYE. Readily convertible assets will be liable to PAYE. (see section 4.4.2)

4.4.2. National Insurance Contributions (NICs)
Employers, employees and directors have to pay respectively employer’s and employee’s NICs on wages. However, NICs are only payable in respect of the value of certain benefits in kind, broadly, benefits in kind received by a director or employee which are “readily convertible assets”, generally meaning assets which can be turned into cash. Readily convertible assets include assets like shares and securities which are traded on a stock exchange where the asset in itself is convertible into cash. There are special rules for stocks and securities acquired by reason of a person’s employment which determine if such stocks or securities are ready convertible assets. These later measures were introduced to overcome various schemes to effectively pay employees their salaries without incurring national insurance contributions.

The employer’s rate of national insurance contribution is equal to 12.8% on all earnings above £89 per week. Employees’ national insurance contributions are payable at 11% of that part of the employees’ earnings between £89 and £595 per week and 1% on any excess over £595 per week.

Generally an employer cannot pass the burden of the employer’s national insurance contribution on to the employee. However, in the case of share options granted to a director or employee where a liability to national insurance contributions arises on the exercise of those options, the employer and employee can elect for the employee to bear the costs of the employer’s national insurance contribution arising in that case.
5. **Statute of Limitations**

Generally the UK Inland Revenue cannot reopen the tax position of any individual taxpayer within the period of five years following 31 January falling after the end of the relevant tax year (6 April to 5 April). For a company, the period is six years from the end of the relevant accounting period. However, the time limit is extended to 20 years in the case of negligence or fraud.
## APPENDIX

### Withholding Tax Rates Applicable in Certain Tax Treaties with the United Kingdom

<table>
<thead>
<tr>
<th>Country</th>
<th>Interest (%)</th>
<th>Royalties (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>15</td>
<td>0</td>
</tr>
<tr>
<td>Canada</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>France</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Germany</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ireland</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Italy</td>
<td>10/0(^1)</td>
<td>8</td>
</tr>
<tr>
<td>Japan</td>
<td>10</td>
<td>10</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Russia</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Spain</td>
<td>12</td>
<td>1</td>
</tr>
<tr>
<td>Switzerland</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>United States</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

\(^1\) The 0% rate applies to interest paid in connection with sales on credit of industrial, commercial, or scientific equipment and merchandise delivered by one enterprise to another enterprise. It also applies if (i) the payer of the interest is a state, one of its political or administrative subdivisions or territorial authorities, (ii) the interest is paid in consideration of a loan granted or guaranteed by the other state, administrative subdivisions or territorial authorities, or a public body of that other state, or (iii) the interest is paid to other institutions or bodies in the framework of an agreement concluded between both states.
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