WORK PACKAGE 2015 – MONITORING GUIDANCE ON INBOUND PROFITS

I. Background

1. Point n. 5 of the Code Group's Work Package 2015, which was adopted by the ECOFIN Council on 8 December 2015, provides that the Group will continue its work on monitoring the guidance on inbound profit transfers. This work started in February 2012 and has continued in the following years.

2. This guidance requires Member States that grant a corporate tax exemption on foreign source dividends (in intercompany situations) to apply either effective anti-abuse provisions (e.g. CFC rules) or a switch over provision (i.e. a provision according to which, under certain circumstances, relief from double taxation is granted via the credit method rather than by means of exemption). The objective is to ensure effective taxation of inbound profits.

3. To ease the monitoring exercise, a questionnaire on Member States' tax treatment of inbound profit transfers was agreed by the Group, circulated to the Member States and filled in by all of them. A consolidated version of the responses provided by Member States was circulated at the Group meeting of September 2012. At a later stage, it was decided that the questionnaire should be filled in also with respect to Member States' dependent and associated territories.

4. However given the lack of detail in the guidance, the Commission services were unable to assess whether Member States' anti-abuse provisions fully complied with the agreed guidance. To address this issue, at the Group meeting of October 2013, it was decided to take the work forward using a "tool box" approach. The tool box would include the relevant elements that Member States' anti-abuse provisions could contain.

5. Based on previous exchanges had with the Member States to identify those elements that are relevant in designing anti-abuse provisions, the Commission services designed a tool

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1 Annex 3 of doc. 14302/15 FISC 159
2 Doc. 16766/10 FISC 139
3 The document refers to "anti-abuse" provisions to ensure consistency with the wording used in the guidance. However, it would be more appropriate to refer to "anti-avoidance" provisions as the focus is on measures that are aimed at tackling unacceptable tax planning by companies or group of companies.
4 The guidance says: "Member States may opt to tax inbound profit transfers or to operate a participation exemption. Member States which operate a participation exemption should either ensure that the profits which give rise to foreign source dividends are subject to effective anti-abuse or countermeasures, or apply switch-over provisions targeted at ensuring effective taxation. The first could be achieved through a Member State having CFC-legislation or other anti-abuse provisions which ensure that profits artificially diverted from that Member State which may give rise to foreign source dividends are appropriately taxed."
5 Annex to room document #2 of 10 September 2012
6 The replies concerning Member States' dependent and associated territories are still incomplete.
box in the form of a check list. The check list outlines the components that are required for tools which are considered as effectively ensuring the taxation of inbound profits. It could therefore be used to assess the extent to which Member States' rules comply with the guidance on inbound profit transfers.

6. The Commission services proposed two separate check lists, one for switch over provisions and another for CFC rules. Each check list includes both the elements relating to the relevant legal framework (i.e. the "high level" key components of an effective provision - B; more specific aspects of the "high level" key components - C1; and the tools that can be used to implement each component in practice - C2) and the criteria for ensuring the effectiveness of the provisions under examination - D). This would enable the Commission services to make an assessment in two stages: first an assessment on whether an appropriate legal framework is in place and then an assessment on its effectiveness.

7. The check lists were discussed at the Group meetings on 22 October 2014 and 4 February 2015. On this last occasion, the Commission services made a preliminary assessment of the legal framework for the taxation of dividends in the Member States. As regards the assessment on the effectiveness of this legal framework, the close link with the wider and open question of what “effective taxation” is was noted.

II. Recent developments

8. Following the last Group meeting at which the guidance on inbound profit transfers was discussed (on 4 February 2015), there have been developments that are very relevant to this work.


10. One of the key actions listed in the Action Plan is ensuring effective taxation where profits are generated. According to the Action Plan, this objective should be achieved through different initiatives, in different fora, including in the Code of Conduct Group.

11. Second, on 5 October 2015, the OECD presented the final package of measures aimed at tackling Base Erosion and Profit Shifting (BEPS). The package includes the final report on BEPS Action 3 (Design Effective Controlled Foreign Company Rules), which is very relevant to the work on inbound profit transfers.

12. In the light of these developments, and given the relevance of the notion of "effective taxation" in the context of the ongoing Group's work on inbound profit transfers, the Commission services have decided to take forward the work in this area by providing its own view on "effective taxation" with respect to anti-abuse rules. In particular, the

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\(^7\) COM(2015) 302 final
\(^8\) [http://www.oecd.orgctp/beps.htm](http://www.oecd.orgctp/beps.htm)
Commission services have focused on those elements of the toolboxes which are considered as the most relevant to ensure that the Member States' anti-abuse provisions under examination are effective\(^9\).

13. The Commission services have also slightly revised and updated the check list, *inter alia* with a view to better reflecting its own view on "effective taxation" as well as the outcome of the OECD/G20 BEPS work on CFC rules.

III. Approaches to ensure effective taxation of inbound dividends

3.1 Approaches used by Member States

14. Almost all Member States have established certain conditions to grant full exemption for inbound profit transfers or to determine if and when their CFC provisions or switch over rules should become applicable. These conditions normally relate: (1) to the tax status of the subsidiary which distributes the dividends in its country of residence; and/or (2) to the activity performed or the type of income earned by the subsidiary. In addition, as far as CFC rules are concerned, additional conditions relate to: (a) the shareholders to which these rules apply; (b) the foreign entities covered; and (c) type and level of control exercised over the foreign entity.

15. The first set of conditions is normally aimed at ensuring that full exemption is not granted (and that anti-abuse measure kick on) if the underlying profits out of which dividends are paid are not subject to tax in the subsidiary country ("subject to tax test") or have not been adequately taxed in that country ("low tax test"). The "subject to tax test" can also be designed as a "non-deductibility test", if the exemption from taxation for inbound dividends is denied if dividends are tax deductible in the country of the payer.

16. Some Member States have territorial exemptions and consider as relevant, for this purpose, the simple fact that the subsidiary is resident in an EU Member State/EEA country or in a country with which they have a double tax treaty (DTT) in force (in some cases this must concern a treaty including a provision on information exchange). In other words, the subject to tax test or non-low tax test is considered to be met if the subsidiary is resident in one of those countries.

17. Other Member States use different approaches. One approach could be that of drawing up a white list/black list. In such case, full exemption is granted and/or the application of anti-abuse provisions is excluded to dividends coming from countries that are regarded, based on an *ex ante* evaluation, as "good" ones. Besides political reasons, the considerations that are normally relevant in drawing up the lists are the level of taxation applied in the country concerned (which does not have to be low or equal to zero) and

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\(^9\) While the toolboxes on switch over and CFC rules include the key criteria which are necessary for the functioning of the respective provision, not all these criteria are equally relevant when it comes to assess the effectiveness of these provisions. Therefore the Commission services have decided to focus only on some of them (i.e. "subject to tax/low tax test" – including "lower-tier subsidiary test"; "activity test/substance test"; "shareholders covered"; "entities covered"; and "control test").
whether or not the country in question provides for an adequate level of information exchange. The same reasoning applies, *mutatis mutandis*, to the black list approach.

18. Another approach is that of defining what is meant to be "low taxation" and requiring a case-by-case analysis on the level of taxation applied in the subsidiary country.

19. Different methods can be used to establish when the tax rate applied in the subsidiary country is low: (a) a comparison between the tax rate in the subsidiary country and a particular fixed rate that is considered low-tax (absolute terms); (b) a comparison between the tax rate in the subsidiary country and a portion or percentage of the parent country's own rate (relative terms); (c) a comparison between the taxes that have been paid in the subsidiary country and the taxes that would have been paid in the parent country, according to the rules applicable in that country (relative terms). Other possible methods have to be seen as variations of those above.

20. The second set of conditions relates to the business activity performed, the type of income earned and/or the assets owned by the subsidiary ("activity test" – "substance test"). These elements are described either positively i.e. by defining good activities/assets or active income or, more frequently, negatively i.e. by defining bad activities/assets or passive income (e.g. interest, royalties and dividends). These conditions could be used both in connection to switch over rules, where they are normally combined with a "non-deductibility test", a "subject to tax test" or a "low tax test" (e.g. full exemption is granted only if the activity of the subsidiary is not mainly of a financial nature and if the subsidiary is not low taxed) and with CFC rules (e.g. CFC rules would kick in only if more than 50% of the income of the controlled subsidiary is of a passive nature).

21. Finally, as regards the conditions specifically related to CFC rules, the first abovementioned condition concerns the shareholders to which these rules, if all other conditions are met, should be applied, which normally are both individual and corporate taxpayers. The second condition relates to the entities covered, which are normally corporate entities but could also be other entities. The third condition regards the type and level of control exercised over the foreign entity: it can be legal control (which is based on the holding of the capital and/or voting rights), economic control (which focuses on the right to the profits), and/or *de facto* control (which looks at other factors, e.g. who takes the top-level decisions regarding the affairs of the foreign company).

### 3.2 Which approach is the most effective?

22. The Commission services believe that the most effective approach is that of setting a "qualitative" condition which is based on an accurate computation of the level of taxation applied in the subsidiary country (low tax test). A simple "subject to tax test" cannot be regarded as an effective approach because the subsidiary could be subject, in its country of residence, to zero or very low tax.
23. When it comes to the definition of "low taxation", the Commission services believe that a country has to be regarded as low tax when it applies a level of taxation which is meaningfully below the one applied in the parent country.

24. This means that, whichever method is adopted to calculate the level of taxation in the subsidiary country, two elements are essential for the provisions in question to be effective:

   - The comparison should be based, to the extent possible, on "effective" tax rates (i.e. by taking into account not only the statutory tax rate but also the tax base and/or other provisions, like tax credits or refunds, that may reduce the effective tax charge paid by the subsidiary).
   - The benchmark to be used to make the comparison should be meaningfully lower than the tax rate applied in the parent country.\(^{10}\)

25. Although the Commission services attach great importance to effective taxation, they recognise that, in some cases, the computation of the effective tax rate can be a very complicated exercise for taxpayers. This is particularly true if the taxpayer concerned does not have control over the low-taxed entity because, in this case, access to this entity's statutory accounts is likely to be unavailable.

26. Therefore, while a method based on the computation of effective tax rates remains the preferred one, the Commission services have taken this into account for the purpose of assessing the effectiveness of Member States' laws only with respect to CFC rules. In effect, as far as CFC rules are concerned, the computation of the effective tax rate applied in the subsidiary country should be possible, the control over the low-taxed entity being a pre-requisite for applying this legislation.

27. As regards other provisions, given that they do not require control over the low-taxed entity, a reference to "statutory" corporate tax rates could be regarded as sufficient.

28. In the light of the above, the Commission services believe that the participation exemption should not apply / that switch over provisions should apply if the subsidiary is subject, in its country of residence, to a tax on profits at a statutory corporate tax rate lower that 40% of the statutory tax rate that would have been charged under the applicable corporate tax system in the Member State concerned.

29. As far as CFC provisions are concerned, they could be considered as effective (as regards the definition of low jurisdictions) if they apply to subsidiaries that are subject, under the general tax regime in their country of residence, to an effective corporate tax rate lower that 40% of the effective tax rate that would have been charged under the applicable corporate tax system in the Member State concerned.

\(^{10}\) This approach is in line with the recommendations included in the OECD/G20 report on BEPS Action 3
30. The alternative of making reference to the foreign tax actually paid is a variation of this approach and can also be regarded as effective. The same is true if the legislation provides for a comparison between the tax rate in the subsidiary country and a particular fixed rate that is considered low-tax (absolute terms).

31. It goes without saying that in the case of Member States adopting a white list/black list approach for determining when anti-abuse provisions do not have/have to be applied, the effectiveness of such provisions would depend on whether the criteria for listing a country reflect the considerations above. In other words, it is important that, in drawing up the lists, Member States take into account the level of taxation applied in the subsidiary countries, being this the effective level of taxation (as far as CFC rules are concerned) or also the statutory level (as far as switch over provisions are concerned).

3.3 Lack of effectiveness of territorial exemptions

32. As regards the approach of granting territorial exemptions, the Commission services believe that, at present, such an approach is generally more open to tax planning and, therefore, less effective than an approach based on the assessment of the actual taxation applied in the country of the payer.

33. First, it may be that some countries (e.g. countries with which the Member State in question has a DTT in force) have been exempted on the basis of political considerations which may vary from Member State to Member State, as opposed to "objective criteria" which are equal to all countries. In effect some Member States, based on their policy objective, may wish to conclude a DTT with a given country, while other Member States may not wish to do so.

34. Second, we must consider the case in which dividends are received, through a subsidiary located in an exempted country, from a lower tier subsidiary located in a low-tax third country. In such a case, the objective of ensuring that dividends are appropriately taxed would be achieved only if the exempted country where the interposed subsidiary is located has in place a dividend tax system which can be considered as "effective" (i.e. if that country either taxes inbound dividends or applies a participation exemption combined with effective anti-abuse measures).

35. However, this is not always the case in the current context, where countries around the world have not yet implemented the package of measures which resulted from the OECD/G20 work on BEPS. The situation is expected to change in the near future, as soon as countries will start implementing domestically tighter anti-avoidance measures as a result of the BEPS work.

36. As far as EU Member States are concerned, consideration has to be given to the fact that this topic is covered by uniform EU legislation (the Parent-Subsidiary Directive\textsuperscript{11} - PSD) and that therefore, if the conditions prescribed by this Directive are met, Member States

are legally obliged to exempt / to tax while providing a credit for underlying taxes to dividends coming from another Member State.

3.4 Lower tier subsidiary test

37. Dividends are normally received from direct subsidiaries. Therefore, the conditions to identify a subsidiary that qualify for the participation exemption or that would trigger the application of CFC or switch over provisions are normally designed with reference to that subsidiary.

38. However, businesses could circumvent these conditions by interposing a qualifying subsidiary in the participation chain so as to ensure tax free repatriation of profits from non-qualifying lower tier subsidiaries. It is for this reason that most CFC provisions and, in some cases, also other anti-abuse provisions apply to lower tier subsidiaries too.

39. The Commission services believe that a lower tier subsidiary test would certainly make CFC and switch over provisions more effective against tax planning structures. However, on the other side, the Commission services acknowledge that requiring companies to check, in each situation, whether the dividends arising from lower tier subsidiaries are effectively included in the dividends that were distributed to the parent company is a heavy procedural requirement. In the absence of control, as can be the case when switch over provisions are applied, this can even turn to be unfeasible.

40. In the light of the above, the Commission services, while recognising the merit of such a requirement, have not taken it into account for the purpose of assessing the effectiveness of Member States' anti-abuse provisions.

3.5 Activity test - Substance test

41. As regards the "activity test/substance test", the Commission services believe that different approaches could be followed to define, positively, "good" activities/assets or active income or, negatively, "bad" activities/assets or passive income.12

42. The approaches could slightly differ depending on whether they are adopted in connection to switch over rules or in connection to CFC rules and would normally depend on the policy outcome that each country aims to achieve.

43. Normally, as far as switch over rules are concerned, the focus should be on activities which are mainly of a financial nature or on income which is more likely to be geographically mobile (i.e. passive income). To be effective, the notion of passive income should include at least the following categories of income: dividends, interest (or any other income generated by financial assets), royalties and IP income. Other categories of income, like rents and leasing fees could also be included. These categories of income are also relevant for CFC purposes.

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12 The report on BEPS Action 3 recommends that CFC rules should include a definition of income that ensures that income that raises BEPS concerns is attributed to controlling shareholders in the parent jurisdiction but, at the same time, it recognises the need for flexibility to ensure that jurisdictions can design CFC rules that are consistent with their domestic policy frameworks.
44. Moreover, as far as CFC rules are concerned, the following categories of income are also very relevant: income from insurance, banking and other financial activities and income earned from related parties.

45. Whatever the approach chosen, the requirement that the main business/the majority of the income of the subsidiary should be of a passive nature should be considered as met if more than 50% of the activities/income are of a passive nature (lower thresholds are, of course, also acceptable).

46. Finally, for CFC purposes, a substance analysis aimed at checking whether the establishment of the CFC has substance (e.g. in terms of people, premises, assets, etc.) and whether the CFC engaged in substantial activities is very relevant.\(^\text{13}\)

### 3.6 Other conditions related to CFC rules (shareholders, entity, control)

47. The first condition concerns the shareholders to which CFC rules should apply. In this respect, the Commission services believe that in order for CFC rules to be effective all possible shareholders should be covered (basically both individuals and corporate entities). It is indeed clear that limiting the application of CFC provisions to certain shareholders could give room for circumventing these provisions.

48. As regards the second condition, i.e. foreign entities that are within the scope of CFC rules, the Commission services are of the view that this category should be broadly defined so that, in addition to corporate entities, CFC rules could ideally also apply to certain transparent entities (i.e. trusts and partnerships) and permanent establishments, if those entities earn income that raises BEPS concerns and those concerns are not addressed in another manner.\(^\text{14}\) However, for the purpose of assessing Member States' CFC provisions, the Commission has regarded as sufficient the application of these provisions to corporate entities and permanent establishments.

49. Finally, as far as control is concerned, there are two elements to be examined: (1) definition of control; and (2) level of control. As regards the definition of control, the Commission services believe that effective CFC rules should include, at least, both a legal and an economic control test. This means that control should result if either the legal or the economic control test is met. CFC provisions would be even more effective if they included *de facto* tests aimed at ensuring that legal and economic control tests are not circumvented.

50. A CFC should be considered as controlled where resident shareholders hold, at a minimum more than 50% control (lower thresholds are, of course, also acceptable). This control level should be determined through the aggregation of the interests of related parties. Moreover, both direct and indirect control should be taken into account.

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\(^{13}\) Such a test is very important for CFC established in EU Member State or EEA countries as, in this case, CFC rules could only be applied if the establishment of the controlled entity is wholly artificial or to the extent that the controlled entity engages in non-genuine arrangements.

\(^{14}\) This approach is consistent with the recommendations included in the report on BEPS Action 3.
IV. Assessment of effectiveness: preliminary results

51. The Commission services have made a preliminary assessment on the effectiveness of Member States' anti-abuse provisions. The following reservations apply to the assessment made:

- The assessment has been made for the specific purpose of monitoring the guidance on inbound profit transfers. It is therefore without prejudice to the compatibility of Member States' anti-abuse rules with EU law.

- The assessment is based, in addition to the responses provided by Member States to the 2012 questionnaire, on information at the disposal of the Commission services. Should Member States believe that any piece of information concerning their tax system is incorrect or inaccurate, they are invited to signal this to the Commission services which will promptly make the necessary amendments. Moreover, as information regarding some Member States is incomplete, unclear or outdated, further clarification would be needed, in any case, in order for the Commission services to make a final assessment.

52. The scoring system does not reflect the fact that, based on the "Study on Structures of Aggressive Tax Planning and Indicators", it would appear that, at present, a number of Member States de facto exempt a dividend payment although this payment is deductible by the distributing company (i.e. those Member States do not have a specific rule to turn the exemption off under these circumstances). It is expected that this problem would be addressed by the Member States concerned when transposing the amendment to the PSD on hybrid mismatches and/or when implementing anti-BEPS measures as recommended by the G20/OECD. Moreover, it may be that, in practice, double non-taxation would be avoided based on the application of other rules.

53. Based on the reasoning exposed under paragraphs 3.2 to 3.6 above, a Member State would score "effective" as far as switch over rules are concerned if:

- it applies a "low tax test" based on the computation method described above (or even stricter) possibly combined with an "activity/substance test" as described above.

54. A Member State would score "effective" as far as CFC rules are concerned if:

- it applies a "low tax test" based on the computation method described above and/or

- it applies a test whereby the controlled entity earn passive income above 50% of its overall revenues (or below) and

- it applies rules which are in line with the approach proposed by the Commission services as regards at least two of the following elements: the shareholders covered, the foreign entities to which CFC rules apply and the control test.
55. If a Member State that would not score as "effective" as regards its switch over provisions has "effective" CFC rules or vice versa, the final score will be "effective".

56. The results of the preliminary assessment (Annex 1) indicate that: 16 Member States have switch over and/or CFC provisions which can be regarded as "effective"; 6 Member States have switch over and/or CFC provisions whose functioning is, to some extent, unclear and with respect to which the Commission would therefore need clarifications before making an assessment; 5 Member States have switch over and/or CFC provision whose effectiveness is doubtful.

V. Way forward

57. Work in this area should continue with a view to arriving, within a reasonably short timeframe, to a final assessment of the effectiveness of Member States' legislation as regards inbound profit transfers.

58. However, the Commission services are not in a position to make a final assessment because the factual information at their disposal is, to some extent, incomplete, outdated or unclear. This is also a consequence of the fact that the questionnaire used by the Commission dates back to 2012 and, in the meantime, some Member States' legislations have changed. Moreover, some relevant issues that have emerged in the context of the OECD work on BEPS Action 3 are not fully reflected in the questionnaire.

59. To progress quickly, the Group should discuss the effectiveness criteria.

60. In any case, the Commission services would need to contact some Member States to get the information that is missing.

Questions:

1) Do Member States agree with the way the Commission services have defined the effectiveness of the requirements examined in this document?

2) If not, what are the elements on which you would disagree?

3) Do Member States agree with the Commission services' proposed way forward?
## Annex 1

<table>
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<tr>
<th>MS</th>
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<th>Preliminary results: effectiveness</th>
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15 Columns 2 to 4 concern the legal framework and summarise whether a Member State has CFC legislation and/or a switch over clause. Columns 5 to 7 concern the effectiveness of the legal framework in place.
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<td>Further info need on gateways and</td>
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