# Strategies to relocate debt within groups and domestic limitations to avoid base erosion

WSG Tax Meeting

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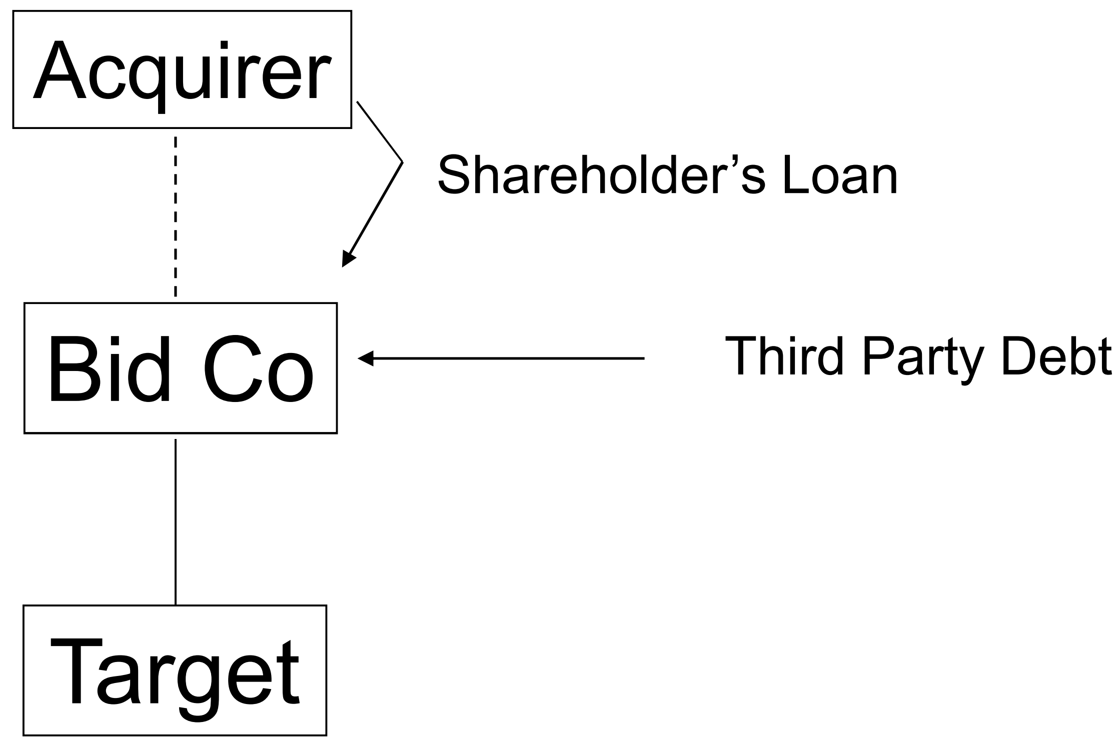
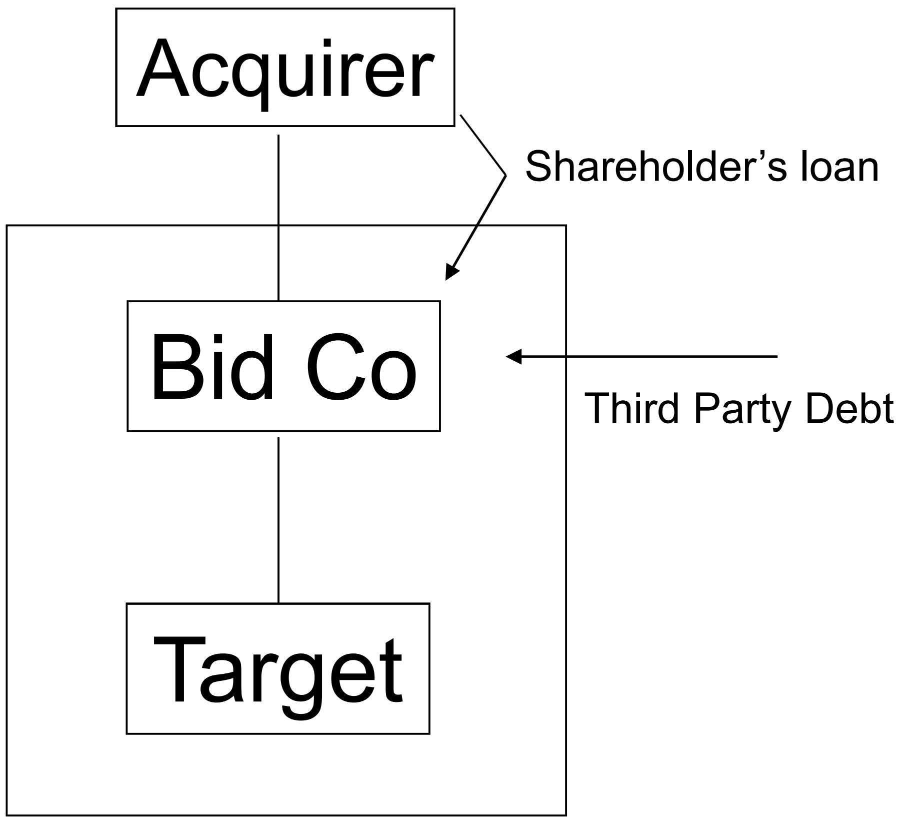
# Debt restructuring and relocating methods

- Debt push down
- Debt buyback
- Restructuring in a liquidation process

# Debt Push-Down



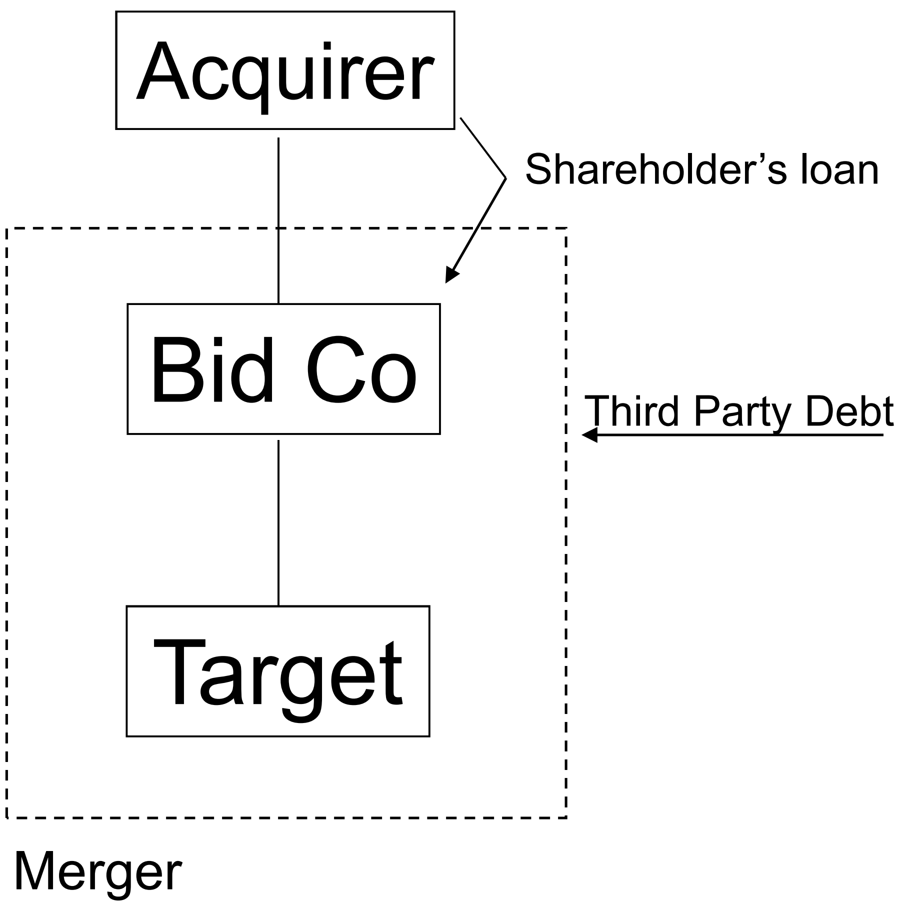
# Tax Consolidation/ Group relief




<u>Conditions</u>?
- Participation level
- Timing
-Administration formalities

<u>Limitations</u>?
-Thin capitalisation
-Transfer pricing
-Others

# Merger with Target




Conditions?

Limitations?

# Debt push down

Corporate tax aspects to address:

– Deductibility of interest expenses at Bidco/ Target level (pre-merger and post merger)
– Withholding taxes in the shareholder's loan
    - Interest/royalties directive: beneficial ownership issues
– Anti-avoidance provisions
– Transfer Pricing?
– Worldwide debt cap - UK

# Deductibility of interest - UK

- Loan relationship rules
- The amounts recognised in profit and loss account
- Connected companies must use amortised cost basis i.e. accruals basis
- FOREX charges treated in same way

# Use of interest - UK

- Distinction between trading and non-trading losses
- Set off against other general profits
- Group relief
- Carry forward/carry back

# UK - continued

- Connected Companies: interest paid > 12 months after year end AND
- Full amount of interest not brought into account by creditor and
- Creditor resident in non-qualifying territory i.e. no double tax treaty with non-discrimination provisions
- THEN deductible on PAID basis

# Unallowable purpose - UK

- If loan relationship has unallowable purpose interest relief restricted
- Unallowable purpose
- Not amongst business or other commercial purposes of the company
- Attributable to activities not within charge to corporation tax
- Tax avoidance purposes e.g. loan to football club
- Disallowance on just and reasonable basis

# Debt push down - Italy

**Interest deductibility**

- Interest expenses and assimilated costs may be fully deducted from entities' corporate tax base up to the amount of interest income realised by the same in a given fiscal year; any excess over that amount (the "Excess") may be deducted up to 30% of the "gross operating income" (similar to EBITDA) derived through the core business of the relevant company
  - for the above purposes, the "gross operating income" is calculated as the difference between (i) the value of production (item A of the profit and loss account scheme contained in art. 2425 of the Italian Civil Code) and (ii) the cost of production (item B of the profit and loss accounts scheme contained in art. 2425 of the Civil Code), excluding depreciation, amortization and financial leasing instalments relating to business assets
  - the relevant items are those resulting from the statutory profit and loss account of the company

# Debt push down - Italy

**Interest deductibility - general rule**

- Any Excess over the above threshold (i.e., 30% of EBITDA) may be carried forward (the "**Carried Forward Interest**") for deduction in the following fiscal years (without any time limit)

- Any excess of 30% of the EBITDA not utilised in a given fiscal year may be used to increase the deductibility basket (represented by the 30% EBITDA figure) in the following fiscal years

- In case of companies being party to a tax consolidation regime, any Excess generated after the inclusion in the tax consolidation may be used to offset the taxable income of another company within the tax consolidation up to the amount of (30% of) such company's EBITDA that has not been used to deduct its own interest expenses

# Debt push-down - Poland

**Rules on tax deductibility of interest**

- General rules applicable to all costs apply:

(a) incurred to generate, secure or sustain the source of revenues;

(b) not explicitly excluded from tax deductible costs (closed-ended list)

- Deductible on cash basis (when paid or capitalized)
- Limitations:

(a) Thin capitalization restrictions (3 to 1 debt to equity); limited „qualified lenders"

(b) Transfer pricing

(c) Acquisition or creation of fixed assets

- It may be concluded that currently, under Polish CIT, decreasing revenues by financial costs (interest) is not strongly restricted

# Debt push-down - Poland

- In case of debt push-down the general CIT rules will apply
- Literally, there may be doubts what is the revenue with which interest on loan drawn to finance the acquisition of the target should be matched, if any:

(a) acquisition of shares,

(b) dividend,

(c) disposal of shares

(d) revenues generated on general business activities)

- Direct and indirect cost of acquisition of a target – distinction
- Risks & ppractice of advance tax rulings



15

# Debt push down, Interest WHT - Italy

**Shareholder's loan**

- in a domestic scenario: no WHT
- cross-border scenario: interest payments would be normally subject to Italian WHT (levied at a 12.5% or a 27% WHT tax, reduced by tax treaties where applicable) unless Interest/Royalties Directive applies
    - To benefit from the exemption under the directive, Acquirer must be the beneficial owner of interest payments (see following slide)
- repayment of principal under the shareholder's loan would not trigger any Italian tax for the recipient

# Debt push down, Interest WHT - Italy

**Beneficial ownership**

- The beneficial owner of interest payments is that "*receiving payments in a capacity of final beneficiary and not of intermediary, such as an agent, representative or nominee*"

- the above is the only domestic provision defining (even if on a general basis) the beneficial ownership concept. However, it is possible to identify certain factors that might be relevant upon determining whether such requirement is met:
  - the relevant financing structure is grounded on sound commercial reasons (i.e. other than the tax saving purpose) which led to have the loan granted in that specific manner;
  - the Acquirer has a reasonable level of equity, which is somehow proportional to the amount of its loans and borrowings;

# Debt push down, Interest WHT - Italy

**Beneficial ownership (continues)**

- the Acquirer has an active role in the management of the fund flows and an adequate structure (e.g. in terms of skilled directors and personnel) to actually carry out such management;
  - the Acquirer achieves an economic benefit from the relevant lending activity;
  - the terms and conditions of the Shareholder's loan do not exactly mirror the terms and conditions of the credit provided by the third parties to the Acquirer
- In addition, since Acquirer would control Bidco, interest exceeding the rate in line with the arm's length principle would not benefit from the WHT exemption

# Debt push down, Interest WHT - UK

20% deduction at source, subject to:

- Interest paid to UK bank
- Quoted Eurobond
- Double tax treaty
- EU interest directive
- Funding bonds (PIK notes)

# Interest WHT - UK

- Only applies to annual interest not short interest
- Annual interest = interest on a loan expected to last for more than 12 months
- Beware series of short term loans

# Interest WHT – UK
# Quoted Eurobond Exemption

Definition:

- Issued by a company
- Listed on a recognised stock exchange
- Carries right to interest
  - e.g. Luxemburg

# Interest WHT – Double tax treaty relief - UK

- Rates reduced to 0 – 15%
- "beneficial ownership"
- Treaty passport scheme:
  - Applies to connected companies
  - Pre-approved structure

# Interest WHT – UK
# Zero Coupon Bond

- Issue Price 100
- Redemption Price 150
- Difference of 50 = discount
- Discount is not interest therefore no withholding
- If connected no deduction until redemption
- Issue series of short term ZCBs

# Interest WHT – UK Payments in Kind ("PIK")

- Instead of paying interest, issue PIK
- When interest paid by PIK 20% of PIK transferred to HMRC
- Deduction for interest on accruals basis

# Interest WHT – Poland

- Definition of interest
- Domestic withholding rate of 20%
- Interest & Royalties Directive – transitional period; exemption from 1 July 2013; now 5%
- Double tax treaty rates; transfer pricing & domestic WTH (Article 11.7 of DTTs – OECD Models)
- Tax residency certificate
- Beneficial ownership – double tax treaty interpretation
- Assignment of loans and DTTs benefits, specifically on WTH exemption on bank loans

# Restrictions on deductibility of interest - UK

Loan Relationship Rules overridden where:

- Distribution
- Transfer pricing/thin capitalisation
- Interest paid to avoid tax
- Worldwide debt cap

# Distribution - UK

Interest re-characterised as distribution when:

(a) Interest > reasonable commercial return
(b) Interest is results dependent
– In (a) excess is not deductible
– In (b) none of the interest is deductible

**Note:** If treated as distribution no withholding tax

# Transfer pricing - UK

- Substitutes arm's length price for actual price
- Exemption for small and medium sized enterprises

# Transfer pricing - UK

- Small enterprise:

  <50 employees, turnover €10 million; or B/S €10 million

- Medium Enterprise:

  < 250 employees, turnover €50 million; or B/S €43 million

# Thin capitalisation - UK

Relevant Factors:

- Whether loan would have been made in absence of special relationship
- The amount of the loan that would have been agreed in absence of special relationship
- Guarantees taken into account

# Thin capitalisation – UK

- Adjustment made purely for tax purposes
- UK borrower can make compensating payment
- Compensating payment ignored for tax purposes
- Useful tax-planning structure

# Interest paid to avoid tax - UK

- Aimed at bullet payment made at start of loan to claim deduction
- But has general application
- Only of limited application

# Debt Cap - UK

- What is the debt cap?
  - The debt cap restricts tax relief for finance expense of groups of companies
  - The aim is to restrict the UK net relief to the group consolidated gross finance expense
  - There is a detailed and rather complex calculation to be done to arrive at the disallowance

# Debt Cap - UK

- To whom does it apply?
  - The debt cap applies to any worldwide group (whether UK or foreign owned)
  - Defined as "any group of entities" which
    - is large
    - contains one or more "relevant group companies"

# Debt Cap - UK

- To whom does it apply?
  - Large:
    - EU definitions
    - > than 250 employees and
    - Annual turnover > €50m and/or balance sheet total €43m
  - "Relevant group company"
    - UK resident company of UK PE of non-resident; which is either
    - the parent company of group; or
    - a 75% subsidiary (with some extension)

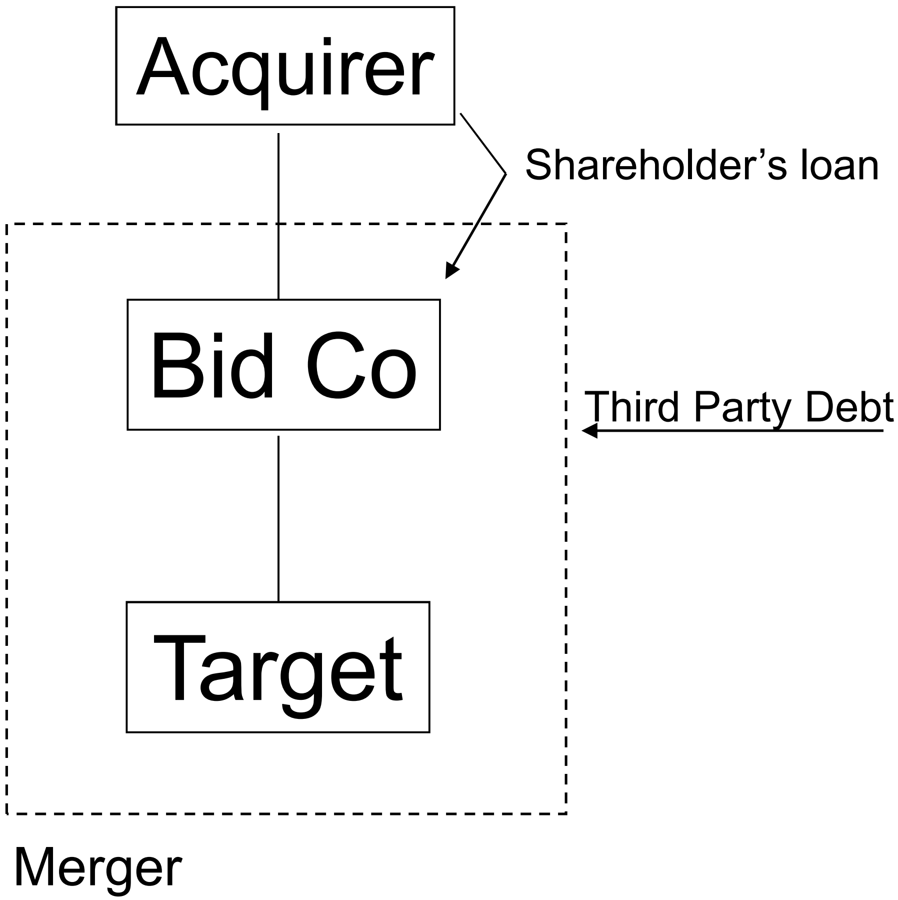
# Debt Cap - UK

- Only applies if UK group company net debt > 75% of world-wide group gross debt
- De-minimis cut off: any company with less than £3m net debt is ignored
- Further de-minimis in calculation of tested amounts

# Intra-group debt restructuring - Poland

- Debt transfers: various solutions
- Transfer pricing: assignment of loan principal against consideration and interest with no consideration; practice of advance tax ruling
- Transactional taxes
- Debt securitisation transactions
- Debt buy-back arrangements

# Merger with Target




Conditions?

Limitations?

# Poland

Merger method commonly used

- No general anti-avoidance provision
- Merger anti-avoidance provisions
- General succession of tax liabilities under the Tax Ordinance
- No aggressive approach of tax authorities subject to existance of merger justification; no tax cases of administrative courts

# Debt push down - Italy

**Interest deductibility - limitations in case of mergers**

- In case of mergers, any surplus of non-deducted interest expenses can be used by the company resulting from the merger provided that the same tests allowing the tax losses carry forward are passed: the “vitality test” and the “net equity test”:
  - “**vitality test**”: tax losses incurred by one of the merged companies prior to the merger may be carried forward only if the profit and loss account of the company whose losses are to be carried forward shows, for the fiscal year prior to the merger, gross proceeds and labor costs higher than 40% of the average of the two preceding financial years;
  - “**net equity test**”: the transferability of the tax losses of each company participating to the merger is limited to the net asset value of the relevant company before the merger, without taking in account capital contributions, if any, made in the 24 months preceding the merger

- If the vitality test and the net equity test are passed, the company resulting from the merger can carry forward the Extra EBITDA

# Debt push down - Italy

**Anti-avoidance**

- Certain leveraged acquisition structures devised to acquire Italian companies are being scrutinized by the Italian Tax Authorities ("**ITA**")

- ITA challenges the deductibility of interest expenses connected to the financings made available to the Italian vehicles on the basis of:

  i. a lack of inherency with the business of Bidco: in the view of ITA, based on a very aggressive interpretation of the OECD Transfer Pricing Guidelines, interest expenses incurred by Bidco for the acquisition of Target should be recharged to the foreign shareholder (Acquirer) as such expenses are not inherent to the Italian business;

  ii. anti-avoidance rules (in the context of a MLBO structure); or

  iii. the abuse of law principle

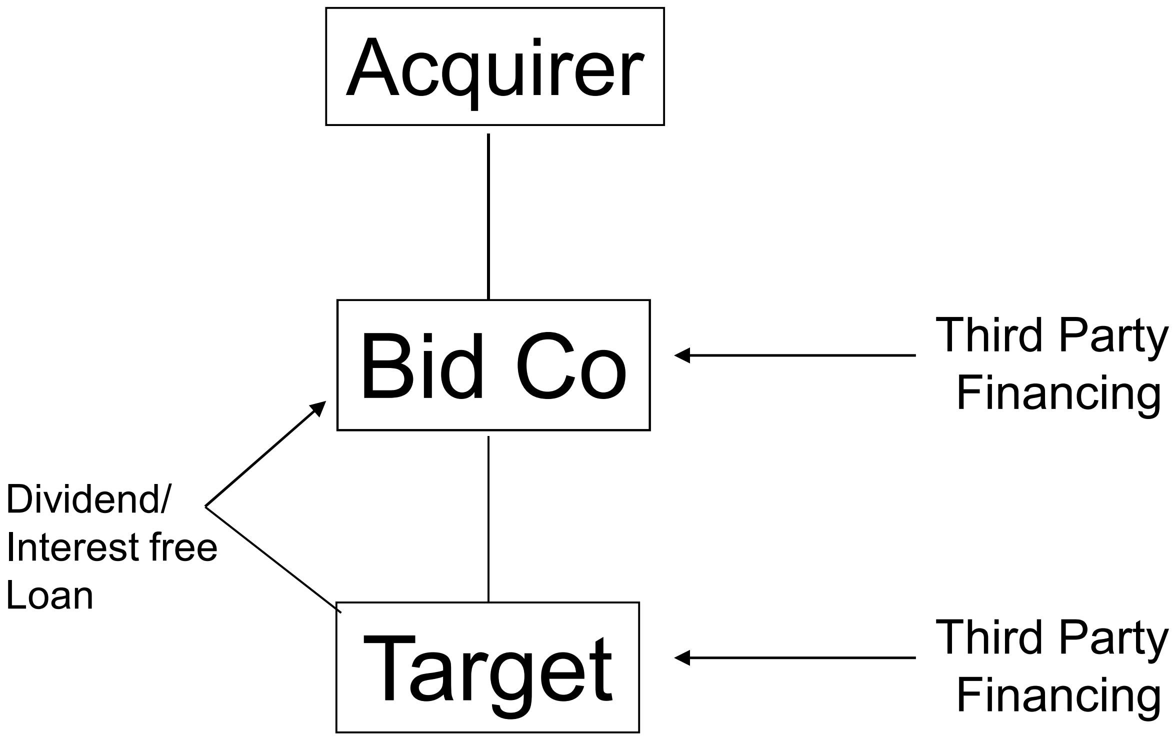
# Debt push down - Italy

**Anti-avoidance**

- The Italian Supreme Court (Decision No. 1372 of January 21, 2011) held that where applying the abuse of law principle:
  - a distinction shall be made between aggressive tax planning and taxpayer' freedom to choose the most adequate legal structures;
  - the factual circumstances must be taken into account; the strategy of groups of companies may not be comparable to that of a single entrepreneur (who may aim at achieving short-term profits);
  - the abusive nature of a transaction must be excluded where same is sustained by business motives (other than tax motives);
  - the fundamental freedoms protected by the Italian Constitution and by the EU Treaty may not be limited for tax reasons; in particular, the freedom of establishment implies a freedom to choose the most adequate business structure even if such structure is chosen exclusively for tax reasons

- In line with the above decision, a very recent decision issued by the Tax Court of first instance (Tax Court of Lombardy) No. 36/34 of April 13, 2011

# Dividend distribution/ Interest free loan to parent




Issues?

Limitations?

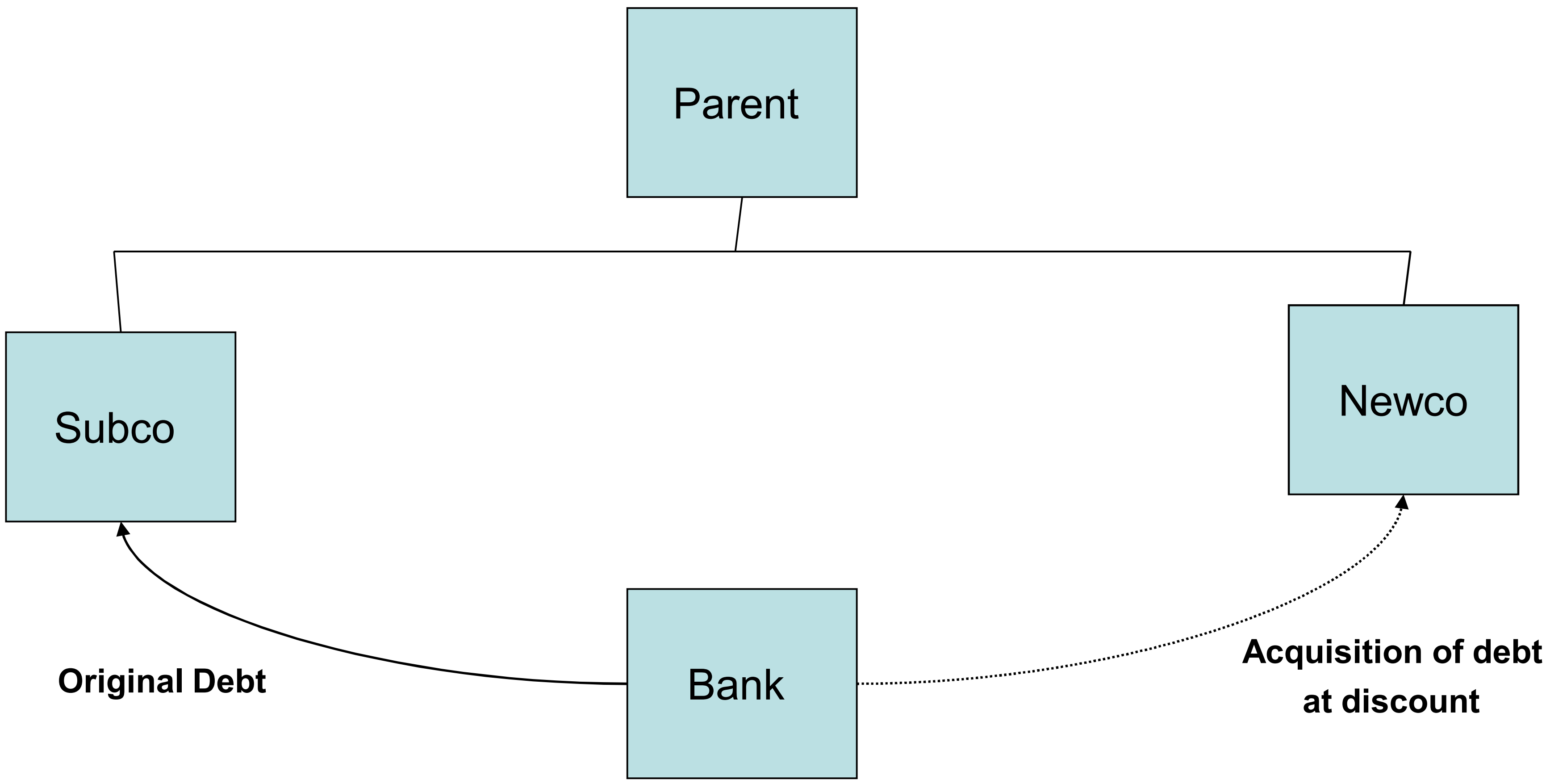
- Possible under corporate law?
- Financial assistance?
- Possible under tax law?

# Debt buy-back - UK

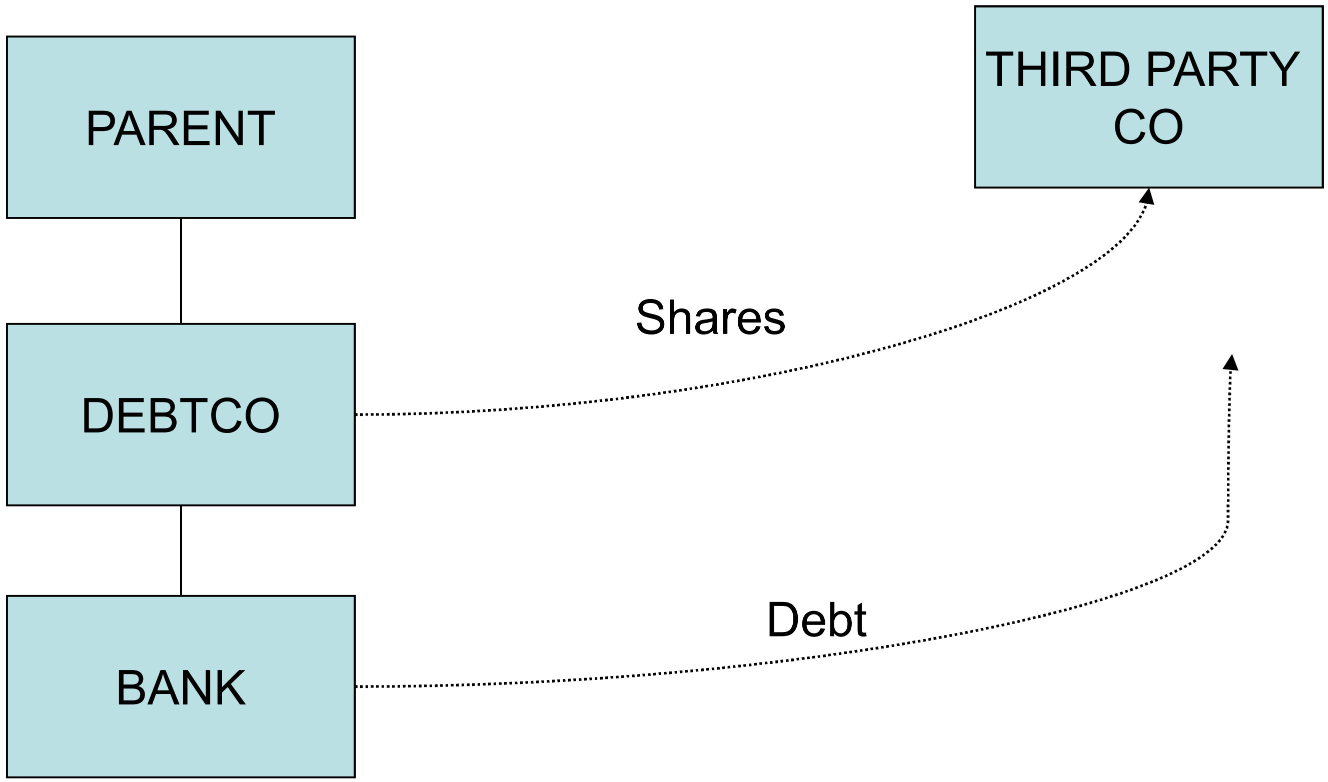
- If affiliate acquires debt at a discount from unconnected party for less than carrying value, then debtor taxed on difference between carrying value of the debt and cost of acquisition

- Three exceptions:
  – Corporate Rescue
  – Debt for debt
  – Equity debt

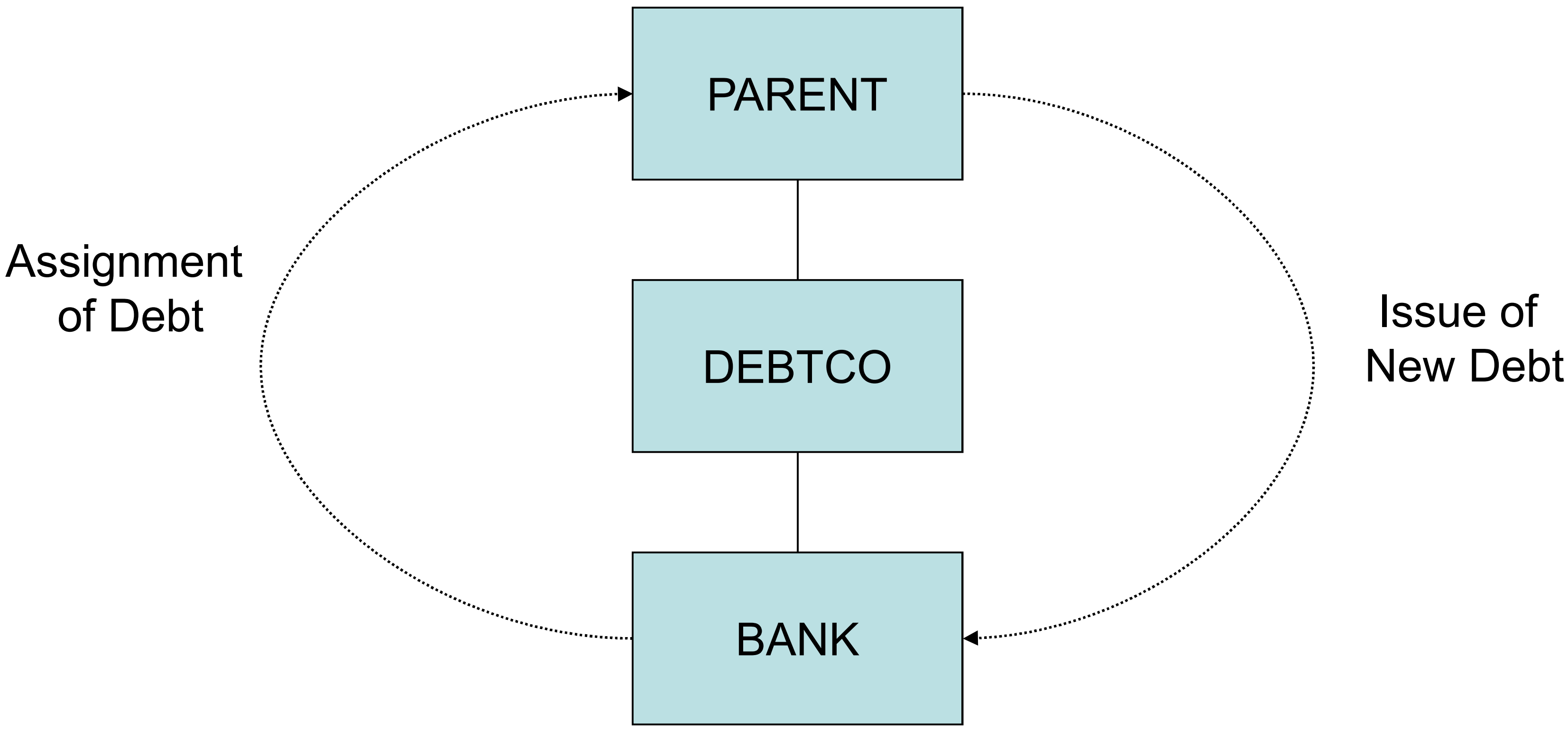
# Debt buy-back
# Original position



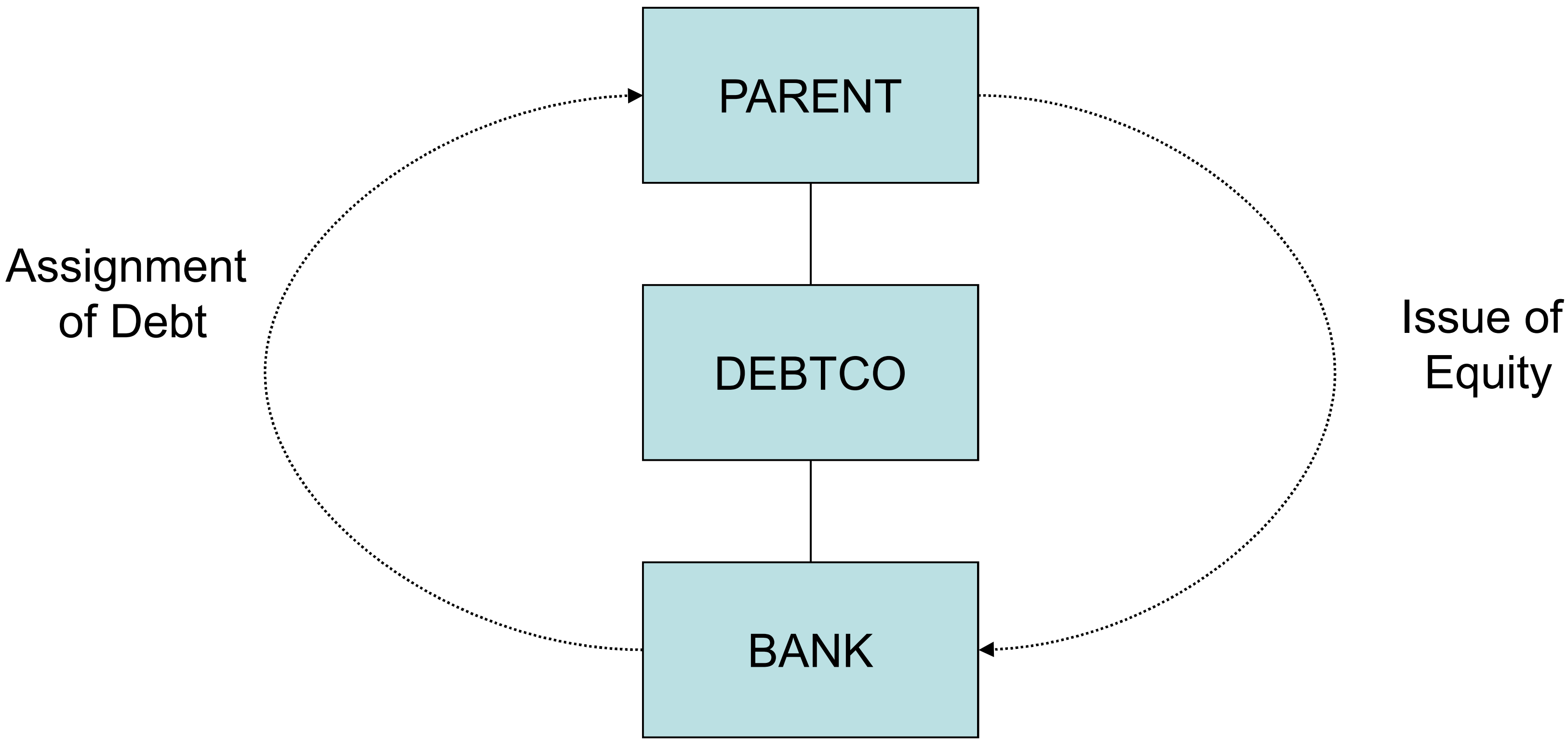
# Debt buy-back
# New Possibility



# Debt buy-back
# New Possibility



# Debt buy-back
# New Possibility



# Debt buy-back
# Corporate rescue exemption - UK

- Three requirements
- Change in ownership of debtor company
- Debt purchase intrinsic to change in ownership
- Reasonable to assume debtor company would have been insolvent

# Debt buy-back
# Debt for debt - UK

- Acquisition of old security is arm's length
- Consideration for acquisition = security issued by purchaser
- New security has same nominal value as old security and same market value at date of issue

# Debt buy-back
# Equity for debt exception - UK

- Two requirements:
- Acquisition is an arm's length transaction
- Consideration given by purchaser either ordinary shares in purchaser (or connected company); or
- An entitlement to ordinary shares in purchaser or company connected with purchaser.

# Restructuring in a liquidation process (1) - Italy

**Issues to consider**:

- The waiver of a **debt** generally characterises as an **extraordinary item of income** subject to taxes in the hands of the debtor for corporate income tax purposes
  - the Italian Income Tax Code provides for that an extraordinary item of income occurs where a liability that has been registered in the company's financial statements becomes inexistent

**Exceptions**

- Where the waiver of company's debt is granted within:
  - a pre-insolvency composition with creditors (*concordato preventivo*)
  - an insolvency composition with creditors; and
  - under certain circumstances other debt restructuring agreement

  Even if the above proceedings entail the agreement of creditors to be paid in an amount lower than their original credit, the reduction of the company's debts, does not trigger any taxes on the extraordinary item of income

# Restructuring in a liquidation process (2) - Italy

**Exceptions (continues)**

1. Waiver by a shareholder of a credit vis-à-vis its participating company
   - no extraordinary item of income occurs and the amounts waived increase the value of the shareholders' participation
     - however, according to the Italian tax authorities, withholding taxes, where due, on any interest component of the waiver should be levied under the "*incasso giuridico*" doctrine
       - this doctrine is based on the assumption that the waiver concerns income to be acquired on a cash basis (such as interest paid to a non resident shareholder) while the debtor has deducted interest on an accrual basis; in such cases, in order to prevent double dipping, the interest due to a non resident shareholder, although it has been waived, is presumptively deemed to be cashed (in spite of the waiver)

# Creditor in insolvent liquidation - UK

- Debtor not required to bring release into charge

# Intra-Group debt restructuring (liquidation) - Poland

- Activating accrued interest: debt-to-equity swap; cash increase of capital and set off
- Withholding tax
- Transfer pricing
- Assignments of debt within the Group


56

# Recent tax developments - debt (re)structuring (Poland)

- Tax treatment of profit participating loans (administrative court judgment 2010, awaiting for final judgment of the Supreme Administrative Court)

- Withholding-tax treatment of interest on loans after debt assignment - bank loan – non-bank assignment (double-tax prevention treaty cases)

- Telecom case – interest free loans & merger; conditions for taxation of free benefit from free use of capital



57

# Debt releases/waivers - UK

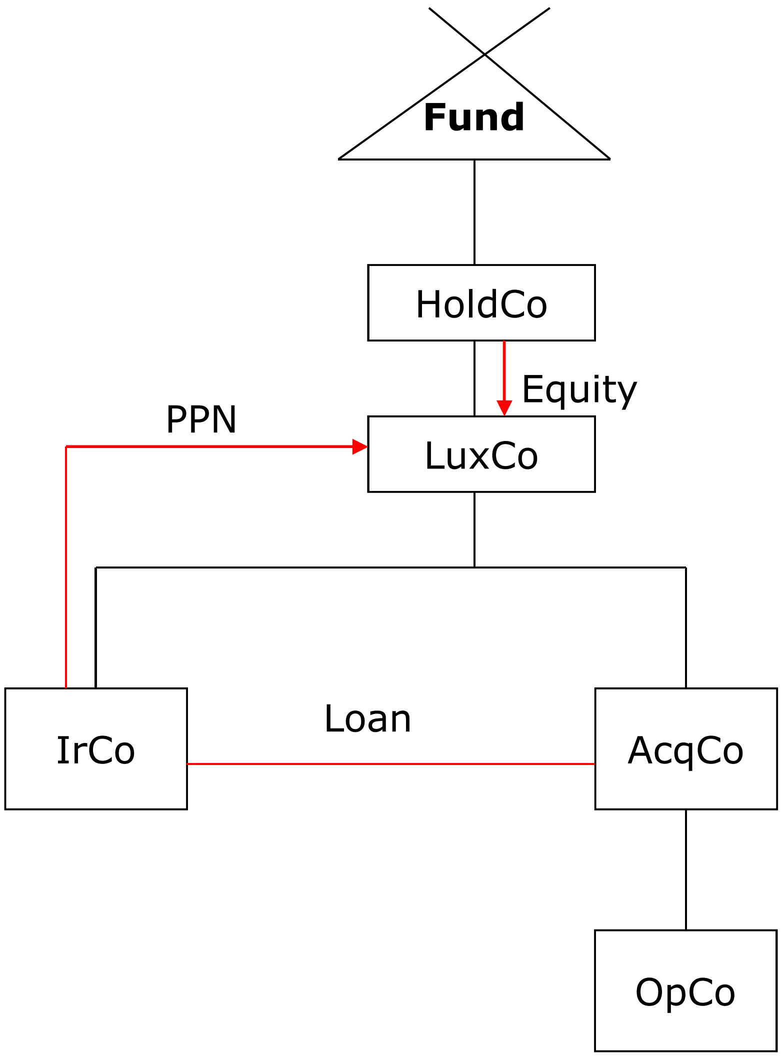
- Basic rule for connected companies:
  - No tax relief for creditor
  - No tax charge on debtor
  - Exceptions for creditor:
    - Debt for equity swap
    - Creditor is insolvent

# Debt/Equity Swap - UK

Creditor gets tax relief if:

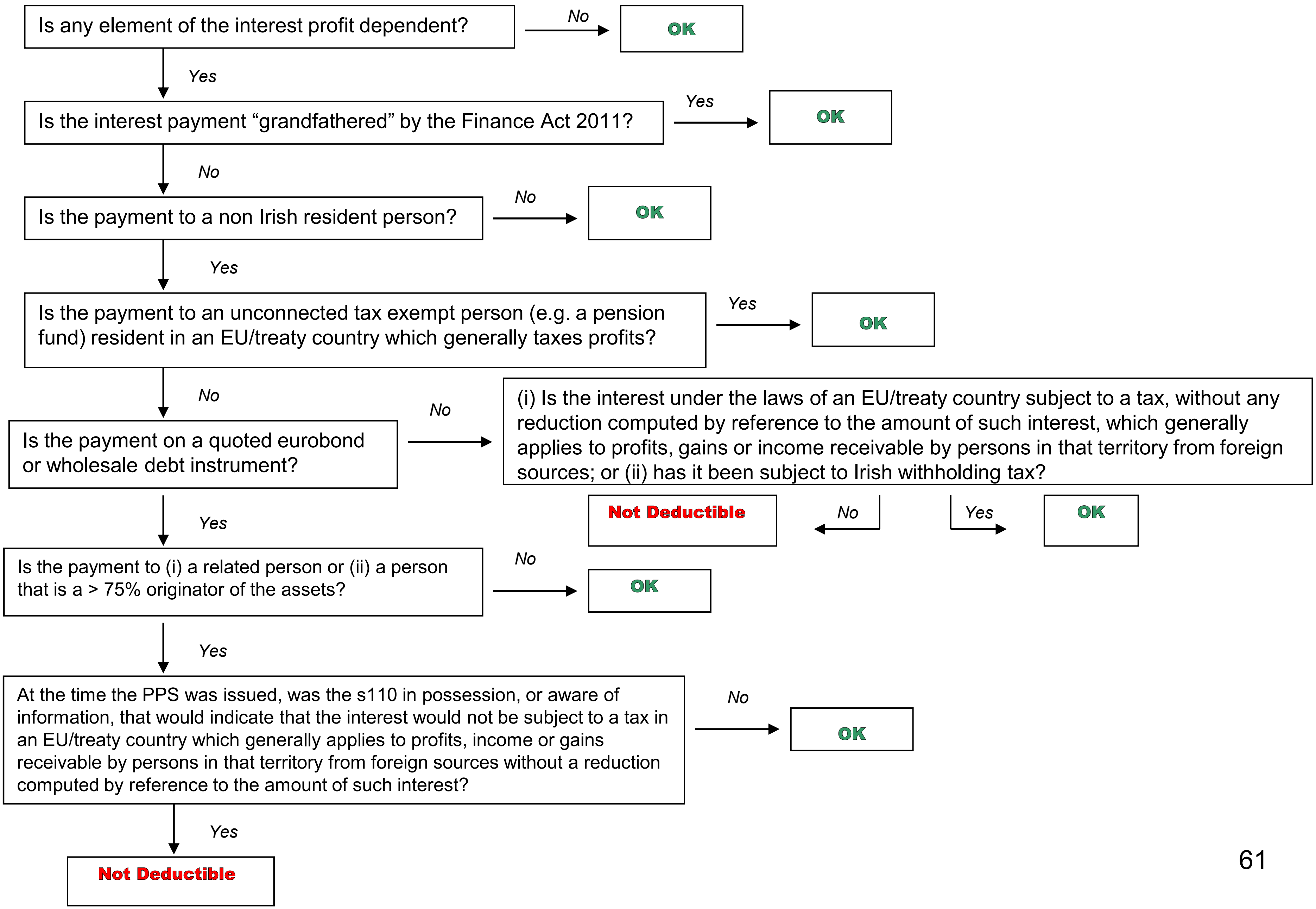
- Debt is discharged in consideration of ordinary shares in debtor company
- No connection prior to the acquisition of shares

# Private Equity – Acquisition Financing

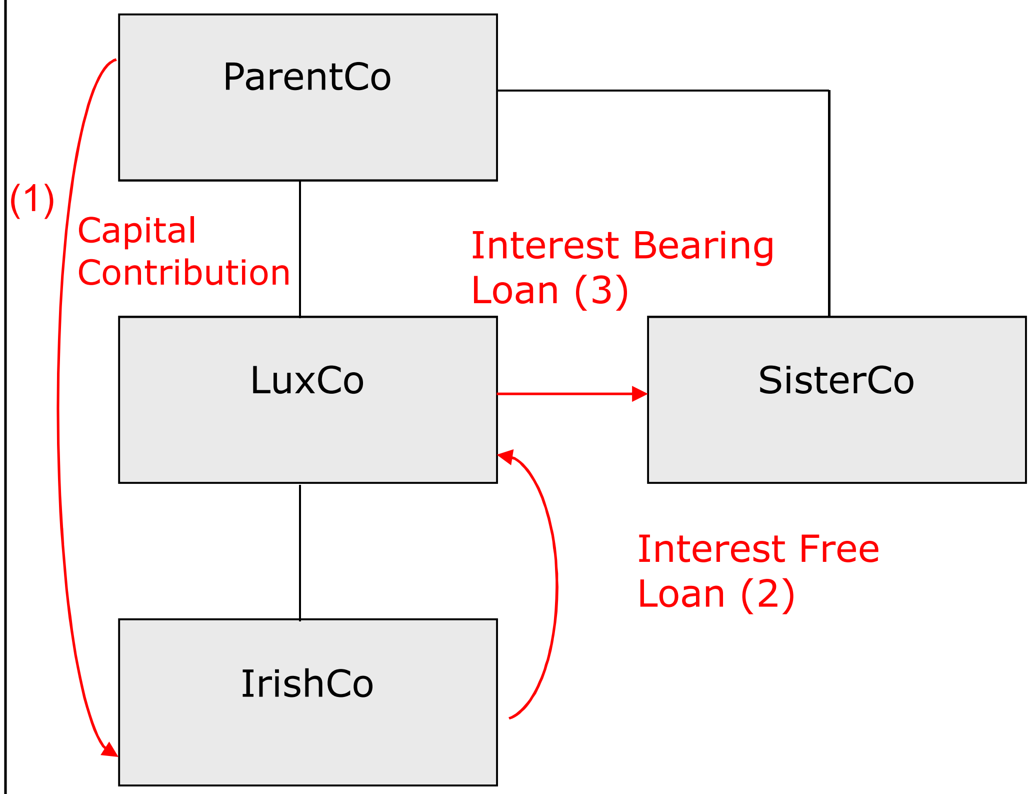



- **Steps:**
  - HoldCo borrows part of acquisition price from third party bank
  - HoldCo subscribes for additional equity in LuxCo
  - LuxCo subscribes for a Profit Participating Note (PPN) issued by IrCo
  - IrCo lends to AcqCo
- **Tax Position:**
  - interest deductions on bank debt can be used to shelter other income generated in HoldCo's jurisdiction
  - receipt of interest on PPN by LuxCo benefits from Lux participation exemption
  - minimal tax at level of IrCo – income on loan to AcqCo matched by interest paid on PPN
  - interest deductions on debt paid by AcqCo can be used to shelter against income generated by the OpCo

# Decision Tree For The Deductibility of Interest Payable on a Profit Participating Security (PPS) by a Section 110 company (s110)



# Tax Arbitrage – interest free loan




- **IrishCo**
  - – no income attributed
  - - no Irish CIT
- **LuxCo**
  - – Income from SisterCo sheltered by deemed interest expense on (2)

# Thank you

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