Chapter 4

Classification of Foreign Entities for Corporate Income Tax Purposes

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4.1. Introduction

The following text deals with the topic of how non-resident entities are treated (transparent or non-transparent) for domestic income tax purposes, in particular corporate income taxation, and whether (or to what extent) the different country approaches are compatible with the prerequisites of the EU freedoms. This is how the question was formulated to all national reporters for the Lisbon EATLP Congress of 2013. It seems to focus on the inbound case of a foreign entity (an entity established abroad under foreign corporate law) earning taxable income in another state.

However when studying this theme and reading the interesting national reports it becomes clear that the questions the reporters had to deal with were in a certain sense too narrow. The determination of the "non-resident entities" being treated, as well as the possible classification as "transparent or non-transparent" has to be defined more in detail. What is an "entity", which states will have to classify the entity, and what are the possible outcomes of a classification process? Before answering the general question, these particular topics will be dealt with in the first two sections of this chapter.

The methods of classification are hardly elucidated in domestic tax law regimes, although because of their tax sovereignty most states do accentuate the need to follow a domestic treatment. Mostly this treatment ends up in a kind of search for an analogy between domestic and foreign entities, but the criteria to look for can differ substantially. This will be further illustrated in the third chapter.

Finally the last part of this report considers the EU context. The compatibility of domestic tax law classifications with the EU freedoms forms only a part of the question. Also, when applying the EU directives to foreign entities, the domestic classification can be overruled. Although the directives still lack a general coherent approach, the question of tax transparency is starting to be integrated into these documents, as will be further illustrated.

4.2. Which foreign entities need to be classified?

Determining whether a non-resident entity is subject to company taxation implicitly answers the previous question of what can be considered to be "an entity" and makes a distinction between residents and non-residents which is, strictly speaking, not relevant to the question at hand. Finally it implicitly seems to suppose that the classification of a foreign entity is only at stake in the case of an inbound activity (a foreign entity earning domestic income).

These three aspects will be treated first, before analysing the classification methods applied in the different countries.

Before considering whether an entity is separately taxable or tax transparent a minimum level of legal independence has to exist. A distinction has to be made between a mere contractual cooperation between partners (an investor lending money, a contractual joint venture, a broker investing a sum of money, …) and the real formation of an entity (a partnership, a fund, a company, …).
This is of particular importance in countries where all kinds of foreign entities are subjected to corporate income taxation, such as e.g. Greece (except non-profit companies), Portugal, Hungary or Italy. The Italian report[1] therefore speaks of *"padrone di sè stesse"* or a legal capacity described as "*the ability to become a center of imputation of subjective legal situations*", even when not having legal personality. The Swedish legislation[2] contains definitions of both a foreign legal entity (although the minimal conditions to qualify are sometimes discussed) and a foreign corporation (an entity having to support taxation in its state of residence).
However sometimes this question of minimal conditions is not answered, because taxation is levied by way of a withholding tax at the level of the debtor of the income. (e.g. Portugal). Besides, it can be noted that some countries apply a kind of residuary category, taxing entities when attributed income cannot be taxed at another level. The Austrian report[3] mentions such a kind of "catch-all"-clause, under which some entities "*are taxable entities, if the income is not taxed in the hands of another person*". The Luxembourg report[4] mentions the "patrimoine d'affectation" which is subjected to CIT (although lacking legal personality) because neither the person having constituted the pool, nor the beneficiary can be taxed on this income.
Especially for foreign entities, therefore, the minimum level of autonomy for the recognition of a separate entity requiring classification could become hard to define.

Once the existence of an entity is accepted, it has to be determined whether the entity is separately taxable or tax transparent. This question arises for both domestic and foreign entities, but will probably present fewer problems for domestic entities. For foreign entities it can sometimes be hard to find a suitable domestic equivalent or an appropriate classification criterion. This report will only deal with the classification of foreign entities.
When speaking of "non-resident entities" one usually distinguishes between domestic entities established and registered under the laws of their state of residence and foreign entities established under the laws of another state, implicitly considering the foreign entity as being located elsewhere and earning some domestic income. The domestic entity will (in most cases) be taxable on its worldwide income, while the foreign entity will only be taxable on its domestic (source) income.

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[1] Cf. Italian national report, sec. 1, especially footnote 3.
[2] Cf. Swedish national report, sec. 4.
[3] Cf. Austrian national report, sec. 2.
[4] Cf. Luxembourg national report, sec. 3.2.1.

However, under the so-called “real seat” doctrine, for many countries (such as e.g. Germany, Hungary, Italy, Switzerland and Belgium), the decisive criterion for the distinction between residents and non-residents will be the place of effective management of the entity. An entity established under foreign company law could therefore also become a domestic entity, while entities established under domestic company law could become foreign entities.
This can be important as sometimes a legislator provides particular regulations for the classification of foreign entities, which are only aimed at non-resident entities. Belgium[5], for instance, enlarges the application of its income taxes for non-resident entities to entities without legal personality, while this enlargement does not seem to apply for resident entities. In Italy[6], domestic shareholders of a resident company may under certain conditions elect to classify the distributing company as tax transparent, while for foreign shareholders this option only exists if the Italian law does not provide for a withholding tax on dividends distributed by the Italian company.

Finally, it should be noted that the classification of a foreign entity is a double question. When income is earned in a source state, that state has to determine the taxable subject and therefore has to classify (potentially) foreign entities. However, in an outbound situation, whereby residents of a country participate in a foreign structure, the partner state also has to classify the foreign entity. This will determine when its domestic residents can be taxed on the income earned by the entity. E.g. in the case of the Parent-Subsidiary Directive, article 4.2 leaves the state of the parent company the option to treat the foreign subsidiary as a transparent entity, thereby still obliging that state to avoid double taxation.

For the sake of simplicity and comparability however, the distinction between resident and non-resident entities will be assumed to follow that of the company law under which an entity is established. The terms “non-resident” and “foreign company” will therefore be used to indicate entities (having a certain autonomous legal recognition) established under the legal system of another country. As the general question was to determine whether a foreign entity is subject to CIT, this report will especially focus on the classification in a source state of a foreign entity receiving “foreign source income”.

4.3. What is the classification of foreign legal entities?

The classification of a foreign entity determines whether such entity is separately taxable or whether its income is taxed at the level of its participating partners, shareholders, … A precise distinction between tax transparency and opacity is however hard to determine.

The question of whether an entity is subject to CIT seems insufficient as some states do separately tax entities but under particular income tax regimes. E.g. Greece[7], which classifies domestic partnerships as opaque, although subjecting them to individual income tax instead of

[5] Cf. Belgian national report, sec. 4.

[6] Cf. Italian national report, sec. 4

[7] Cf. Greek national report, sec. 3.1.

CIT; France[8] has a particular regime of partial transparency for domestic partnerships taxing the entity, but levying the tax debt at the partner level. However, it can be noticed that these particular regimes are seldom transposed to the level of foreign (comparable) entities: all commercial foreign entities are submitted to corporate income taxation in Greece, while in France, although confusion exists regarding the classification criterion to be applied to foreign entities (limitation of liability vs. commercial purpose), this only concerns the question whether to classify foreign entities as tax transparent or opaque. The classification of foreign entities mostly boils down to one general question: is it the entity itself, or are the participating partners taxed on the income received by the entity.

This general classification question has to be distinguished from particular anti-abuse tax provisions that are not at play in this questionnaire. One could think of particular regulations concerning the taxation of e.g. controlled foreign companies. As such, the Swedish report[9] mentions that a foreign "company" (opaque) is considered to be a mere entity (tax transparent) if the level of taxation in its home state is less than 55% of the taxation of a Swedish limited company. Another remarkable example is the case of Denmark.[10] The primary classification of an entity according to the Danish regulations can be overruled if the majority of its members reside in a state that applies a different classification of this entity. A transparent entity can become opaque and vice versa, based on the tax classification of the entity in that other state. This requalification rule is meant to counteract tax-avoidance and will therefore not be dealt with any further.

4.4. How are foreign legal entities classified under a national tax regime?

In most countries the general question of classification is hardly dealt with in tax legislation. Some countries, such as the Netherlands or Sweden, do mention categories of foreign separately taxable entities, but even then the legislation is rather vague. When references to foreign entities are made in the legislation, this is mostly to provide exceptions/enlargements in a particular context, without exhaustively covering the question of classification.
The only, already mentioned, exception is when the legislation explicitly qualifies all foreign entities as separately taxable, without any link to comparable domestic entities. Once a minimum threshold is passed, an entity will be submitted to an autonomous taxation (mostly CIT). It is doubtful whether such treatment is in conformity with the EU freedoms, or with the non-discrimination clauses in double tax conventions. The same domestic income will be taxed differently in the hands of potentially comparable entities, which could hamper foreign entities in their economic activities.

Despite this vagueness, national tax systems do stick to a proper classification of foreign entities. There is no mutual recognition method, whereby a state simply recognizes the tax classification of an entities' foreign home state for domestic tax purposes. In exceptional cases,

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[8] Cf. French national report, sec. 1.1

[9] Cf. Swedish national report, sec. 4.

[10] Cf. Danish national report, sec. 2.3.

such as e.g. Sweden[11], the foreign tax treatment is taken into account to test the domestic criteria. As such Sweden has adopted its own three cumulative criteria to define an “entity” (it can acquire rights and incur liabilities, it can plead in courts or to other authorities, and individual members do not have the assets of the association at their free disposal), but once this test is met, a foreign entity will be classified as opaque if in its home state it is taxed in a way that is similar to the taxation of Swedish companies (a direct tax with a minimum tax rate of approximately 10% to 12%).

It is also remarkable that, even when a country provides an optional classification system for (some of) its domestic entities, this optional approach usually does not apply to comparable foreign entities. E.g. in France, where courts look for resemblances, the national reporters mention[12] that a domestic option to deviate has in practice probably not (yet) been accorded to comparable foreign entities. In Italy, even the classification option of a domestic entity will change in respect of the residence of its shareholders.[13] An optional classification approach in case of domestic shareholders, will be limited if the shareholders are solely non-residents. The United States is a big exception.[14] Domestic entities, as well as foreign entities may to a large extent choose their preferred classification. Unless incorporated or specifically listed (and therefore separately taxable), corporations are classified as tax transparent, unless they opt to be separately taxable. This large amount of freedom can probably be explained by the lack of a federal company law. Each state provides its own legal companies that have to be classified for federal tax purposes. The earlier Kintner-regulations provided criteria for classifying these entities for federal tax purposes, but, due to several difficulties, these were replaced by a more general optional approach, known as the “check-the-box-regulations”. [15] However, this regime is complemented with lots of anti-abuse provisions to combat all kinds of tax evasion that could be realized with an opportunistic tax classification.[16]

With the general absence of domestic legislation and lack of willingness to accept the tax classification of a foreign entities ’ home state, most states have necessarily arrived at a kind of practice whereby some analogy is sought between domestic entities and foreign entities. As (foreign) tax criteria do not determine the classification, foreign civil law is looked at, but the criteria to verify the classification differ throughout the different national reports.

Some states link the classification to the legal personality attributed to an entity. Entities with legal personality are separately taxed, while entities without legal personality are tax transparent. However, the way in which legal personality is determined differs. Sometimes this is merely done by a simple recognition of the legal personality accorded to an entity in its home state, while other states verify the company law of the home state to assess whether the

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[11] Cf. Swedish national report, sec. 4.

[12] Cf. French national report, sec. 3.

[13] Cf. Italian national report, sec. 4.

[14] Cf. American national report, secs. 4.1 and 4.5.

[15] Both regulations can be found under: Treas. Regs. §301.7701-1 to 3.

[16] Particular rules were adopted to act against perceived abuses concerning, amongst others, foreign tax credits and circumvention of subpart F effects.

foreign entity has the characteristics the taxing state itself usually attributes to legal persons (a separate capital, option to sue and being sued, …).
The first method seems easier to apply, but can discriminate where there are different notions of legal personality. The latter method will result in greater similarity, but presents the classifying state with the problem of determining the essential characteristics of legal personality, which seems hardly possible.

Another criterion that can be seen is the difference between capital companies and partnerships. Describing it in far too general terms, a partnership is an undertaking between different partners "*intuïtu personae"*, while the company is a mere capital structure formed "*intuïtu pecuniae"* to have its own economic activity. Therefore the partners in the partnership carry an unlimited responsibility, while the responsibility of shareholders in a company is limited to their attributed capital. This explains why partnerships are tax transparent and companies are classified as opaque. The same reasoning could then be applied to foreign entities by verifying the responsibility of the participating partners. However in a more developed company law, companies could also be formed "*intuïtu personae*", while partnerships could be structured under limited responsibility. The decisive criterion for classification could then move from partnerships *vs.* companies towards limited *vs.* unlimited responsibility.
However this approach reveals two different tests (*intuïtu personae* vs *intuïtu pecuniae* and limited vs. unlimited liability) and leads to difficulties in the case of e.g. entities whereby the extent of liability of the participating partners differs or is not clear enough to determine.

Finally, in their strive for equal treatment, some states do not classify foreign entities based on specific criteria, but apply a resemblance test whereby they seek to determine with which domestic entity the foreign entity coincides the most. The foreign entity will then have the same tax treatment as its domestic equivalent.
Very often, however, it is far from clear as to which domestic entity a foreign entity most resembles. Especially in states which recognize a broad variety of company forms, the different characteristics are mainly details, making it difficult to find the exact match. It is also possible that a foreign entity does not have a comparable domestic equivalent, which happens e.g. in the case of trusts. A final question that also has to be dealt with is the possibility of statutory amendment. In the search for a comparator one cannot simply look at the legal regulations of a state, but must also analyse the concrete functioning of an entity, thereby necessarily also taking into account all statutory deviations. This makes the question of classification a highly individual task, which can become very time consuming and may lead to legal uncertainty.

4.5. EU compatibility of classification methods

As far as European law is concerned, a distinction can be made between the EU compatibility of a domestic classification method and the classification of entities for the application of EU directives.

The question of the EU compatibility of a domestic classification is to a certain extent linked with the neutrality between a corporate and personal income tax system. E.g. the German

report[17] mentions a dualism between (separately taxed) corporations and (tax transparent) partnerships, whereby neither system is clearly advantaged. In German practice, both entities are used without a clear preference. However this is measured by taking into account all different tax levels in a general domestic tax context. A foreign entity however will only partially be submitted to a coherent domestic tax system. As follows from judgments of the Court of Justice, e.g. the Tate & Lyle Investments case (C-384/11), differences caused because of such partial treatment are not acceptable. Therefore, it seems most appropriate to submit similar entities to a similar tax regime.
Nonetheless, as already described, a perfect similarity is hard to find. Countries applying a resemblance test experience difficulties comparing in practical situations. Moreover, the German reporters indicate[18] that some German legal doctrine derives from EU case law that even a resemblance test would not be in conformity with European law. An entity receiving the classification of “legal person”, “juristic person” or “business corporation” in its home country should, according to this doctrine, be treated as such in foreign Member States for taxation based on source tax rules. In my personal opinion, the German reporters correctly oppose to this doctrine. Therefore the basic idea of finding a kind of substantive resemblance with the tax treatment of comparable domestic entities and overlooking mere formal denominations seems to conform to EU law. Any conflicts and detrimental effects arising from a combined taxation are rather caused by a lack of harmonization. However, the main difficulty is that the precise reasons for classification of domestic entities are often rather implicit.

Besides this topic, some reports also deal with the application of the EU directives to foreign entities. The list of qualifying companies added in annexes to the directives and the “subject-to-tax” condition are therefore important to mention. However, these solutions do not solve all the possible types of problems.
E.g. the Luxembourg report[19] mentions a mere formal interpretation of the subject-to-tax condition leading to Belgian investment companies distributing dividends to Luxembourg companies under the advantages of the Parent-Subsidiary Directive even though the Belgian tax base of these companies is favourable. Strictly speaking, this seems to be more about a favourable tax treatment than a matter of classification but similar questions could arise in the case of hybrid entities.
On the other side exists the problem of a tax transparent (reverse hybrid) entity distributing income to foreign shareholders. As the entity is not subject to tax in its home state, the terms of the Parent-Subsidiary Directive do not apply to it. The receiving shareholders risk taxation in the home state of the entity, when the entity receives the income, and again in their home state, when the entity redistributes the income. They will not qualify for any solution in the Directive against this double taxation.
It is clear that, although the topic of transparency is starting to be integrated into the directives, there is still no all coherent approach.

[17] Cf. German national report, sec. 1.1.

[18] Cf. German national report, sec. 4.1.
[19] Cf. Luxembourg national report, sec. 5.

Finally, although these developments have mainly taken place since the 2013 Congress, it can also be mentioned that from a cross-border perspective different action is being taken to counteract the exploitation of different classifications. The use of (reverse) hybrid entities also serves as a complex tool for tax planning schemes, whether or not in combination with double tax conventions or European Directives.
Focusing on the use of hybrid entities and instruments the European Council agreed to amend the Parent-Subsidiary Directive obliging the State of the Parent company to impose tax on received dividends where the distribution of this income was deducted at the level of its subsidiary. These amendments are to be implemented in domestic legislation by December 31, 2015 at the latest.[20]
This topic is also the second action point in the general BEPS action plan at the OECD level. New domestic regulations, as well as treaty amendments are proposed to neutralize the effects of the use of hybrid instruments or entities. These proposals were intended to be finalized at the G20 finance ministers' meeting in September 2014.[21] However, even after that meeting it was clear that some progress still has to be made.

4.6. Conclusions

It can be concluded that because of international commerce states are confronted with the classification of foreign legal entities in different contexts. Most reports mention real estate income and the presence of permanent establishments as relevant factors for taxation, thereby referring to the case of a foreign source state in an inbound situation. However, in a so-called outbound situation, states also have to qualify foreign entities in order to define whether their resident partners are subject to tax on the income of the entity.

In neither of these situations is the classification of the foreign entity dealt with to any significant extent in national law. Besides anti-abuse provisions, some particular rules do exist, but for the most part the classification of a foreign entity is carried out in practice by courts and administrative bodies. It would seem logical to apply the same approach to foreign and domestic entities, but it is hard to determine similarity, as well as how it can be reached. At least, it is remarkable that, when for particular domestic entities deviating (in some cases optional) rules exist, these are seldom transposed to comparable foreign entities.

Finally, most reports stay rather silent concerning the treatment of this topic in an EU context. Although the concept of transparency, as well as a "subject to tax-condition" are integrated into the Directives, it is clear that this theme still needs to be treated to a far more extensive approach in the European context.
Recently this theme has been under consideration at the European, as well as the OECD level, but the main concern in these forums is to neutralize the perceived abuse of hybrid structures in tax planning schemes, instead of solving all possible conflicts.

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[20] Directive 2014/86/EU, *Pb.L*. July 25, 2014, nr. 219.
[21] Cf. www.oecd.org/tax/beps.htm