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Investment in foreign entities

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Entity Classification for income tax purposes

Entity Classification for income tax purposes

Norway

- There is no statutory guidance on how to characterize a foreign entity for Norwegian tax purposes
- The accepted approach is a «two-step» approach
  1. determining the characteristics of the foreign entity under foreign commercial law
  2. comparing these characteristics with those of recognized categories of entities under Norwegian law
- The tax treatment of an investment in a foreign entity will be in line with the legislation applying for the comparable Norwegian entity

Sweden

- For tax purposes it shall be determined whether a foreign entity meets the critera in order to be classified as a «foreign legal entity» or not. The rules on this are found in the Swedish income tax law.
- Beside from this, a separate test has to be made in order to determine whether a foreign entity shall be classified as a mutual fund («investment fund») or not. Guidelines for this test are issued by the Swedish Tax Agency.

Entity Classification for income tax purposes

Denmark

- There is guidance issued by the Danish tax authorities on how to characterize a foreign entity for Danish tax purposes and there are several published rulings on Danish tax classification of foreign entities
- Elements such as liability for the investors plays a major role (if one investor has unlimited liability the entity may be considered transparent)
- Also, whether the entity has articles of association, legal bodies such as a board or management
- Distributions of profits according to the capital invested, existence of separate financial statements, possibility of new investors (open-ended) has also been added importance
- Note the foreign classification should as a general rule not impact the Danish classification

Finland

- No formal rules.
- Tax law recognises «a foreign body corporate» and a «foreign partnership». Also (a rare) «foreign fully passthrough entity» - a concept entirely coined by case law with no equivalent Finnish entity.
- The classification of a foreign entity into one of the categories named above is based on overall evaluation of facts and circumstances – starting point is to find a closest comparable domestic entity.
- Legal characteristics tend to carry more weight in the classification than the local tax treatment of the entity.

Tax treatment of investments in corporate entities

Tax treatment of investments in corporate entities

Norway

- Dividends and capital gains are taxable at a rate of 23 % (25 % for taxpayers subject to Financial activities tax)
- The participation exemption method will apply for corporate investors unless
  - The foreign entity is established in a low tax jurisdiction outside of the EEA
  - The foreign entity is established in a low tax jurisdiction inside of the EEA unless the substance requirement is met
  - The foreign entity is established in a normal tax jurisdiction outside of the EEA, and the Norwegian investor holds at least 10 % of the shares or voting rights
- 97 % of dividends will be exempt, while capital gains are fully exempt
- For pension funds and life insurance companies, the participation exemption method do not apply if the shares are held as a part of the management of the clients funds

Sweden

A foreign corporate entity may fall under the Swedish participation exemption rules, provided it is deemed similar to a Swedish limited liability company. If the holding in the foreign corporate entity is deemed business related under the participation exemption rules, dividends as well as capital gains are tax exempt.

Tax treatment of investments in corporate entities

Denmark

Investments in listed corporate entities

- Dividends and capital gains are taxable at a rate of 22 % based on the mark-to-market principle. The participation exemption method will as a main rule apply for corporate investors
- For pension funds dividends and capital gains are taxable at 15.3 %

For investments in unlisted corporate entities

- Dividends are taxable at 15.4 % and capital gains are tax exempt. The participation exemption method will as a main rule apply for corporate investors
- For pension funds dividends and capital gains are taxable at 15.3 %

Tax treatment of investments in corporate entities

Finland

- Taxability of dividends distributed by a foreign entity at the hands of a Finnish investor depends on several factors:
  - Individual vs. corporate investor, corporate investor's possible special status (listed entity, certain institutional investors), distributing entity's status (listed/non-listed, EEA/non-EEA, taxable/tax-exempt), treatment of dividend for the distributing entity (deductible/non-deductible), treaty-based exemptions in certain cases with +10% holdings....
  - Conclusion: - It's a mess, but a couple of «easy rules» exists (e.g. EEA non-listed to «normal» FI Ltd-> fully exempt irrespective of holding size or - time).
- Taxability of capital gains: for corporate investors – 100% taxable at 20% unless participation exemption rules apply. For individuals, 100% taxable at 30/34%

Tax treatment of investments in partnerships

Tax treatment of investments in partnerships

Tax treatment

Norway

- A limited partnership is considered a semi-transparent entity for Norwegian tax purposes, and the partners are the tax subjects. Norway does not apply any see-through or a fully transparent approach.
- Taxable income will be calculated as if the partnership is a separate tax entity. The participation exemption method will apply.
- The calculated taxable income is then attributed to the Norwegian individual or corporate partners based on their proportionate profit share, and taxed at a rate of 23 % (25 % for taxpayers subject to Financial activities tax).
- Distributions from a partnership are not taxable for a corporate partner. However, 3 % of the distribution will be subject to tax at 23 % (25 % for taxpayers subject to Financial activities tax).
- Capital gains from disposition of the partnership interest are taxable at a rate of 23 %. (25 % for taxpayers subject to Financial activities tax). The participation exemption method may apply. However,
  - Capital gains will not be exempt if the partnership holds shares and the fair market value of the shares not comprised by the participation exemption method does not exceed 10 % of the fair market value of the whole share portfolio. This requirement has to be met in a period of the last two years prior of the disposition.
  - Capital loss will be deductible if the partnership holds shares and the fair market value of the shares not comprised by the participation exemption method exceed 10 % of the fair market value of the whole share portfolio. This requirement has to be met in a period of the last two years prior of the disposition.
  - For pension funds and life insurance companies, the participation exemption method do not apply if the shares are held as a part of the management of the clients funds

Tax treatment of investments in partnerships

Tax treatment (continued)

Sweden

- If a foreign partnership does not meet the criteria to be deemed a «foreign legal entity», it will be fully transparent for Swedish tax purposes. The Swedish partner will be taxed in the same way as he had been the owner (of his share) of the partnership's assets and liabilities.
- On the other hand, if a foreign partnership does meet the criteria to be deemed a «foreign legal entity», it is normally (if partner-taxed according to the foreign jurisdiction) partner-taxed, i.e. the partners are the tax subjects.
- Taxable income will be calculated at the level of the partnership. The participation exemption rules will be applied on dividends and capital gains, provided the dividend/capital gain should have been tax exempt, should the partner have been the direct holder of the partnership's assets.
- The calculated taxable income is then attributed to the Swedish partner and taxed at 22 % (if a corporate partner).
- Distributions from a partnership are not taxable for a partner.
- Capital gains due to the sale of a share in a partnership may be tax exempt (under the Swedish participation exemption rules) for a corporate partner, provided the partnership is resident within the EEA.

Tax treatment of investments in partnerships

Tax treatment (continued)

Denmark

- A limited partnership is as a general rule considered a transparent entity for Danish tax purposes, and the partners are the tax subjects.
- Taxable income will be calculated based on the individual investor's tax status and share of the partnership and taxed at either 22% or 15.3% only for pension funds.
- Distributions from a partnership are not taxable for the partner. Capital gains on the partnership share are taxable at a rate of 22% (15.3% for pension funds). NB. Option to apply the net principle for life insurance companies and pension funds.

Tax treatment of investments in partnerships

Tax treatment (continued)

Finland

- Finnish or foreign partnerships are not considered separate taxpayers. The amount of taxable income is calculated at the level of the partnership and then allocated – after deduction of any allocable share of NOLs from previous years – to be taxed as the income of the partners according to their respective entitlement to the income, irrespective of any actual distributions. However, with respect to foreign partnerships, the tax authorities have allowed reporting of distributions instead of allocable income share if the investor cannot ascertain their allocable income share.
- The whole allocated amount is «business income» or «other income» of the partner, depending on the activities carried on by the partnership. The income does not retain its character – i.e. the partners are not allocated a share of e.g. dividends, interests, and gains earned by the partnership. Distributions not taxable (but see the exception mentioned above).
- No participation exemption for capital gains available.
- Dividend taxation can be quite quirky…. Based on the wording of the law, in case of a Finnish partnership, a partner is entitled to a deduction equivalent to the partners share of dividend income received by the partnership to the extent the same dividend, if earned directly by the partner, would have been exempt to that partner.
    - Based on the wording of the law, this deduction is not available for dividend income received through non-Finnish partnerships.
- Only positive net income is allocated to partners. NOLs are preserved at partnership level -> costs incurred by the partnership cannot be used by the partners to offset other income.

Tax treatment of investments in partnerships

Reporting obligations

Norway

- Any Norwegian partner in a foreign partnership has an extensive reporting obligation to Norwegian tax authorities. Partnership statement where taxable income are calculated should be submitted to Central tax office for large enterprises.
- In addition, the Norwegian partner should submit a partners statement as an attachment to the partners own tax return.

Sweden

- Income from partnership shall be included in the partners' corporate income tax return.

Denmark

- To compute the correct tax, the tax payer requires sufficient reporting information from the partnership and potentially underlying funds if funds of funds investment. No specific reporting obligations towards the Danish tax authorities, however during an audit the Danish tax authorities may ask into the partnership and the tax treatment

Finland

Tax treatment of investments in partnerships

Foreign Tax credit

Norway

- As a starting point, foreign tax credit will be available if the partner has been subject to legal double taxation.
- However, foreign tax credit may not be effective as
  - The basis for taxation are calculated differently in Norway and abroad
  - The taxation are carried out in line with different principles in Norway and abroad
  - There are quite demanding documentation requirements, and therefore full foreign tax credit may be challenging.
- Any tax withheld on dividends from a portfolio company to the foreign partnership may be subject to foreign tax credit in Norway

Sweden

- As a general rule, foreign tax may be credited against the partners' corporate tax, provided <u>the partner</u> has been subject to foreign tax liability (i.e. has been subject to double taxation).
- However, if the partnership itself has been liable to tax abroad, the foreign tax shall be deemed as paid by the partner.
- Documentation requirements

Tax treatment of investments in partnerships

Foreign Tax credit (continued)

Denmark

- As a starting point, foreign tax credit will be available if the partner has been subject to double taxation and the partnership is transparent, i.e. only credit for legal double taxation.

Finland

- Foreign tax credits available at partner level if the partner has been subject to double taxation (the partner and not the partnership has been subject to tax in the source jurisdiction) or if the partnership has been treated as a taxable entity by the source jurisdiction.

Tax treatment of investments in partnerships

Treaty benefits

Norway

- Any double tax treaty between Norway and the country where the foreign entity is incorporated will apply if the Norwegian partner are subject to tax in the country of incorporation.
- Any double tax treaty between Norway and the country of residence of the investments in the fund may apply if the third party country withhold any tax on dividends or other income to the partnership.

Sweden

- Any double tax treaty between Sweden and the country of residence of the investments in the partnership should apply according to the commentary to the OECD model treaty.
- However, uncertainty due to restrictive view from the Swedish Tax Agency.

Denmark

- As a general rule, the partners should be entitled to treaty benefits but there could potentially be an issue with different tax classification of a foreign entity in two countries.

Finland

- Treaty benefits available on a case-by-case basis - In practice certain investments and certain countries (notably U.S. dividends) can be challenging.

Tax treatment of investments in mutual funds

Tax treatment of investments in mutual funds

Norway

New legislation for taxation of mutual funds was introduced 1. January 2016. Taxation will now be carried out in line with the underlying assets in the fund.

- The funds equity portion has to be determined based on fair market value.
- The investors income will be treated as income from shares in line with the determined equity portion, and therefore also may be subject to participation exemption.
- Other income will be treated as capital income and taxed at a rate of 23 % (25 % for taxpayers subject to Financial activities tax).
- If the equity portion exceeds 80 %, all income will be treated as share income.
- If the equity portion is less than 20 %, all income will be treated as capital income without any tax exemptions.

Personal investors

For personal investors share income are taxed at a rate of 30,59 %, while other income from the fund will be taxed at the ordinary capital income rate of 23 %.

If the personal investor rather invest trough a capital insurance contract, all the income are taxed at the ordinary capital income rate of 23 %, even if the contract is a unit link contract.

Tax treatment of investments in mutual funds

Sweden

- Mutual funds (investment funds) are exempt from tax.
- Investors are instead taxed yearly for a deemed income, based on the market value of the shares in the fund (income 0,4 %).
- Dividends and capital gains on participations in the fund are taxable. A corporate investor is taxed with 22 % on such dividends/capital gains.
- Dividends on Swedish shares distributed to foreign mutual funds are exempt from Swedish withholding tax (EEA or treaty country).

Tax treatment of investments in mutual funds

Denmark

Corporate investors

Taxation for corporate investors follows the mark-to-market principle at 22%.

Personal investors

For personal investors it is important to distinguish between share based and bond based mutual funds (Danish term is “investment institutes with minimum taxation”).

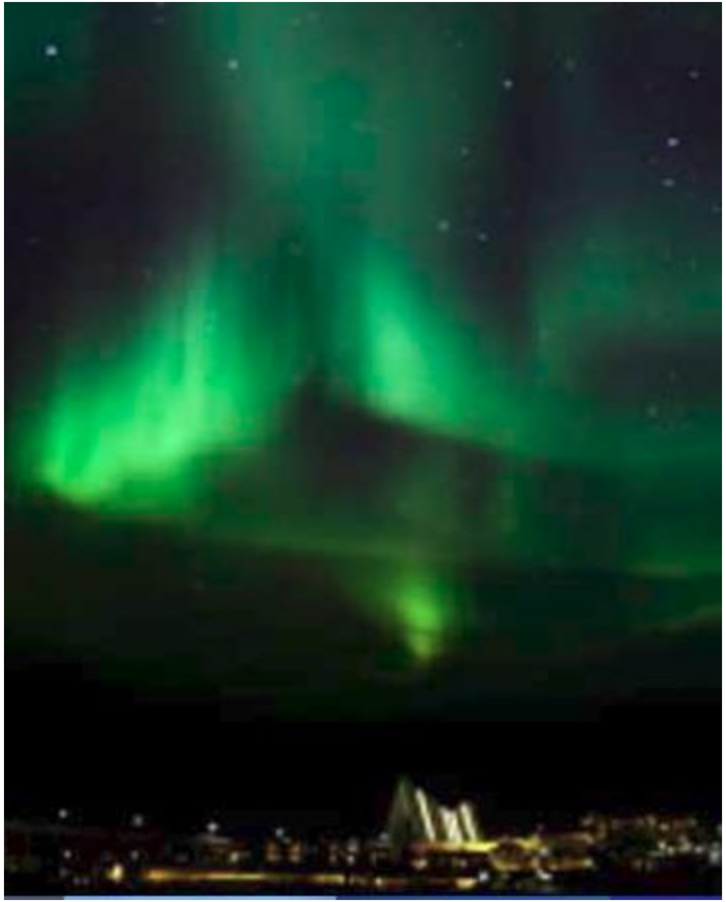
- If the funds equity portion on a yearly average is at least 50% of the fund’s asset, the fund is considered a share based mutual fund.
  - The investors income will be treated as income from shares and taxed at either 27% or 42%
- If the funds equity portion on a yearly average is less than 50% of the fund’s assets, the fund is considered a bond based mutual fund.
  - The investors income will be treated as capital income and taxed up to 42%

Tax treatment of investments in mutual funds

Finland

- Taxation of investment in foreign funds depends on the classification of such funds for Finnish purposes.
- As a starting point, mutual funds often compare to Finnish «investment funds» - a type of regulated fund vehicle in a non-corporate form. Finnish investment funds are considered body corporates for tax purposes even though they have no legal personality.
- Distributions are taxed as «fund distributions» -> 100% taxable income for all taxpayers (CIT 20%, individual capital income tax rates 30/34%)
- Capital gains for disposal of fund interest similarly 100% taxable income for all taxpayers.

- There is a limited amount of case law available in which some specific funds (a Lux FCP, a Dutch FGR) have been characterized as «foreign fully pass through entities» - a concept with no Finnish equivalent. In these cases, the fund was completely disregarded from Finnish tax perspective -> investor taxed as if having invested in the underlying assets directly.
  - Required very special conditions – is not a principle for characterizing any category of funds, but could be available in individual cases – so not all contractual funds or even all FCPs or FGRs qualify for this treatment, but it may be possible to build a fund that does -> if such treatment is desired, an advance ruling is a must.



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