Tax Management International Forum

Comparative Tax Law for the International Practitioner

Hybrid Transactions in the Form of Loans

In this issue of the International Forum, leading experts from 19 countries and the European Union address the ways that Forum countries deal with hybrid transactions in the form of loans. Hybrid mismatch arrangements that can produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction have been a driving concern for the Organisation for Economic Cooperation and Development. In its final report under Action 2 of its action plan on base erosion and profit shifting (BEPS), the OECD called on tax authorities to adopt domestic rules that would prevent taxpayers from exploiting differences in the tax treatment of a financial instrument to create unintended tax benefits.

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Contents

THE TAX MANAGEMENT INTERNATIONAL FORUM is designed to present a comparative study of typical international tax law problems by FORUM members who are distinguished practitioners in major industrial countries. Their scholarly discussions focus on the operational questions posed by a fact pattern under the statutory and decisional laws of their respective FORUM country, with practical recommendations whenever appropriate.

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THE FORUM

Hybrid Transactions In the Form of Loans

Topic

These questions examine how Forum countries deal with transactions that may fall under the OECD's BEPS recommendations dealing with hybrid transactions in the form of loans. The OECD's principal rule calls for a "payer jurisdiction" to deny a deduction if a payment "gives rise to" a "deduction/non-inclusion" outcome.

Questions

I. Assume that a corporation (FCo) in a foreign country (FC) has advanced funds to a corporation (HCo) in your country (HC). On the books of HCo, this transaction is recorded as a liability. Might the HC tax authority seek to recharacterize the transaction under HC income tax law as a transaction that is not a loan in the circumstances described below?

A. FCo treats the transaction as a loan for FC accounting and income tax purposes, but there is no documentation such as a loan agreement. What would be the general rules under HC income tax law for making a recharacterization, if one would be made? Would it matter whether or not HCo and FCo are related?

B. FCo does not treat the transaction as a loan for FC accounting and income tax purposes. What would be the general rules under HC income tax law for making a recharacterization, in this case? Are those rules different from those discussed under I.A.? Would it matter whether or not HCo and FCo are related?

C. Would your answer to question I.A. differ if a loan agreement of some sort does exist? What effect would this have? If a loan agreement by itself would not change the result, could additional factors cause such a change? What would (or might) those be?

II. Assume that the transaction is accepted by the HC tax authority as a borrowing by HCo from a nonresident lender:

A. What are the general rules regarding the deduction of interest paid to a nonresident lender? Do they differ if it is known that the lender does not include the interest income in taxable income? (And if so, how?) Does it matter if the lender and borrower are related?

B. Are there specific limits to an interest deduction based on the ratio of debt to equity? Has HC adopted the OECD's proposed worldwide ratio test? If so, how is this test applied? Does it matter if the lender and borrower are related?

C. Does HC tax law limit an interest deduction based on other factors? If so, what are these other factors, and how do they affect the deduction?

D. Does HC income tax law allow the tax authority to determine that part of a debt will not generate an interest deduction, but that some part of it may? (i.e., does the law permit "bifurcation" of a transaction into some portion that permits deductible interest, and some portion that does not?)

E. How would an income tax treaty affect the answers just given? For example, do HC's treaties permit full or partial ("bifurcated") recharacterization? If interest on an advance that is accepted as debt exceeds a reasonable interest rate, how is the interest treated for deduction and treaty purposes?

III. The questions above considered an FC corporate party as the lender. If FCo were an entity that is treated as transparent for FC tax purposes, such as a partnership, how would any answers above change?

IV. How would answers above differ (if they would differ) if the advance is made by FCo, a foreign corporation that has a permanent establishment (PE) in HC? (i.e., the interest may in principle be deductible by the payer, but HC tax law in principle may apply to the lender.) What factors would be necessary to attract the interest to that PE?

V. Are legislative changes to the above matters proposed or in the legislative process? If so what are they, and what do you see as the likelihood that they will come into effect?

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ARGENTINA

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I. Possibility of Argentine Tax Authorities Recharacterizing Advance of Funds by FCo to ArgeCo

General Comment

Whether to finance an Argentine entity's business and activities with debt or equity is one of the most important choices facing investors doing business in Argentina — both at the time the initial investment decision is made and during the subsequent life of the investment, particularly in a cross-border context. This is a result of the fact that, in addressing the debt-equity conundrum, Argentine income tax law adopts the traditional system in which debt and equity financing are associated with entirely different tax consequences at the level of the Argentine entity (here, ArgeCo), i.e., interest is deductible for the borrower while profit distributions are not. This fundamental difference in treatment makes loan financing preferable for tax purposes for profitable business borrowers. At the same time, it makes the Argentine tax authorities particularly alert to the potential use of artificial cross-border arrangements and the use of hybrids aimed at preserving an Argentine borrower's (i.e., ArgeCo's) interest deductions, in circumstances where they would not otherwise be available. Against this background, it is not uncommon for the tax authorities to challenge arrangements with a view to recharacterizing debt as equity.

As already noted, dividends are not deductible for Argentine tax purposes — nor are they subject to withholding tax under Argentine tax law (unless distributed out of non-taxable corporate earnings and profits, in which case an equalization tax applies).[1] Interest, on the other hand, is deductible for the payer, but taxed in the hands of the recipient via a withholding mechanism; the applicable withholding tax rate is 35%, (equal to the statutory corporate tax rate) unless an applicable tax treaty provides otherwise,[2] or the foreign beneficiary is a financial institution, in which case the effective domestic withholding tax generally[3] falls to 15.05%.[4]

Thus, where interest is subject to withholding tax at a rate lower than the 35% statutory corporate income tax rate, considerable intra-group tax advantages may arise from the use of debt-financing schemes (not only for the ArgeCo borrower but also for the group as a whole). Moreover, during periods of currency fluctuation, in addition to the interest deductions, exchange loss deductions may reduce an Argentine borrower's tax base even further.

As a result of this statutorily created preference for debt financing over equity financing, and Argentina's historical position as a net capital importing country, the tax legislation has for many years contained anti-base erosion rules restricting the deduction of cross-border expenses generally, and interest in particular. In addition, the tax authorities have for many years consistently scrutinized and challenged certain presumed tainted financing schemes using the Argentine general anti-abuse rule (GAAR — i.e., the economic reality principle).

1. The Deduction of Interest

As a general rule, Argentine tax law allows the deduction from gross taxable income of both interest expenses and foreign exchange losses.[5] However, the Argentine tax authorities have challenged the deduction of interest and foreign exchange losses deriving from certain loans obtained to acquire equity participation. The argument behind such challenges revolves around the untaxed nature of equity yields (i.e., dividends) and the ITL's mandate that allows the deduction of expenses only if they are or have been incurred to obtain taxable income. The most significant argument used to counter this challenge, in turn, revolves around the accounting principle pursuant to which liabilities are deemed to finance corporate assets in their aggregate rather than being traced to a particular asset; of course this argument is much more feasible in the case of operating entities (as opposed to exclusive holding entities), where taxable-income producing assets coexist with untaxed-income producing assets. The taxpayer's position based on the application of this accounting principle has been upheld by the courts in cases where loans were used to finance dividend distributions, capital reductions or redemptions, but there have been cases with similar fact patterns in which the opposite conclusion has been reached.[6]

2. Statutory Restrictions on the Deduction of Interest

Interest deductions are subject to statutory limitations under the ITL; current limitations include transfer-pricing adjustments, and thin capitalization and time-matching rules. These limitations apply only when the foreign lender and the Argentine borrower are related parties, as statutorily defined, or, in the

case of the transfer pricing and time-matching rules, when the lender is located in a non-cooperative foreign jurisdiction.

The ITL contains a definition of "related parties" with uniform application for all relevant income tax purposes. Under this definition, a local company or permanent establishment (PE) is deemed related to a foreign party if the latter: (1) directly or indirectly manages or controls (or is managed or controlled by) the Argentine party; or (2) has the power to direct or define the activity of the Argentine party (or is subject to the latter's power to direct or define its activity) as a result of equity participation, inter-company indebtedness or any other type of influence.[7]

Implementing regulations issued by the tax authorities offer specific examples of related parties. The following factors, *inter alia*, evidence a relationship of control:

- Common directors, officers or administrators;
- Exclusive agency, distributorship or dealership for the purchase and sale of goods, services or rights on behalf of the other party;
- The supply of technology or know-how for the Argentine party's business activity;
- A business association (for example, a joint venture, an alliance or a partnership) that influences the determination of prices; and
- The provision of substantial funds required for the performance of business activities by the other party (for example, via a loan or guarantee of any kind).

Since the definition of related parties implies the existence of an economic link that is usually associated with control, management, decision-making or influence with respect to the local company's activities, in a case of indebtedness (for the foreign lender to be considered a related party), that type of economic relationship would only be deemed to exist if and when the lender was able to influence the course of the borrower's business under the terms and conditions of the indebtedness (for example, by deciding or controlling distribution channels, additional financing means, payment terms, dividend distribution policies, etc.).[8]

Although there is no precedent on point, it is the authors' opinion that these administrative regulations go beyond the regulated legislation by introducing new assumptions of control. In this regard, it could be argued that a finding that a transaction has been agreed on between related parties must be based on specific circumstances evidencing equity or functional control.[9]

As noted above, these deduction limitation rules (with the exception of the thin capitalization rules) also apply to transactions entered into with entities located in "non-cooperative jurisdictions." In the past, these rules and other anti-avoidance rules used to refer to "low or no-tax (black-listed) jurisdictions."[10] Under an amendment to the ITL passed in 2013, all ITL references to "low or no-tax jurisdictions" are to be understood as referring to "non-cooperative countries for purposes of fiscal transparency." The regulations further state that cooperative countries for purposes of fiscal transparency are those countries, territories, jurisdictions or special regimes that have signed with Argentina TIEAs or tax treaties containing broad exchange of information clauses, to the extent the exchange of information is effective. Countries may also qualify where they initiate negotiations to enter into either one of the previously mentioned types of agreements. In addition, to the extent possible, these agreements are to observe the standards adopted by the OECD Global Forum on Transparency and Exchange of Information.

A list of cooperative jurisdictions is not provided in the regulations, but is published on the tax authorities' official website. This constitutes a flexible regime under which the tax authorities evaluate and determine on an ongoing basis whether a jurisdiction is to be included on a dynamic list. The last released list (applicable from January 1, 2016) regards as cooperative jurisdictions Hong Kong and most of the traditional tax havens (the Cayman Islands, Bermuda, Georgia, Guernsey, the British Virgin Islands, and Turks and Caicos).[11]

a. Thin Capitalization Rules

Argentina's thin capitalization rules apply to interest payable to foreign related lenders, when the Argentine borrower's debt-to-equity ratio exceeds 2:1. In those circumstances, the full interest expense accrued on the debt exceeding the 2:1 ratio is disallowed as a deduction and recharacterized as a dividend distribution.

The thin capitalization rules do not apply when the effective rate of withholding tax on the interest payments is 35% or higher. Thus, for the thin capitalization rules to apply, interest must be subject to withholding tax at a lower effective rate under domestic law (i.e., 15.05%) or at a reduced treaty rate.

b. Transfer Pricing Rules

As already noted, related party transactions and dealings with entities located in non-cooperative jurisdictions are deemed not to have been entered into at arm's length, and hence are subject to transfer pricing adjustments.

c. Time Matching Rules

Under the ITL, expenses (including interest on corporate financing) incurred by a domestic entity that give rise to Argentine-source income in the hands of a foreign related entity or an entity resident in a non-cooperative jurisdiction may not be deducted unless they are actually paid or constructively received by the foreign beneficiary prior to the filing date for the income tax return of the domestic entity corresponding to the taxable year in which the expenses accrued.

3. Recharacterization Challenges

There are no statutory rules in the ITL or its implementing regulations providing clear guidance on debt/equity recharacterization. Nonetheless, when auditing fiscal years 2001 and 2002, a period during which there were enormous foreign exchange losses as a result of the devaluation that followed Argentina's withdrawal from convertibility (i.e., when the Argentine peso was pegged to the U.S. dollar by law), the Argentine tax authorities focused their attention on

interest and foreign exchange loss deductions, providing precise auditing guidelines distinguishing between genuine borrowing and disguised equity (which does not support tax deductions); these guidelines were set out in Instruction 747/05 (the "Instruction").

Although the guidelines were developed to examine and determine the treatment to be accorded to cross-border debt financing in that particular context, it is worth noting that they remain the only practical guidelines reflecting the tax authorities' position on the issue. It therefore seems likely that, if the devaluation of the Argentine peso that took place at the end of 2013, the end of 2015 and during the first few months of 2016 prompts the tax authorities to challenge arrangements giving rise to interest expenses and foreign exchange losses incurred during those years, the guidelines contained in the Instruction also will be used in the ensuing discussions, findings and conclusions.

The Instruction resurrected standards developed in prior administrative and judicial decisions applying a GAAR (the Argentine substance-over-form principle or *principio de la realidad económica*) to back-to-back and other financing schemes used by lenders resident in, or making use of, tax haven jurisdictions.

In general terms, the Instruction states that third-party debt financing may be challenged and recharacterized as equity based on certain facts and circumstances, including:

- A lack of standard loan documentation (for example, a document indicating a "date certain"[12] with respect to the obligation, which is a condition for an obligation to become effective against third parties under Argentine substantive law) and a lack of evidence of an actual transfer of funds;
- The absence of a specific repayment schedule;
- The existence of a reasonable relationship between the amount loaned and the borrower's net worth; and
- The lender's subjective expectations concerning the loan (for example, repayment, assumption of risks, permanence of the funds).

The Instruction could have included (but did not include) other standards routinely used by the tax authorities and the courts to assess genuine lending, such as:

- A lack of standard auditing procedures to assess the borrower's business risk and repayment ability;
- A lack of guarantees to secure repayment (for example, liens on real property and other business assets, pledges of stock or other intangibles, or personal guarantees);
- The disbursement of loan proceeds before the full satisfaction of agreed-upon conditions precedent; and
- The lender's response to default on the part of the borrower with respect to payment (for example, unwillingness to sue or renegotiate the payment terms, etc.).

The existence of one or a combination of the above facts and circumstances has supported court conclusions that a lending transaction was not genuine, and thus, that the borrower's deductions on account of interest and foreign exchange losses should be disallowed. In some cases, the position taken by the tax authorities and later confirmed by the judiciary was that the alleged financing disguised what was in fact a capital contribution; in others, the principal of the tainted loan was recharacterized as an unjustified taxable increase in net worth (*enriquecimiento patrimonial no justificado*) of the domestic borrower (i.e., a fake financing made out of the borrower's previously undeclared funds, which is taxable in the latter's hands at a 35% rate).

Such conclusions have been reached even when the financing arrangement that was the subject of the challenge was granted by a recognized financial institution. In this regard, it is worth mentioning *Autolatina* (an Argentine joint venture of Ford Motor Co. and Volkswagen AG), in which the Supreme Court analyzed a back-to-back lending structure. The case concerned a loan made by Deutsche Bank New York to Ford Argentina, which was secured by a cash deposit maintained by Ford Argentina with the lender.[13] The Supreme Court held that the taxpayer had not demonstrated the existence of a genuine loan consistent with the criteria set forth in the then-applicable Argentine National Civil and Commercial Codes, and further, that the written evidence showed that Deutsche Bank acted as a mere intermediary without assuming lender-type credit risks. The Supreme Court was also of the opinion that, although the taxpayer asserted that the remittance and reception of the funds had been evidenced, the sender of the funds was never duly identified. Thus, in addition to upholding the tax authorities' challenge to the interest and foreign exchange loss deductions, the Supreme Court held that the amount of the loan was an unjustified increase in net worth taxable in the hands of the borrower (Ford Motor-Autolatina) at the 35% statutory corporate tax rate. Finally, the Court held that the bank was not the effective beneficiary of interest paid under the loan and, therefore, validated the application of the non-documented expenses rule under which the amount of expenses unsupported by sufficient evidence and identification of the beneficiary are subject to income tax in the hands of the payor.

Case law handed down after *Autolatina* has further held that evidence on the existence of a debt must be indisputable. In this regard, it has been emphasized that the complete sequence of the transaction carried out must be demonstrated; in particular, the following facts/steps must be proven: (1) ownership of the borrowed funds; (2) delivery of the borrowed funds to the borrower and their subsequent application to the borrower's business; and (3) reimbursement of the lender.[14]

Notwithstanding the foregoing, the Courts have stated that a tax authority challenge based solely on an assumption built simply on the lack of repayment (the usual expectation in an equity financing scheme), cannot be upheld even though lack of repayment is deemed by the Instruction to be an important indicator; otherwise, the tax authorities would be afforded the ability to maintain the existence of fraud based merely on mistrust or lack of fulfillment.[15]

In summary, as a capital importer, Argentina had developed both statutory and case law rules aimed at preventing the erosion of the national tax base even before the BEPS Action Plan was conceived and implemented. In particular, transfer pricing rules,

thin capitalization rules and time-matching rules have been used for that purpose, along with GAAR developments. In addition, the statutory imposition of a withholding tax with respect to inter-company financing (unless treaty protected) at a rate equal to the corporate tax rate has functioned as an effective deterrent to the utilization of structures giving rise to highly leveraged Argentine entities. As far as recharacterization precedents are concerned, although most concern back-to-back transactions and disguised equity financing schemes, administrative and court guidelines developed in that context are commonly used to assert the existence of a qualifying (genuine) financing structure and, hence, to assess the applicable tax treatment.

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

The fact that a document indicating a date certain[16] with respect to an obligation is a necessary condition for the obligation to become effective against third parties under Argentine law, has led the tax authorities and the courts to focus on a written loan agreement as the primary element for providing evidence of the existence of debt financing.[17] In addition to the loan agreement itself, other standard documentation considered by the courts as evidence of a genuine debt has been reports or notes from board meetings analyzing the convenience of executing the loan agreement or its extensions. In other cases, the registration of the loan in the financial statements of the debtor coupled with a special note explaining the destination of the borrowed funds has been deemed significant.[18]

That being said, the lack of a written agreement has not always been a decisive factor supporting recharacterization, and the courts have admitted *succedaneum* (i.e., alternative) evidence demonstrating the existence of genuine financing (for example, the lender's ownership of the borrowed funds and sufficient lending capacity, the lender's actual disbursement of those funds to the borrower, the application or use of the funds by the borrower, and the borrower's repayment of the borrowed funds).[19] In this respect, it is worth mentioning the arguments made by the Federal Tax Court relaxing the formal documentation requirements in a case involving a loan by Ericsson Treasury Service (a Swedish company) to its related Argentine party, Compañía Ericsson.[20] The Federal Tax Court accepted that agreements between related parties may not necessarily comply with all the formal requirements applicable to transactions between independent companies. The court specifically referred to the OECD Transfer Pricing Guidelines to support its conclusion. The OECD Guidelines recognize that related parties may conduct transactions in a manner different from that in which transactions are conducted between wholly independent parties. Further, the Guidelines acknowledge that the terms of a transaction may also arise from correspondence and communications between the parties, rather than from a single, integrated written contract. The Federal Tax Court held that the relative informality of the inter-company loan did not imply an attempt to avoid tax. The court noted that its finding was further supported by the similarity of the terms and conditions of the inter-company loan with a subsequent bank loan.[21]

The existence of a written loan agreement with a date certain[22] and the relevant authentications if the document is executed outside Argentina is recommended in order to avoid recharacterization risks under a strictly formal approach. However, it is unlikely that the mere absence of a formal written loan agreement would allow the tax authorities successfully to challenge in court the existence of genuine debt financing, particularly when the complete sequence of the transaction can be demonstrated (the lender's ownership of the borrowed funds and sufficient lending capacity, the lender's actual disbursement of those funds to the borrower, the application or use of the funds by the borrower, and the borrower's repayment of the borrowed funds, plus interest thereon).

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Argentina has no statutory rule referring to the accounting and/or income tax treatment of a financing instrument in a foreign country. Nor are there any administrative precedents in which the tax authorities have relied on foreign country accounting and/or income tax rules in analyzing the nature of a financing structure.[23] Moreover, unless a statutory rule requires an Argentine debtor to provide evidence of how a financing instrument is recorded in the books of a foreign lender, the Argentine tax authorities will only be entitled to access such information under a tax exchange of information agreement (TIEA) or tax treaty procedure.

Nonetheless, there have been some isolated cases in which evidence of a foreign lender's treatment of the funding it was providing as a credit rather than a capital contribution/an investment was filed by the taxpayer to avoid recharacterization, and that evidence was considered by the intermediate courts in upholding the taxpayer's position.[24]

In addition, although it does not deal with hybrid mismatches as such, it is worth noting the existence of an old provision in the ITL that was enacted to prevent other types of distortions derived from foreign countries' income tax rules having an impact in Argentina. Under this provision, a partial or full exemption from tax on Argentine-source income derived by a foreign beneficiary is not effective to the extent the exemption may result in the transfer of revenue to the advantage of the foreign country concerned as a consequence of the tax treatment applying in that country.[25]

For this provision to apply, the following conditions must be fulfilled: (1) there must be Argentine-source income that is expressly exempted from Argentine tax; and (2) the income must be derived by a nonresident or a foreign company (including the Argentine branch of a foreign company) subject to tax on that income under the law of the nonresident's/foreign company's country of residence. As a result, Argentine-source income derived by a foreign beneficiary whose country of residence does not tax foreign-source income is not affected by the provision. Also beyond the scope of the provision is tax-exempt income derived by a for-

eign taxpayer from a tax-credit country if that country allows a matching credit for the amount of income tax that would have been paid but for the exemption provided under Argentine law. Conversely, if the income is taxable in the foreign country because no matching tax credit is given/no tax sparing clause is recognized, Article 21 of the ITL will apply to prevent a transfer of revenue to that country. Although Article 21 cannot be strictly characterized as an anti-avoidance rule, it is worth drawing attention to it because it specifically looks at the income tax treatment of an exempt item of income in the foreign jurisdiction in order to protect Argentina's taxing jurisdiction.

In conclusion, if the tax authorities were to challenge a financing transaction, evidence of its treatment as a loan by the foreign lender might be of assistance in proving the existence of a genuine debt transaction. Likewise, if the Argentine tax authorities were to rely to any degree on evidence that the financing granted was treated as equity rather than debt in the financial statements of the FCo lender or under the applicable FC income tax rules, this might lead the tax authorities to attempt to recharacterize the transaction, but in no circumstances would a recharacterization be made solely on that basis; in other words, it is unlikely that such recharacterization would be successful in the case of a genuine third-party transaction regarded as such under Argentine tax law.

C. Difference if a Loan Agreement of Some Sort Exists

As noted above, both the tax authorities and the courts have relied on other relevant indicators besides the standard documentation. In addition to evidence relating to the sequence of the loan transaction (ownership of the funds, transfer to the debtor, application and return), the courts have also considered other factors.

Thus, the existence of a reasonable relationship between the amount lent and the borrower's net worth has been considered (in some cases in line with the Instruction). Failure to meet this requirement has been supplemented by other ratios (referred to in case law precedents and rulings) such as the amount of a borrowing company's debt in relation to the company's capital and free reserves, or the relationship between the amount of the relevant loan and the value of the borrower's fixed assets.[26]

The lack of adequate guarantees to secure repayment of a loan (for example, mortgages or liens on other business assets) might be considered negative factors adversely affecting an attempt to justify a transaction as a genuine financing transaction. Similarly, a number of precedents have considered that the existence of automatic renewals of principal and interest obligations or the absence of a term within which principal has to be returned (due to tacit renewal) put at risk the debt character of a transaction.[27]

In sum, the existence of a loan agreement may be a starting point for defeating a tax authority recharacterization challenge. However, other relevant factors would also be relevant so that, in the end, it could be a combination of all the relevant circumstances highlighted above that would determine the assessment of a financial transaction as a genuine loan or an equity contribution.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

As explained below, Argentina's income tax rules place only three types of restrictions on the deduction of interest paid to nonresident lenders: thin-capitalization rules, transfer pricing rules and time-matching rules. Challenges to the deductibility of interest and foreign exchange losses other than those discussed above have been based on the recharacterization of the underlying instrument or transaction giving rise to the interest/foreign exchange loss deductions rather than from challenges to the interest/exchange loss deductions themselves.

While the non-inclusion of interest in the taxable income of the lender would likely be regarded as grounds for challenging the existence of genuine debt financing, as explained below, unless new legislation is enacted, it is unlikely that such a challenge would succeed on those grounds alone in the context of third-party financing.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

There is a specific limit on the deductibility of interest based on a debt-to-equity ratio specified by the thin capitalization rules in the ITL. As noted above, the thin capitalization rules apply to interest payable to foreign related lenders when the Argentine borrower's debt-to-equity ratio exceeds 2:1 and interest is subject to an effective withholding tax rate lower than 35%. In the case of inter-company loans, if the recipient of the interest is resident in a treaty-partner jurisdiction, the rules will apply only if: (1) the applicable tax treaty provides for a reduced rate of source country withholding tax; and (2) the treaty expressly allows the application of the Contracting States' domestic thin capitalization rules, either under the treaty's non-discrimination provision or under a specific Protocol rule.[28]

Where the thin capitalization rules apply, the full interest expense accrued on the debt exceeding the 2:1 ratio is disallowed as a deduction and recharacterized as a dividend distribution. It should be noted that the rules do not apply if the foreign lender is located in a non-cooperative foreign jurisdiction, simply because in that case the effective rate of withholding tax is 35%.

Under prior law (i.e., that applying before the 2003 amendment to the ITL), instead of a single debt-to-equity ratio, interest deductions were proportionally disallowed consistent with the greater of the two following limitations:

- The amount of the borrowing company's interest-generating debt at the close of the fiscal year could not exceed two-and-a-half times the company's net worth as of the same date; or
- The amount of the borrowing company's deductible interest in a given fiscal period could not exceed 50% of the company's taxable net income (before deduction of interest) for the same period.

The second test was in some senses more in line with the fixed (EBITDA-based) ratio rule proposed by the OECD under Action 4 of the BEPS Action Plan. However, there are no current plans to revive this old domestic law test or to introduce a new test that more closely resembles that contemplated under Action 4. Nor are any worldwide or group ratio proposals currently under consideration.[29]

Nonetheless, it is worth repeating that interest arising from debt granted by foreign related parties or lenders located in non-cooperative jurisdictions is subject to withholding tax at an effective rate of 35% — this high withholding tax rate is already a strong disincentive to increase the leverage of local entities through inter-company loan agreements.[30]

B. Limits on Interest Deductions Based on Other Factors

Inter-company transactions are generally treated as transactions between unrelated parties, provided the terms and conditions are similar to those that independent parties would have agreed upon.[31] However, the recognition of expenses arising from such transactions is subject to special time-matching rules designed to prevent the deduction of expenses by a domestic entity in the year in which they accrue without corresponding income recognition (and withholding) at the level of a foreign related beneficiary. In these cases, the expenses cannot be deducted unless they are actually paid to, or constructively received by, the foreign beneficiary prior to the filing date for the income tax return of the domestic entity corresponding to the taxable year in which the expenses accrued.[32]

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Bifurcation of a transaction into a portion that allows deductible interest and another portion that does not occurs when the thin capitalization rules apply and the acceptable 2:1 ratio is exceeded; in such circumstances, interest on the debt exceeding the limit is treated as dividend income and, hence, is not deductible for the paying entity.

D. Effect of an Income Tax Treaty Between Argentina and FC

Argentina's tax treaties do not contain any specific rules on the recharacterization of transactions. Nor is there any case in which a financing transaction has been recharacterized in the context of a treaty, except for an isolated administrative precedent issued by the tax authorities in 1996.[33] That precedent addressed the recharacterization in a treaty context (the relevant treaties were the Argentina-Italy and Argentina-Spain tax treaties) of insurance premiums paid by a domestic borrower as additional interest. In making the recharacterization, the tax authorities had recourse to the domestic economic reality principle in assessing the facts, without any apparent reservation. However, the discussion focused on the taxable basis for the application of the withholding tax rather than on the deduction of the interest expense. Specifically, the insurance premiums, which were paid by a local borrower to foreign insurers in connection with money lent to the borrower by foreign banking institutions located in Spain and Italy, were deemed subject to interest withholding tax since, in the tax authorities' view, the economic reality was that the effect of the premium payments was that the borrower was in fact assuming a higher financial cost, equal to the insurance cost incurred by the lender to cover the potential insolvency risk of the borrower.

Extensive case law precedent and the widely held opinions of legal scholars suggest that, as a general rule, the Argentine tax authorities are entitled to reclassify transactions, including loan agreements and payments made thereunder, via the application of the domestic GAAR in a tax treaty context.

With respect to the specific circumstances in which interest on an advance that is accepted as debt exceeds a reasonable interest rate, under most of Argentina's tax treaties, such interest will not enjoy treaty protection[34] and its deductibility will be challenged based on Article 9 of the applicable treaty and the transfer pricing rules. It should be noted that these are the consequences that will follow where the transaction concerned is a related-party transaction. Argentina's treaties (and treaties generally) do not specify how the excess interest is to be treated in these circumstances — i.e., as non-protected interest or as dividends. However, it seems likely that the excess interest would be treated as non-protected interest subject to withholding tax at the regular domestic rate of 35%.

Interesting questions also arise regarding the interaction of restrictions on deductibility and the Non-discrimination Article in Argentina's tax treaties. In particular, there has been some debate in Argentina as to whether the Non-discrimination Article precludes the application of the domestic time-matching rule. As explained above, this rule provides for the use of the cash and disbursement method rather than the accrual method in determining when a deduction can be taken for an expense paid to a foreign related party — i.e., the deduction of the expense is deferred until payment is made.

The Argentine competent authority on treaty interpretation has had the opportunity to analyze whether the time-matching rule contravenes the principle of non-discrimination as set forth in Argentina's tax treaties because the time-matching rule does not apply with respect to purely domestic payments. The competent authority concluded that the Non-discrimination Article does not apply until there is an actual or a constructive payment to a treaty-partner resident. In arriving at its conclusion, the competent authority referred to the wording of the treaty Non-discrimination Article, which stresses the concept of the payment being made. Specifically, the relevant wording (Article 27(4) in the treaty concerned) provides that ". . . interest . . .and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State."[35]

With regard to the interaction of the thin capitalization rules and the Non-discrimination Article, most of

Argentina's tax treaties allow the application of the thin capitalization rules.

To summarize, the provisions of Argentina's tax treaties may affect the application of restrictions on deductibility, principally based on the interpretation of the Non-discrimination Article. Although existing restrictions have *a priori* passed the non-discrimination test (the time-matching rule) or have been expressly excluded from the scope of the non-discrimination test by provisions in treaty Protocols (the thin-capitalization rules), any proposal to introduce new restrictions will need to be carefully implemented if the restrictions are to pass the test. In this regard, certain precedents on the restrictions applicable to the deduction of royalty payments and contravention of the non-discrimination principle will need to be considered.[36]

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The position set out above would not change if FCo were an entity that is treated as transparent for FC tax purposes.

IV. Withholding Tax Issues

There are no specific rules or precedents on the withholding tax treatment of the interest paid when a loan is recharacterized as a capital contribution.[37] However, if a loan is so recharacterized and the corresponding interest deduction is challenged, the taxpayer could argue that a correlative adjustment should be made (to implement the difference in withholding treatment arising from the challenge to the deduction) by virtue of the fact that dividends are generally not subject to withholding tax.[38]

The deduction of interest is not specifically conditioned on the payment of the corresponding withholding tax. The time-matching rule only provides that interest has to be constructively or effectively paid for it to be deductible for the payor. Since withholding must be made on payment of the interest, it is generally understood that the purpose of the rule is to match the deduction of the expense for the domestic payer with the subjecting to tax in Argentina of the item of income obtained by the foreign beneficiary. However, since the wording of the statute does not specifically articulate that condition, it could be argued that where the payment of an expense is effected without the corresponding withholding being made, the expense should still deductible.

V. Difference if FCo Has a Permanent Establishment in Argentina

Under Argentine domestic law, the taxable income of an Argentine branch is generally determined on the basis of separate accounting. The income attributable to a PE is the income resulting from specific activities conducted directly by the PE. As a result, income is included in a PE's taxable base to the extent it is attributable to the PE (i.e., income and losses that are generated through the direct or indirect intervention of the PE[39]). Thus, the position set out above would differ only if the borrowing activity and the interest arising therefrom were attributable to FCo's PE in Argentina.

This "effective connection" rule is also adopted in some of Argentina's tax treaties. In fact, Argentina's treaty law in this respect generally follows the OECD Model Convention rules on the attribution of profits to a PE. Under these rules, if an enterprise of one Contracting State has a PE in the other Contracting State, the other State may tax the foreign enterprise only on the amount of the profits that is attributable to the PE. In other words, only the profits made through the activities of a PE are taxable in the State in which the PE is situated.

That being said, a number of Argentina's tax treaties contain a limited force of attraction rule.[40] Under this rule, income derived from the sale of goods identical or similar to those sold by a PE, as well as income derived from the performance of activities (e.g., lending) identical or similar to those performed by a PE, would be attributed to that PE. Notwithstanding this treaty rule, it can reasonably be argued that, based on the existence a more favorable rule under domestic law, treaty force of attraction rules should be disregarded.

In conclusion, it is only where interest paid is effectively connected to a PE located in Argentina that the restrictions on the deductibility of payments made to foreign beneficiaries (whether related or not) will not apply, with the result that the transaction concerned will be treated as a domestic transaction not generally subject to any limitations on interest deductibility.

VI. Legislative Changes

No legislative changes that would affect the position set out above are currently proposed.

NOTES

[1] Income Tax Law (ITL), first Art. (unnumbered) after Art. 69.

[2] Argentine tax treaty rates on interest payments are generally around 12%.

[3] Interest paid to a nonresident financial institution will benefit from the reduced tax rate only if the lender meets the following requirements: (1) it is supervised by a Central Bank or equivalent; (2) it resides in a jurisdiction that is not deemed a "low or no-tax jurisdiction" for Argentine tax purposes, or, if the residence jurisdiction is a low or no-tax jurisdiction, the jurisdiction is party to a tax information exchange agreement (TIEA) with Argentina; and (3) it is not prohibited from providing information to its tax authorities by bank secrecy or similar privacy laws.

[4] ITL, Art. 93, para. 1, c). This rate also applies to payments made: (1) by Argentine financial institutions; or (2) to nonresident suppliers financing imports of capital assets (including in the form of financial leasing transactions), nonresident financial institutions and certain nonresident investors in debt securities.

[5] ITL, Arts. 81 and 68, respectively.

[6] *See, Swift Armour* S.A. (fiscal period 1999), Federal Tax Court, Courtroom A (10.25.05); affirmed, Court of Appeals, Courtroom I, (5.6.10); *Tetra Pak,* Federal Tax Court, Courtroom B (9.23.11). To the contrary, see *Swift Armour S.A.* (fiscal period 2000), Court of Appeals, Courtroom III (12.29.11), *Tetra Pak*, Court of Appeals, Courtroom I (11.7.13).

[7] ITL, Art. 15.1.

[8] Additional indications of relationship can be found in a tax authorities' regulation dealing with transfer pricing reporting obligations (General Resolution AFIP 1122). This resolution states, as a general principle, that two parties are deemed related if they agree terms and conditions that would not have been agreed by third parties in similar circumstances. Under this broad definition, the mere granting of favorable and preferential terms and conditions would evidence an economic link making the parties to a transaction "related."

[9] This conclusion is justified by the fact that, when it expanded the scope of the deduction limitation rules to payments to entities located in low or no-tax jurisdictions ("non-cooperative jurisdictions" under current law), the ITL did not modify the definition of control so as to include (by means of an assumption) transactions entered into with such entities, but instead expressly modified the scope of application of the rules.

[10] Although not expressly stated in the ITL or the implementing regulations, the basic characteristics of tax havens delineated by the OECD were taken into account in drawing up the former list (i.e., no or low effective tax rates, ring fencing regimes, lack of transparency, and lack of effective exchange of information).

[11] *See* http://www.afip.gov.ar/noticias/20160405jurisdiccionesCooperantes.asp.

[12] A public order rule provides that certain documents are valid against third parties only if they indicate a "date certain" (*fecha cierta)*. For this purpose, a date certain may be deemed to exist if the agreement concerned has been entered in a public registry, such as a notary book.

[13] *Autolatina Argentina*, Supreme Court of Justice (3.15.11).

[14] *Sofrecom Argentina,* Court of Appeals, Courtroom IV (10.27.16). In the same sense, *Delta Dock SA*, Federal Tax Court, Courtroom A (5.31.12), *Lexmark Internacional de Argentina Inc. Sucursal Argentina,* Federal Tax Court, Courtroom A (6.3.14).

[15] *See Lexmark Internacional de Argentina Inc. Sucursal Argentina*.

[16] *See* note 12, above.

[17] For instance, this is the position taken in the Instruction. With regard to agreements executed abroad, consular or Apostille authentication have also been also considered, along with the capacity of the signing representatives. (Ruling 72/97; subsequently considered in Ruling 29/03).

[18] This requirement is reflected in Ruling 52/06.

[19] *Tucartu*, Federal Tax Court, Courtroom B (7.10.07), *Torreta, Fernando Jorge*, Federal Tax Court, Courtroom A (12.28.06), *Fomerca,* Federal Tax Court, Courtroom B (8.11. 06).

[20] *Compañía Ericsson*, Federal Tax Court, Courtroom C (8.15.07).

[21] In this regard, it is relevant to consider the statements made *in re Formerca* where the Federal Tax Court highlighted the fact that the tax authorities had not proved that the documents supplied by Formerca were not those commonly used in the market to evidence the existence and granting of loans.

[22] *See* note 12, above.

[23] The ITL *does* make reference to foreign accounting rules in the context, for instance, of the anti-deferral rules and the assessment of income taxable in the hands of an Argentine resident shareholder or partner on a current (accrual) basis.

[24] *Sofrecom* and *Lexmark Internacional de Argentina*.

[25] ITL, Art. 21, para. 1.

[26] Ruling 45/06; *Huani Latinoamerica S.A.I.C.,* Federal Tax Court, 9.16.80.

[27] *See* Ruling 52/06.

[28] *See, e.g.*, the Argentina-Canada, Denmark, Finland, Norway, Spain and Sweden tax treaties.

[29] As explained above, in establishing the existence of a genuine debt, the courts have used other ratios based on the relationship between the amount borrowed and the borrowing company's net worth, such as the amount of the company's debt in relation to the amount of its capital and free reserves, and the amount of the relevant loan and the value of the company's fixed assets.

[30] For a thorough discussion on these issues, *see* Mariano Ballone, *Debt-equity conundrum* (Argentine Report), Cahiers de droit fiscal international, Vol. 97b, 2012.

[31] ITL, Art. 14, para. 3.

[32] ITL, Art. 18 b), last para.

[33] Ruling 57/96.

[34] Argentina-United Kingdom tax treaty, Art. 11 (7):

Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds, for whatever reason, the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount of interest. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

[35] Memorandum 369/2002.

[36] The ITL and the Transfer of Technology Law (TTL) set limits on deductions for payments made under transfer of technology agreements. The TTL provides that payments made under licensing agreements not properly registered with Argentine patent and trademark office are not deductible. The ITL provides for a deduction limitation with respect to a registered agreement under which an Argentine licensee is not allowed to deduct more than 80% of the amounts (negotiated at arm's length) paid under a registered trademark license agreement. Notwithstanding this limitation, Argentina's treaties provide that arm's length royalties paid by an enterprise of a Contracting State to a resident of another Contracting State are, for purposes of determining taxable income, to be deductible on the same terms as they would be if paid to a resident of the payor's State of residence. Under Argentina's domestic tax rules, royalties paid by an Argentine entity to a resident licensor are not subject to any limitation. Thus, under the treaty Non-discrimination Article, the deduction of arm's length royalties would not be subject to any limitation and the 80% domestic deduction restriction would not apply. The only quantitative limitation on the deduction of royalties in a treaty context would be compliance with the arm's length standard. This criterion has been confirmed by the Argentine competent authority on treaty interpretation (Memorandum 108/01 and Note 1421/04).

[37] Moreover, in addition to disregarding the characterization of a loan and challenging foreign exchange losses and interest deductions associated therewith, the tax authorities could argue that an amount equal to the borrowed principal was an unjustified increase in the borrowers' net-worth.

[38] For other issues associated with recharacterization, *see* Mariano Ballone *op. cit.*:

> That would be the case of accrued interest or paid off interest that give rise to value added tax and the debt

financing is then reclassified by the tax authorities. In that case, would the tax authority allow a matching VAT input credit in favor of the debtor who must consider now these payments as dividends (not subject to value added tax)? Another conflicting issue is what happens with income tax withholdings applied on the then recharacterized interest paid to the foreign beneficiary given that dividends are not generally subject to withholding?

[39] It should be noted that, while the activity generating the income must be performed directly by the PE, the PE's intervention in the generation of the income can be direct or indirect (activity is not a synonym for intervention).

[40] E.g., the Argentina-Australia, -Belgium, -Canada, -Denmark, -Finland, -Netherlands, -Norway and Sweden tax treaties.

AUSTRALIA

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I. Possibility of Australian Tax Authorities Recharacterizing Advance of Funds by FCo to AusCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

The classification of financing arrangements as debt or equity for Australian tax purposes is based on a set of substance-over-form rules contained in Division 974 of the Income Tax Assessment Act 1997 (ITAA 1997). This distinction between debt and equity is fundamental to the tax treatment of the transaction.

Returns on debt (such as interest) in an entity may be deductible to the entity but not frankable,[1] while returns on equity (such as dividends) may be frankable but not deductible. The debt/equity classification also affects whether the payment of the return is subject to interest withholding tax or dividend withholding tax, as well as the operation of the thin capitalization measures (discussed in II.A., below).

Division 974 was introduced in 2001, and contains the debt and equity rules. These rules distinguish between debt interests and equity interests, and focus on economic substance over legal form. The principle economic indicator of a debt interest is the non-contingent nature of the returns on the interest.

It should be noted that Division 974 does not contain any direct taxing provisions. It classifies an instrument as debt or equity, while the tax outcomes are set out in other provisions of the tax legislation. One such tax outcome is that an income tax deduction will be denied (but franking allowed) for "interest" from a scheme that has the legal form of a loan (a debt interest), but an economic substance similar to an ordinary share (an equity interest).

The debt test is set out in Subdivision 974-B and consists of five elements that must each be satisfied:

- There must be a scheme;
- The scheme must be a financial arrangement;
- The entity (issuer) must receive a financial benefit;
- The entity (issuer) must have an *effectively non-contingent obligation* to provide a financial benefit; and
- It must be substantially more likely than not that the value of the financial benefit provided will be at least equal to the value received.

The equity test is then set out in Subdivision 974-C, which lists four types of schemes that are equity interests. These are:

- An interest as a member or stockholder of a company;
- An interest with a right to a return (fixed or variable) that is contingent upon economic performance;
- An interest with a right to a return (fixed or variable) that is at the discretion of the company concerned; and
- An interest with a right to be issued with, or that will or may convert to, an equity interest in the company concerned.

When both the debt test and the equity test are satisfied, a tiebreaker test contained in Subsection 974-5(4) applies, which states that if an interest satisfies both the debt test and the equity test, it is treated as a debt interest and not as an equity interest.

Accordingly, for Australian tax purposes, the advance from FCo to AusCo will be assessed against these debt and equity test criteria. The fact that the advance is recorded as a liability by AusCo will not affect the assessment of the economic substance of the transaction. The principle factor that will influence the outcome is whether AusCo has an effective non-contingent obligation to return to FCo an amount at least equal to the amount invested.

The fact that there is no documentation such as a loan agreement does not in itself affect the assessment. However, the lack of documentation may make it difficult for the entities to provide evidence supporting their assertion that the transaction is in the form of a loan (i.e., a debt interest).

For example, under Subsection 974-35, the valuation of the financial benefit received or provided requires calculation of the nominal or present value of the financial benefit with reference to the performance period of the arrangement. Without relevant documentation to support this calculation, it may difficult to satisfy the debt criteria. The Australian Taxation Office (ATO) provides guidance to the effect that "it is advisable that the loan be documented so that these terms can be demonstrated to be effectively non-contingent obligations of the company."[2]

Whether or not FCo and AusCo are related parties will not in general affect the basic classification of the transaction as debt or equity. However there is a special small business turnover carve out for "at call" loans between "connected entities."[3] Subsection 974-75(6) provides that if a company has an annual turnover of less than $20 million, then its related party "at call" loans will be treated as being debt interests rather than equity interests.

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It should be noted that the legislation does not refer to "related parties" but to "connected entities," a connected entity being defined as an associate of the entity concerned, or another member of the same wholly owned group if the entity concerned is a company and is a member of such a group.[4] Associates of a company are further defined to include controlled or controlling companies, which means either "sufficient influence" is exerted, or a majority voting interest is held.[5]

This means that if FCo and AusCo were related parties (meeting the definition of "connected entities"), the loan was an "at call" loan, and AusCo had a turnover of less than $20 million, the loan would be classified as a debt interest. If AusCo had a turnover of more than $20 million, then there is a risk that the loan would be classified as equity and any interest paid to FCo would be classified as an unfranked dividend.

Furthermore, if FCo and AusCo are related parties, they may be affected by the controversial and complex Subsection 974-80, known as the equity override integrity provision. Under this subsection, if return on a debt interest in one scheme is designed to be used to fund the return on an equity interest in a separate scheme, then the debt issued is recharacterized as an equity interest. The Treasury released an Exposure Draft Bill in late 2016 (see V., below), which attempts to address the uncertainty surrounding the operation of this section.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

As described in I.A., above, the classification of a transaction as debt or equity is based on the substance-over-form principle, and set out in the Division 974 debt and equity rules. These same rules would apply, regardless of the treatment of the transaction by FCo. The treatment of the transaction as a loan by FCo would not influence the assessment of the economic substance of the transaction for Australian tax purposes.

C. Difference if a Loan Agreement of Some Sort Exists

As described in I.A above, the Division 974 debt/equity rules take into account the economic substance of the transaction, not its legal form. The principle test for debt is whether there exists an effectively non-contingent obligation. In this case, the existence of a loan agreement by itself does not affect the outcome, although as discussed in I.A, above, it may help in providing evidence of the effective obligation of AusCo.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

In general, a loss or outgoing is deductible if it meets the general deduction criteria in Section 8-1 of the Income Tax Assessment Act 1936 (ITAA 1936). This means the interest paid by AusCo to FCo will be deductible by AusCo under Section 8-1 if it is incurred in gaining or producing assessable income. The tax treatment of the interest income in the hands of the lender is not relevant.

However, there are various provisions affecting the deductibility of interest, including interest on loans to finance employee superannuation contributions[6] and certain insurance premiums,[7] thin capitalization rules (see II.A., below), transfer pricing rules (see II.B., below) and the general anti-avoidance provisions (see II.B., below).

Interest paid to non-residents is subject to a 10% withholding tax under Section 128B of ITAA 1936, and the payer is not entitled to a deduction for the interest if the withholding tax requirements have not been met.[8]

Whether the lender and borrower are related does not by itself affect the deductibility of interest, but may be an influencing factor when applying the transfer pricing and anti-avoidance provisions.

A. Specific Limits to an Interest Deduction Based on the Ratio of Debt to Equity

Australia has not adopted the OECD's approach to limiting interest deductions, but does have a thin capitalization regime set out in Division 820 of ITAA 1997, which applies to foreign controlled entities, Australian entities that operate internationally and foreign entities that operate in Australia.

The Australian thin capitalization rules disallow a proportion of debt deductions (which include not only interest, but also other expenses incurred in connection with a debt interest) for certain categories of entity when the entity's debt used to fund Australian assets exceeds certain limits. Whether the lender and borrower are related parties is not by itself relevant, as the thin capitalization rules apply to all debt, not just foreign related-party debt. However, the interaction of the transfer pricing rules with the thin capitalization rules (see II.B., below) means that the amount of the debt deduction will first be determined under the transfer pricing provisions, with the adjusted debt deduction (if applicable) then being subject to the thin capitalization limits.

There are eight categories of entity to which the thin capitalization rules may apply, each with its own "maximum allowable debt" amount. These categories are structured around whether the entity is an authorized deposit taking institution (ADI), a general or financial entity, and an inward or outward investor. The maximum allowable debt is calculated with reference to three further amounts: a "safe harbor debt amount," an "arm's length debt amount" and a "worldwide gearing debt amount." Broadly, the safe harbor debt-to-equity ratio is currently 1.5:1 for general entities, and 15:1 for non-bank financial entities. If the maximum allowable debt limit is exceeded, the entity's interest deductions are limited on a proportional basis, to the extent the maximum debt is exceeded.

The thin capitalization rules will not apply if the debt deductions for an entity (and its associates) do not exceed $2 million,[9] or for an outward investing entity that is not also foreign controlled, if 90% or more of the total average value of all its assets are represented by Australian assets.[10]

B. Limits on Interest Deductions Based on Other Factors

For Australian tax purposes, transfer pricing rules set out in Subdivision 815-B apply to all international transactions entered into by Australian entities (including dealings with unrelated parties). These rules

ensure that cross-border dealings are taken to operate under arm's length conditions (in line with the OECD 2016 Transfer Pricing Guidelines). Arm's length conditions are broadly defined as conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.[11]

In terms of Australia's transfer pricing rules, AusCo's interest deduction (regardless of whether AusCo and FCo are related parties) will be based on the loan being priced under arm's length conditions.

However, the interaction of the transfer pricing rules with the Division 820 thin capitalization rules needs to be considered. Subsection 815-140(2) provides that, for transfer pricing purposes, an interest rate is to be adjusted to an arm's length rate, but the rate must be applied to the debt interest actually issued. The amount of the debt deduction calculated in this manner will then become the amount of the debt deduction for purposes of Division 820.[12]

The ATO has recently released draft Practical Compliance Guidelines PCG 2017/D4 concerning the ATO compliance approach to cross-border related-party financing arrangements. Although it does not provide guidance on the technical interpretation of Australia's transfer pricing rules, PCG 2017/D4 does set out the ATO's framework for considering risk and applying compliance resources in relation to related-party financing arrangements.

The Guidelines propose a risk framework for assessing tax risk in relation to funding arrangements and allocates risk scores to various attributes of such arrangements. These attributes include:

- Pricing (consistent with global group cost of funds, traceable global third party debt or relevant third party debt of the borrowing tax entity);
- Leverage of the borrower;
- Interest coverage ratio;
- Appropriate collateral;
- Subordinated or mezzanine debt;
- Headline tax rate of the lender entity jurisdiction;
- Currency of debt different to operating currency;
- Arrangement covered by a taxpayer alert;
- Involvement of a hybrid entity;
- Presence of exotic features in the loan; and
- Sovereign risk of the borrower.

Although the guidance does not constitute a safe harbor, if an entity's circumstances align with the low risk category, PCG 2017/D4 states that the ATO will generally not allocate compliance resources to test the relevant tax outcomes of a related-party financing arrangement.[13]

Australian tax law also contains general anti-avoidance rules set out in Part IVA of the ITAA 1936. In broad terms, Part IVA will apply where a tax benefit has been obtained from a scheme, and the sole or dominant purpose of carrying out the scheme was to obtain the tax benefit. If Part IVA applies, then the Commissioner of Taxation has the discretion to cancel the relevant tax benefit. If the transaction between AusCo and FCo was entered into for the dominant purpose of obtaining a tax benefit, Part IVA may apply to deny an interest deduction.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Australian tax law does not generally make provision for the bifurcation of a transaction into debt and equity components. The debt and equity tests described above serve to classify an arrangement as either a debt interest, or an equity interest, with a tie-breaker rule (which treats the arrangement as a debt interest) applying when both tests are satisfied.

The general deduction rule in Section 8-1 of ITAA 1936 allows apportionment of an interest deduction. If a loan is used for both assessable income-producing and non-income-producing purposes, the interest on the loan will have to be apportioned between the deductible and non-deductible amounts in accordance with general principles.[14]

However, Sections 25-85 and 230-15(5) of ITAA 1997 contain "revenue safeguards,"[15] which prevent excessive deductible payments on debt/equity hybrids that satisfy the debt test. Despite such hybrid instruments being classified as "debt interests," the return on such instruments (being similar to a dividend) may be considerably in excess of the interest payable on straight debt. The deduction allowable on a return paid on a "debt interest" is therefore capped at 150 basis points over the "benchmark rate of return" on an equivalent straight debt interest, adjusted for the increased risk of non-payment because of the equity-like nature of the return.

D. Effect of an Income Tax Treaty Between Australia and FC

Australia's nonresident interest withholding tax rate of 10% may be varied by its tax treaties. For example, under the Australia-United States tax treaty, interest withholding tax on interest paid to certain government entities and financial institutions is 0%.[16]

Most of Australia's tax treaties contain transfer pricing provisions that provide for the allocation of profits between related parties under arm's length conditions. Subdivision 815A (Treaty-equivalent cross-border transfer pricing rules) provides that treaty transfer pricing rules are independent of existing "domestic" transfer pricing rules. Thus for both deduction and treaty purposes, a return of interest in excess of a reasonable rate (non-arm's length) will be disallowed.

It should be noted that there is a divergence between the debt and equity rules in Australia's income tax laws, and the definitions of dividends and interest in many of Australia's tax treaties. For example, in the Australia-United States tax treaty, dividends are defined as:

Income from shares and other income assimilated to income from shares by the taxation law of the Contracting State of which the company making the distribution is a resident for the purposes of it tax.[17]

The term "income from shares" is problematic when compared to the debt and equity rules in Division 974. If an Australian company issues a share with debt-like features (for example, redeemable preference shares), this hybrid instrument will be classified as a debt interest under Division 974, and the return

will be classified as interest for income tax deduction purposes. However, under the Australia-United States tax treaty, the return is "income from shares" and may be classified as a dividend.

This conflict is overcome in many instances (but not all, depending on the wording in the relevant tax treaty) by Section 2A of the International Tax Agreements Act 1953, which states that a reference in an agreement to income from shares, or to income from other rights participating in profits, does not include a reference to a return on a debt interest (as defined in Subdivision 974-B of the ITAA 1997).

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

In general, the current Australian tax provisions discussed above apply equally to interest payments to corporate lenders and to interest payments to fiscally transparent lenders.

However, it is worth noting that, in Australia, limited partnerships are taxed as companies for Australian income tax purposes. There is then an exception contained in Division 830 of ITAA 1997, which provides that certain entities (called "foreign hybrids") that are treated as partnerships for purposes of foreign income tax are to be treated as partnerships for purposes of ITAA 1997.

In 2016, the Australian Board of Taxation released its final report on the implementation of the OECD hybrid mismatch rules. The Government then announced, in its 2016 Federal Budget, that it would implement the OECD rules to eliminate hybrid mismatch arrangements, taking into account the recommendations made by the Board of Taxation in its report. The 2017 Federal Budget announced anti-hybrid measures to apply to regulatory capital.

As part of its adoption of the OECD recommendations regarding anti-abuse rules in tax treaties, the newly signed Australia-Germany tax treaty contains one of the first new provisions incorporating the OECD approach. Under this treaty, treaty benefits will be available for income (including profits or gains) derived by or through fiscally transparent entities or arrangements but only to the extent the income is treated as the income of a resident of one of the treaty partner countries under that country's domestic law.[18]

IV. Withholding Tax Issues

See V., below.

V. Difference if FCo Has a Permanent Establishment in Australia

A resident of a country that has a tax treaty with Australia is generally subject to tax in Australia on business income that is effectively connected to a permanent establishment (PE) in Australia. Other business income is generally not taxable in Australia. A resident of a country that does not have a tax treaty with Australia is generally subject to tax in Australia on income from an Australian source.

Australia imposes interest withholding tax (at 10%) on interest paid by an Australian resident to a nonresident lender that does not have a PE in Australia. If FCo has a PE in Australia and the interest is effectively connected with the PE, the interest is not subject to interest withholding tax (but will be taxable by assessment in Australia). There is no definition of "effectively connected" in the tax treaties, or in the Australian tax legislation. It is suggested that the U.S. domestic rules, which make use of an "effectively connected" test for U.S. source income, may offer some guidance.[19]

VI. Legislative Changes

The Australian Government has moved quickly and forcefully against multinational tax avoidance, and has often been among the first movers in adopting the OECD BEPS recommendations.

In 2015, the Board of Taxation released a report following its review of the debt/equity rules. In response, Treasury released an exposure draft bill in late 2016 targeting improvements to the debt and equity integrity rules. This bill is yet to be introduced to Parliament.

In 2016, the Board of Taxation released a report on the implementation of anti-hybrid rules, and the Australian Government then announced in its 2016 Federal Budget that it will implement the OECD rules to eliminate hybrid mismatch arrangements, taking into account the recommendations made by the Board. This was followed by a recent announcement in the 2017 Federal Budget of specific rules targeting regulatory capital. Legislation is still being developed for this measure.

The Australian Treasury also released a consultation paper in late 2016 regarding Australia's adoption of the BEPS Convention (Multilateral Instrument). Although not yet announced, it is anticipated that Australia will be among the first signatories to the Multilateral Instrument in June 2017. Like the Australia-Germany tax treaty, treaty development going forward is anticipated to include anti-abuse measures.

Finally, the current Government is unlikely to change the thin capitalization rules to more closely align with the OECD BEPS Action Item 4 (involving interest deductions and other financial payments). However, it is the policy of the opposition to adopt a worldwide group test.

NOTES

[1] Australia operates a dividend imputation system. When a corporate tax entity distributes profits to its members, it may pass on ("impute") credits for the tax already paid on the profits. The distribution is "franked" and the recipients may use these franking credits as tax offsets.

[2] https://www.ato.gov.au/business/debt-and-equity-tests/in-detail/guides/debt-and-equity-tests—guide-to—at-call—loans/?page=3.

[3] An "at-call" loan is a loan made to a company by a connected entity that does not have a fixed repayment term and is repayable on demand (Subsection 974-75(4)).

[4] Section 995-1 ITAA 1997.

[5] Section 318 ITAA 1936.

[6] Section 26-80 ITAA 1997.

[7] Section 26-85 ITAA 1997.

[8] Section 26-25 ITAA 1997.

[9] Section 820-35 ITAA 1997.

[10] Section 820-37 ITAA 1997.

[11] Section 815-125(1) ITAA 1997.

[12] Tax Laws Amendment (Cross Border Transfer Pricing) Bill 2013: Modernisation of Transfer Pricing Rules Exposure Draft – Explanatory Memorandum § 2.99 – 2.101.

[13] Australian Taxation Office Practical Compliance Guideline PCG 2017/D4 § 20.

[14] Australian Tax Handbook § 8 040.

[15] Tax Laws Amendment (Taxation of Financial Arrangements) Bill 2008 Explanatory Memorandum § 3.75.

[16] Australia-United States tax treaty, Art. 11(3).

[17] Australia-United States tax treaty, Art. 10(6).

[18] Australia-Germany tax treaty, Art. 1(2).

[19] Australian Tax Handbook § 36 240.

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BELGIUM

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I. Possibility of Belgian Tax Authorities Recharacterizing Advance of Funds by FCo to BelgianCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Belgian income tax law contains a list of items of income that are taxed as interest under Article 19 of the Income Tax Code.[1] The concept of interest encompasses, *inter alia*, interest, premiums and any other proceeds from loans (including the granting of collateral with respect to financial instruments), deposits or any other receivable.[2]

Belgian income tax law does not contain any definition of what is to be considered a loan or, in a wider sense, debt, as opposed to equity.[3] According to the Belgian tax administration, legal scholars and case law, in the absence of any specific provision in the (income) tax law governing the classification of a financing instrument as debt or equity, it is necessary to refer to general law, i.e., the Belgian Civil Code, for the legal rules governing loan relationships and the Belgian Company Code for the company law framework.[4]

With respect to loan agreements, most legal scholars consider that the decisive element for purposes of the classification of an agreement as debt is the right of the lender to be repaid at least the initial outlay, even perhaps where the right of repayment exists only in the case of a *concursus creditorum*.[5]

According to Belgian legal scholars,[6] none of the following features is, of itself, sufficient for the characterization of a debt instrument as equity:

- The instrument either having or not having a maturity date;
- The payment of profit-participating remuneration with respect to the instrument;
- The convertibility of the instrument into shares;
- The payment of "interest" in kind;
- Subordination; or
- The borrower being thinly capitalized.

The Belgian ruling commission followed this line of reasoning in a number of cases involving the characterization of financing instruments, such as profit participating loans,[7] profit participating securities[8] and subordinated loans.[9]

In addition, the accounting treatment of an instrument will govern its tax treatment, and more precisely, the recognition for tax purposes of the corresponding interest expense.[10]

The lack of documentation of the loan agreement is not fatal; however, without proper documentation, it may be difficult for the parties to evidence any particular feature of a debt instrument. In addition, with respect to its ability to deduct interest paid to a (non-resident) lender, a Belgian borrower bears the burden of proof[11] (see II. A., below).

As a general rule, the Belgian tax authorities will characterize a transaction based on the rules laid down in the Belgian Civil Code and the Belgian Company Code. If a transaction has been incorrectly characterized by the parties, the tax authorities may assess tax based on its correct legal characterization.[12]

Before the introduction of a general anti-abuse provision in Belgian (income) tax law, the Belgian tax authorities frequently attempted to reclassify debt as equity in accordance with the private law concept of "sham."[13] D. Wyntin summarizes the position as follows:[14]

> Characteristics such as an interest-free remuneration or a profit-linked interest rate, the absence of a fixed date of reimbursement, and circumstances such as the full control by the creditor of the company, the lack of substantial guarantees and the evident insufficiency of capital to exercise the activities of the company, were cause for the Tax Administration to requalify the loan as equity according to the simulation theory. Simulation supposes two agreements concluded at the same time. There is a "simulated" transaction as explained to third parties hiding the real concealed agreement to which only the contracting parties are privy. Notwithstanding, the Supreme Court accepted only one criterion for the requalification as equity: the fact that the funding effectively undergoes the possibility of sharing the losses of the company, that the funding is subject to the negative hazards of the company's business. In its judgment of 11 January 1966, the Supreme Court concluded "*. . . que cette somme était soumise aux aléas de l'entreprise et donc aux éventuelles pertes sociales, condition essentielle pour qu'il ait apport en société*" ("that this sum was subject to the contingencies of the enterprise and thus to eventual company losses, an essential condition for the existence of a corporate contribution" [authors' translation]). All other characteristics, although at first sight appearing as capital-related characteristics, and any external circumstances did not and do not justify the identification of the financial instrument as equity: the undercapitalization of the company, the subordinated character of the loan, the profit-linked or profit-sharing interest payment, the fact that no interest is paid in a year that the debtor has made a loss, the absence of a fixed reimbursement date, the fact that certain authorities such as the Belgian Banking Commission consider the loan as equity for reasons of solvency, etc. The requalification of the type (b) (requalification based on the characteristics of the debt

itself), such as the legal theory of simulation, is only accepted by the Belgian Supreme Court insofar as the funding effectively shares the potential losses of the company's business. In reality, it is nearly impossible to provide this kind of evidence.[15]

In 1993, the Belgian tax legislator introduced a general anti-abuse provision in Article 344, § 1 of the ITC.[16] This provision was replaced in 2012 with a view to providing the Belgian tax authorities with a more effective means of combatting tax abuse.[17] Under the new provision, tax abuse occurs when a taxpayer carries out, by means of a legal act or a series of legal acts, a transaction by means of which the taxpayer: (1) places itself, contrary to the purpose of a provision of the ITC or its executory decrees, outside the scope of application of that provision; or (2) claims a tax benefit provided for by a provision of the ITC or its executory decrees, the aim of which is essentially the obtaining of such an advantage, when the granting thereof would be contrary to the purpose of the provision. It remains to be seen whether the Belgian tax authorities will rely on the new general anti-avoidance rule in tackling hybrid financing instruments.

Finally, the Belgian tax authorities can already rely on specific rules designed to combat hybrid transactions. In a European context, the legal framework will be expanded even further in the coming years.

With a view to neutralizing the effects of hybrid mismatch arrangements, the European Union has amended Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (the "Parent-Subsidiary Directive") as follows:[18]

- Council Directive 2014/86/EU of July 8, 2014, addresses the issue of double non-taxation deriving from mismatches in the tax treatment of profit distributions between companies resident in Member States by excluding from the tax exemption for distributed profits received profits that are tax-deductible for the distributing subsidiary.
- Council Directive 2015/121/EU of January 27, 2015, introduced an anti-abuse provision designed to prevent misuse of the Parent-Subsidiary Directive and ensure greater consistency in its application in different Member States. A Member State is not to grant the benefits of the Parent-Subsidiary Directive where an arrangement or a series of arrangements has been put into place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the Directive that is not genuine having regard to all the relevant facts and circumstances.

Belgium implemented both amendments into Belgian tax law via a Bill of December 1, 2016.[19] The application of the new provisions is not limited to distributions between Member States: the new provisions also apply in a domestic context and with respect to dividends paid between Belgian companies and companies resident in non-EU Member State countries.[20]

The new provisions effectively eliminate[21] the use of some hybrid instruments (at least) in an EU context (for example, profit participating loans in a Belgium-Luxembourg or Belgium-Netherlands context,[22] which are treated in certain circumstances as debt at the level of the Belgian debtor but as equity at the level of the Luxembourg/Dutch parent). Following the implementation of the Council Directive in Luxembourg and the Netherlands, the income arising from such instruments can no longer be exempted in the hands of the recipient Luxembourg/Dutch resident parent company. During the parliamentary work leading up to the December 1, 2016 Bill, the Minister of Finance indicated that the implementation of the Directives would have only limited consequences for Belgian taxation, since Belgium espouses a broad definition of debt, as opposed to equity.[23] In addition, the parliamentary work cites no hybrid instrument that would fall within the scope of the new provisions in Belgium.

Belgium has yet to implement Council Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market. For more details, see VI., below.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Belgian income tax law does not contain any specific recharacterization rules, other than those described in II.A., below, that might apply where FCo does not treat the transaction as a loan for FC accounting and income tax purposes. Belgian income tax law does, however, contain specific anti-abuse provisions that impact a Belgian borrower's ability to deduct interest expenses in cases where the creditor is either not subject to tax on the interest payments or is subject to a tax regime that is substantially more beneficial than that resulting from the common law provisions applicable in Belgium (see further at II.B. and C., below).

By way of illustration, the Belgian ruling commission has in the past granted a number of rulings with respect to profit participating loans, in which it accepted the deductibility of the interest payable at the level of the Belgian corporate issuer, even though such instruments were treated as equity for Luxembourg tax purposes under a substance-over-form approach.[24] As indicated at I.A., above, the implementation of Council Directive 2014/86/EU of July 8, 2014, effectively eliminated the use of this hybrid instrument, as confirmed by the Belgian Minister of Finance.[25]

C. Difference if a Loan Agreement of Some Sort Exists

If a formal loan agreement exists, the Belgian tax authorities will scrutinize the rights and obligations of the parties under the agreement for purposes of characterizing the contract, as legal form prevails over economic substance unless the tax authorities are able to rely on an anti-avoidance rule. The primacy of legal reality derives from two fundamental principles: the legality of tax[26] and the governance of tax law by private law.[27]

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

As a general rule, any expenditure defrayed or charge incurred by a company during a taxable year with a

view to generating or preserving taxable income is deductible from that company's gross operating income as a business expense, provided the existence and amount of the expenditure/charge can be substantiated by supporting documents or other means of evidence.[28] The taxpayer bears the burden of proof in this respect.[29] The ITC explicitly provides that interest on capital borrowed from third parties that has been used within an enterprise, and all charges and analogous fees relating to it, are deductible expenses.[30] The interpretation of the requirement that for an expense to be tax-deductible it must be incurred with a view to acquiring or preserving taxable income is the subject of much debate among legal scholars and in case law.[31]

Unlike interest payments, dividend payments are not tax-deductible.[32] However, in order to address this discrepancy between debt and equity financing, as of assessment year 2007, Belgium introduced the notional interest deduction.[33] The deduction consists in a reduction of the corporate tax base of the company concerned by means of the application of a reference interest rate to the company's risk capital.[34] Even though the notional interest deduction generates a tax deduction in the same way as an interest payment (even though it is a non-cash expenditure), it does not lead to the recharacterization of equity funding as debt funding. The introduction of the notional interest deduction has given rise to extensive (international) tax planning activity[35] and in a number of cases the Belgian tax authorities have attempted to deny the deduction arguing that the Belgian corporation concerned was awarded an abnormal or gratuitous advantage where the corporation was excessively funded through equity capital.[36]

In order to be deductible, interest must be paid at an arm's-length[37] rate taking into account the risks relating to the operation, the financial position of the debtor and the duration of the loan.[38] As D. Van Stappen has rightly pointed out, the provisions concerned do not specify what is considered to be an arm's-length rate of interest and what is not, nor do they prescribe any specific (transfer pricing) methods for determining an arm's-length rate.[39] Interest is considered to be at arm's length where it is paid to financial institutions or institutions of an equivalent nature, as well as where it is paid with respect to publicly issued bonds or similar securities.[40]

In addition, under article 26 ITC, where a Belgian company grants an abnormal or gratuitous advantage to a (directly or indirectly) affiliated nonresident, the amount of the advantage is added to the taxable profit of the Belgian grantor.[41]

Belgian tax law has no general rule linking the ability to deduct interest at the level of a Belgian borrower to taxation of the interest in the hands of the foreign creditor;[42] there are, however, specific anti-abuse provisions that would limit BelgianCo's ability to deduct interest expense if FCo is not subject to income tax or is subject, with respect to the corresponding interest income, to a tax regime that is substantially more beneficial than that resulting from the application of the general provisions of Belgian law (II.A., below for the 5:1 debt to equity rule and II.B., below for payments to "tax havens").

As explained in I.A., above, Belgium has already implemented Council Directive 2014/86/EU of July 8, 2014, which addresses the double non-taxation arising from mismatches in the tax treatment of profit distributions between companies resident in different EU Member States by excluding from the tax exemption applicable to received distributed profits, profits that are deductible for the distributing subsidiary. Although the Bill of December 1, 2016 addresses the 95% deduction of dividends received under Belgian domestic law[43] rather than denying a deduction for "interest" payments with respect to hybrid instruments, it effectively eliminates the use of some hybrid instruments (at least) in an EU context, such as profit participating loans in a Belgium-Luxembourg or Belgium-Netherlands context, which are treated, in certain circumstances as debt at the level of the Belgian debtor but as equity at the level of the Luxembourg/Dutch parent. Following the implementation of the Council Directive in Luxembourg and the Netherlands, the income concerned can no longer be exempted at the level of the recipient Luxembourg/Dutch parent company.

As will be further discussed in VI., below, Belgium has yet to implement Council Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market. The Directive includes a provision on hybrid mismatches similar to the recommendations contained in the OECD BEPS final report on Action 2 and addresses mismatch situations attributable to differences in the legal characterization of a financial instrument or entity.[44] According to Article 9 of the Directive, "to the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment." Belgium is required to implement this rule by December 31, 2018.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

Two sets of debt-equity ratios could apply to a loan granted by FCo to BelgianCo:

- First, a 1:1 debt-equity ratio[45] would apply with respect to a loan[46] (other than a bond or similar security issued by way of public offering) granted by FCo to BelgianCo if FCo acts as a member of the board of directors[47] of BelgianCo. The statutory provision concerned provides for the reclassification of interest into dividends insofar as the interest exceeds interest payable at the market rate.[48] As a consequence, the interest on the loan is reclassified and treated as a dividend to the extent the total of the interest-bearing loans is higher than the paid-up capital at the end of the taxable period plus taxed reserves at the beginning of the taxable period or to the extent the interest is not at arm's length. According to the Court of Justice of the European Union (CJEU), this rule does not apply where FCo is a company resident in an EU Member State: since interest payments are not classified as dividends if made to a director that is a Belgian company, the CJEU found

the rule concerned to be incompatible with the freedom of establishment provided for by Article 49 of the Treaty on the Functioning of the European Union (TFEU).[49]

- Second, a 5:1 debt-equity ratio[50] applies with respect to a loan (other than a bond or similar security issued by way of public offering or a loan granted by a financial institution), where the beneficial owner of the interest payable on the loan is either: (1) not subject to income tax or is subject, with respect to such interest income, to a tax regime that is substantially more beneficial than that resulting from the application of the general provisions of Belgian law; or (2) is part of a group to which the Belgian debtor belongs.[51] As a consequence, interest is no longer a deductible expense[52] to the extent the aggregate amount of such loans exceeds five times the sum of the taxed reserves existing at the beginning of the taxable period and the paid-in capital existing at the end of the taxable period. Furthermore, an anti-abuse provision was introduced in order to prevent the circumvention of the rule by interposing a creditor that is not tainted. The provision applies where the tax authorities are able to demonstrate that the main purpose of the structuring is tax avoidance.[53]

So far Belgium has not adopted the OECD's proposed fixed ratio test. Belgium has yet to implement Council Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market, including interest limitation rules in line with the OECD BEPS Report on Action 4. For more details see VI., below.

B. Limits on Interest Deductions Based on Other Factors

Belgian tax law contains two rules designed to deal with payments (including interest payments) to "tax haven" countries:

- First, under Article 54 of the ITC, an interest payment made to an entity that either is not subject to tax or is subject to a tax regime that is significantly more advantageous than the Belgian regime is not tax-deductible for the Belgian taxpayer making the payment unless the taxpayer demonstrates that the payment is in consideration for an actual, genuine transaction and the payment is at arm's length. If the beneficiary of the payment is established in the European Union, it can be argued that this reversal of the burden of proof is not in line with the freedom of establishment provided for in the EC Treaty.[54]
- Second, Articles 198, § 1, 10° and 307 of the ITC[55] require reporting where payments exceeding 100,000 euros per year are made by a Belgian taxpayer to an entity located in a tax haven or to a permanent establishment (PE) or a bank account in a tax haven.[56] The reporting must be made on a special form attached to the income tax return. In the event of non-reporting, the payments will be treated as disallowable expenses for income tax purposes. Where payments are reported duly and on a timely basis, the taxpayer making them must still prove that they were made in consideration for actual, genuine transactions with persons other than wholly artificial arrangements for the payments to be deductible.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

There is no general tax provision in Belgian tax law that allows an instrument to be bifurcated into debt and equity components.

Based on the specific interest limitation rules described above, excess interest will either be characterized as a dividend (for both the borrower and the lender) or be treated as a non-deductible expense for tax purposes for the borrower only, hence:

- Under the 1:1 debt-equity rule,[57] to the extent the total amount of the interest-bearing loans is higher than the paid-up capital at the end of the taxable period plus taxed reserves at the beginning of the taxable period, or to the extent the interest is not at arm's length, interest on a loan is characterized as a dividend both for the Belgian borrower (with the consequence that the excess is no longer a deductible expense[58]) and the foreign lender (with the consequence that the excess is treated as a dividend for withholding tax purposes). The debt itself is not, however, recharacterized as equity.
- Under the 5:1 debt equity rule,[59] interest is no longer a deductible expense for the Belgian borrower to the extent the aggregate amount of such loans exceeds five times the sum of the taxed reserves existing at the beginning of the taxable period and the paid-in capital existing at the end of the taxable period. The excess is not characterized as a dividend.[60]
- An interest payment that falls within the scope of the application of the rule in Article 54 of the ITC that addresses payments to tax havens is treated as a non-deductible expense for tax purposes [61] if the taxpayer fails to establish that the payment relates to a genuine and legitimate operation; if the taxpayer satisfies the burden of proof (genuine and legitimate operation), but the expense exceeds the normal limits (i.e., the arm's length standard), only the deduction of the excessive part of the payment is allowed.[62]
- Under the transfer pricing rules, only the part of the interest that is not at market rate is treated as a disallowed expense for tax purposes.

D. Effect of an Income Tax Treaty Between Belgium and FC

With respect to tax treaties, Belgium adheres to the "monistic school," with the consequence that where there is a conflict between domestic law provisions and treaty provisions, the treaty provisions prevail.[63] According to the Belgian tax authorities, the provisions of a tax treaty do not restrict the right of Belgium to apply its domestic anti-avoidance provisions in treaty situations, although this contention is the subject of debate among legal scholars.[64]

Since Belgium's tax treaties are based on the OECD Model Convention, the basic question is whether the Belgian tax law provisions addressing thin capitalization and payments to tax havens are in line with Article 9 (arm's length principle)[65] and Articles 10 and 11 of the OECD Model Convention. Specifically, the question is whether an interest payment characterized as a

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dividend payment under domestic rules should be characterized in the same way for purposes of applying the treaty provisions on withholding tax in the source State.[66]

As regards the 1:1 debt-equity rule,[67] a characterization will in most instances conflict with the arm's-length requirement set forth in Article 9 of the OECD Model Convention since the ratio applies without variation, regardless of the industry in which the company operates or the company's status, and since the company does not have the opportunity to prove that its debt-equity ratio is in accordance with market conditions.[68] The characterization of interest as dividends will have no effect on the application of Articles 10 and 11 of the OECD Model Convention, since such income is not derived from another corporate right (as is required by Article 10(3) of the OECD Model Convention for income to fall within the definition of "dividends" for purposes of Article 10).[69] However, many of Belgium's tax treaties deviate from the OECD Model Convention in this respect and allow dividend withholding tax to be imposed in such cases.[70]

As regards the 5:1 debt-equity rule,[71] legal scholars observe that the discussion is similar to that which has developed with respect to Article 18, al. 1er, 4° of the ITC:

Although neither of the two provisions allow the taxpayer to demonstrate that the statutory debt/equity ratio corresponds to the ratio which prevails e.g. in the same kind of business in Belgium and could therefore be criticized for not respecting the "arm's length" -principle, there is a notable difference between the two provisions. Where the 1:1 debt/equity ratio of Art. 18, 4° BITC will in many instances be below the market (or industry) ratio, such will not necessarily be the case with a 7:1 debt/equity ratio [since July 1, 2012, reduced to 5:1] which may be well above the market (or industry) ratio.[72]

As regards the transfer pricing rules and the rule in Article 54 of the ITC, which addresses payments to tax havens, legal scholars such as L. De Broe are of the opinion that:

> . . . .transfer pricing rules increasing the taxpayer's burden of proof or reversing it cannot be said to violate article 9 (1) OECD model convention. However, to the extent that they are only applicable in case of payments made to non-residents such rules conflict with the non-discrimination requirement set forth in article 24 (4) OECD model convention because the deduction is not allowed under the same conditions as for payments made to residents. They also conflict with the non-discrimination principle set forth in article 24 (5) OECD model convention provided that the more burdensome rules of proof are caused by the fact that the company is controlled by non-residents. Although article 54 ICT increases the taxpayer's burden of proof only in case of payments to non-residents (but independent from the fact that the Belgian payor is controlled by non-residents) it does not infringe the provisions of Article 9 (1), nor of 24 (4) and (5) OECD model convention because if the taxpayer fails to meet his burden of proof there is only a profit adjustment up to the arm's length standard.[73]

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

For purposes of the taxation of nonresident taxpayers (which are taxable under the "nonresident tax" rules) the ITC considers a partnership without legal personality to be a taxpayer if it is constituted in a legal form analogous to that of a Belgian corporation.[74] Otherwise, a foreign partnership without legal personality will be treated in accordance with its treatment under the civil or commercial law (rather than tax law) of its country of residence or creation, as the case may be.[75] The interest income attributed to such a partnership will be considered attributed to its partners.

The situation may be different when a tax treaty applies. A few of Belgium's treaties specifically address the status of partnerships, providing that, although it is not taxable as such, a partnership may be recognized as a resident of the relevant Contracting State for treaty purposes. Where the applicable treaty does not specifically address partnerships, Belgium applies the principles set out in the OECD Partnership Report and grants treaty benefits to the partners rather than the partnership.[76]

It may be inferred from the above that from a deductibility (as well as from a taxability) perspective, interest paid to a foreign partnership will be treated according to the above rules. As already noted, if interest is attributed to a partnership without legal personality under foreign law, the interest will be considered attributed to its partners. This may have consequences for the deductibility of interest (for example, where: (1) although the partnership is located in a country that has a normal tax regime, the partner is located in a tax haven; or (2) the partner is a resident of Belgium whereas the partnership is located in a tax haven). The rate of withholding tax (see IV., below) may also vary depending on the residence of the partner in receipt of the interest income.

If the foreign partnership concerned is treated as transparent for foreign tax purposes but has legal personality under foreign common law, the foreign tax transparency will in principle be disregarded for Belgian tax purposes and the interest will be treated as income of the partnership.[77] This will also be the case if the foreign partnership is created under a form analogous to a Belgian corporate form (*société en nom collectif* or *société en commandite simple*).

That being said, a number of rulings concerning U.K. limited liability partnerships (LLPs) have held that, because Belgium's tax treaties take precedence over its domestic law, the tax transparency of such entities would be recognized in Belgium, albeit only for purposes of taxing their Belgian partners.[78] The share of the income attributable to the LLPs' foreign partners remained taxable in the hand of the LLPs. This approach seems to be inconsistent with a recent Supreme Court decision to the effect that, because a French *société civile immobilière* (SCI) has legal personality under French civil law, it should be treated as non-transparent for Belgian tax purposes even though under French tax law the income of an SCI is taxed in the hands of its partners.

IV. Withholding Tax Issues

Generally, withholding tax at a rate of 30% is imposed on all interest payments made by a Belgian debtor or through a Belgian intermediary. No general domestic law exemption is available for cross-border payments.

Specific exemptions can, however, apply depending on the status of the creditor, the status of the borrower and the nature of the debt instrument,[79] or under a specific tax treaty.

For withholding tax purposes, the same rules regarding the characterization of a payment as interest or dividend as those described in II.D., above will apply.

Since domestic withholding tax exemptions depend on the status of the creditor, the status of the borrower, the nature of the debt instrument, or the applicable tax treaty, the Belgian tax courts have had to deal with the characterization of debt instruments for withholding tax purposes. For instance, interest on bond issues as opposed to ordinary loans benefits from a withholding tax exemption under Article 107, § 2, 10° of the RD/ITC. In a number of cases, the tax authorities have characterized bond issues as ordinary loan agreements and thus denied the specific withholding tax exemption for bond interest.[80]

Belgian income tax law has no rule linking the tax deductibility of interest payments to the payment of any withholding tax due, even though a Belgian resident company that is a debtor with respect to interest is liable for making the withholding tax payments with respect to payments of the interest.[81]

V. Difference if FCo Has a Permanent Establishment in Belgium

If FCo has a Belgian establishment[82] or, where a tax treaty applies, a PE in Belgium, income realized through the Belgian establishment/PE is subject to Belgian nonresident corporate income tax. There is no force of attraction rule.[83] For purposes of determining the taxable profits of the Belgian establishment/PE, the establishment is treated as a separate entity (the "direct method").

As a consequence, for income from personal property (such as loans or shares) to be allocated to a Belgian establishment/PE it is necessary that the property itself can be attributed to the Belgian establishment/PE:

Some tax commentators are of the opinion that the allocation of goods to a PE depends on the economic risks attached to the Belgian operation which can affect the value of the assets.[84] The degree of exposure to economic risks is reflected in the manner in which the assets are recorded in the PE's accounts (whereby all subsequent changes in value will affect the PE's profits and losses). Other commentators have added a functional criterion, that is, a sufficient link with the PE's business. An example would be the acquisition of assets financed by the PE's funds.[85]

VI. Legislative Changes

No specific legislative changes that would affect Belgian resident corporations and their foreign lenders are currently pending before the Belgian parliament. However, Belgium has yet to implement Council Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.[86] This Directive was adopted in order to implement OECD BEPS conclusions at the EU level and includes interest limitation rules[87] designed to combat BEPS resulting from excessive interest payments, a framework for addressing hybrid mismatch arrangements and a general anti-abuse rule.[88] These measures must be implemented by December 31, 2018, and enter into force with effect from January 1, 2019. Regarding the interest limitation rules, Article 11.6 of the Directive stipulates that:

> by way of derogation from Article 4, Member States which have national targeted rules for preventing BEPS risks at 8 August 2016, which are equally effective to the interest limitation rule set out in this Directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.[89]

The implementation of Article 11.6 has raised major concerns among practitioners with respect to the identification of existing national measures that could pass the equally effective test.[90] As discussed in II., above, Belgium's tax law contains thin capitalization and anti-abuse provisions as well as various arm's-length provisions that limit interest deductions; however, the existing measures do not provide for an interest limitation rule based on the earnings of the interest paying company. Nevertheless, Belgium was one of the Member States that insisted on the insertion of paragraph 6 in Article 11 of the Directive. It remains to be seen whether Belgium will try to demonstrate to the European Commission the equivalent effectiveness of the existing Belgian measures; all information necessary for evaluating the effectiveness of the national targeted rules must be communicated to the European Commission before July 1, 2017. Legal scholars have expressed doubts that Belgium will pass the test.[91]

NOTES

[1] Income Tax Code 1992 ("ITC").

[2] ITC, art. 19, § 1er, 1° ; S. Vanoppen, "The Debt Equity Conundrum," IFA, Cahiers, 2012, 97b, p. 117:

> Following this definition, it must be noted that taxable interest does not necessarily have to relate to proceeds generated from a contractual relationship evidenced by a loan agreement: payments qualify as interest when their underlying source is a receivable which does not meet the Civil Code definition of loan, in principle requiring the repayment of the nominal value/principal amount which has been invested.

[3] A. Haelterman and E. Maes, "Tax Issues in Consensual Debt Restructuring," D&FI, 2012, n°5, p. 211:

> Under Belgian tax law, no specific rules determine what is deemed to be equity or debt. Thus, as a rule of thumb, the definition under Belgian civil and commercial law must be taken into account. An equity investment essentially requires the intent of the parties to share in the profits as well as the losses resulting from the entrepreneurial activity (the so-called *affectio societatis*). A debt investment entails a return which is certain or at least determinable, regardless of whether the company actually realizes any net earnings. On the other hand, a creditor is not expected to participate in any gain resulting from the profitable affairs of the company, whether through dividends, sales on the secondary market, or upon liquidation. In practice, a binding and preliminary tax ruling will often be rec-

ommended to confirm the classification of a hybrid instrument and to secure the envisaged tax treatment.

[4] For a detailed discussion, see S. Vanoppen, "The Debt Equity Conundrum," IFA, Cahiers, 2012, 97b, pp. 122–33.

[5] S. Vanoppen, "The Debt Equity Conundrum," IFA, Cahiers, 2012, 97b, pp. 124–33:

> Below will be described how, in the reporter's view, the classification of "loan relationships" for Belgian tax purposes (as based on non-tax law) is indeed to be regarded as based on a "one decisive element" approach, that is to say "the right of the lender to be repaid the initial outlay (or principal amount) at least and possibly only in the case of a *concursus creditorum*." According to Belgian general (contract) law, a loan relationship is characterized by two basic obligations relating to each party of the loan agreement: the first basic obligation is the obligation of the lender (creditor) which marks the start of the loan relationship and which consists in the delivery (transfer) of the goods lent; the second basic obligation is the obligation of the borrower (debtor), which consists of the restitution or the repayment of the given goods marking the end of the loan relationship. From the latter, it follows that in principle a repayment at maturity of the goods lent (i.e. at the end of the term) is a basic requirement for a contract to qualify as a loan agreement. Notwithstanding the second basic obligation (requiring the repayment of goods lent at maturity), the Belgian Civil Code (in Articles 1909 to 1914) also recognizes a specific type of debt contract/loan relationship (*eeuwigdurende rente* or perpetual interest), in which the absence of a stated maturity date does not lead to the classification of the given agreement as a loan agreement being disallowed (. . .) In this respect, the reporter would like to refer to the Belgian scholar Haelterman who points to the fact that a loan relationship becomes due in case of a bankruptcy (also in the absence of a stated maturity) as the decisive element for the purposes of classification. According to his view, the theoretical possibility to require repayment (even if only in case of default or *concursus creditorum*) can be considered to be decisive for an instrument's classification as debt. In order to classify perpetual bonds, other scholars have similarly argued that "the obligation to repay the loan is one of the key characteristics of debt instruments as opposed to equity." On the question of the "benchmark" test used by Haelterman, it has been shown above that the Belgian Civil Code provides for a legal framework to enter into a "perpetual" loan agreement with (a) the lender (creditor) waiving its right to demand repayment, (b) the borrower (debtor) setting aside its right to repay via a non-redemption clause up to 10 years (after which its discretionary right to repayment revives) and (c) the initial outlay (or principal) becoming repayable in case of default and *concursus creditorum*. This means that even if a loan relationship has no fixed maturity on which the initial outlay will mandatorily be repaid (or become repayable) and repayment of the principal will only occur at the discretion of the debtor/borrower (after some possible non-redemption clause has been forgone) or in cases of default or *concursus creditorum*, the contractual relationship does not lose its classification as a loan relationship. Fully in line with the general (contract) law principles (as rooted in the Belgian Civil Code) set out above, one can argue that when a lender has the right to be repaid the initial outlay at least and possibly only in case of a concursus creditorum, the given contractual relationship can still qualify as a loan relationship.

A. Haelterman, "*Quelques réflexions sur la notion d'intérêt à la lumière de quelques nouveaux instruments de placements et de financement*," Revue de droit de l'U.L.B., 1999, p. 89; H. Lamon, F. Weynants and D. Berckmans, "Tax Treatment of Debt Instruments without Fixed Right to Redemption," D&FI, 2001 p. 143; S. Martin and P. Smet, "New tendencies in tax treatment of cross border interest of corporations," IFA, Cahiers, 2008, 93b, p. 130:

> Belgium generally applies a "form-over-substance" theory to financing structures. If the Belgian company receiving the financing technically has the legal obligation to pay back the principal amount and to pay a periodic compensation regardless of the availability of distributable reserves, the financing will generally be classified as debt financing, even if the investor's economic position is similar to that of an equity investor.

[6] S. Martin and P. Smet, "New tendencies in tax treatment of cross border interest of corporations," IFA, Cahiers, 2008, 93b, pp. 131-2

> The following features are "as such" not sufficient to classify a financing instrument as equity financing:
>
> - Perpetual: the existence — or not — of a maturity date is not essential to its characterization as a loan, as the Belgian Civil Code expressly recognizes the perpetual loan. The debtor must, however, have the right to repay the loan at any time.
> - Profit-participating remuneration: the administrative guidelines expressly stipulate that a profit-participating interest payment is classified as interest.
> - Convertibility into shares in the debtor, including automatic conversion: the administrative guidelines analyze the conversion as an attribution (by the company to the investor) of the principal amount and unpaid interest to the investor, followed by the contribution (by the investor) of its claim (relating to the principal amount and unpaid interest) to the capital of the company in exchange for shares. As the investor is formally entitled to the repayment of the principal amount, the convertible financing instrument is technically debt financing. Furthermore, the Belgian Commission for Accounting Standards has stated that automatically convertible bonds should be analyzed as debt instruments until the conversion takes place.
> - Payment of interest "in kind," in the form of shares of the issuer: similarly to the conversion of a convertible bond, the payment in kind should be analyzed as an attribution of interest (by the company to the investor) followed by a contribution of the interest claim (by the investor) to the capital of the company in exchange for shares. Therefore, the interest is technically paid.
> - Subordination and thin capitalization: the Supreme Court has ruled that funds (which were formally put at the disposal of the company in the form of the subscription of a bond) were not subject to the enterprise risk (and could therefore not be classified as equity), in a case where the bond was not secured. The company was thinly capitalized and the compensation was profit-participating. These principles have recently been confirmed in several advance rulings issued by the Belgian Ruling Commission.

[7] Ruling (*Décision anticipée*) n°700.065, May 5, 2007.

[8] Ruling (*Décision anticipée*) n° 600.099, May 4, 2006.

[9] Rulings (*Décisions anticipées*) n° 2016.799, January 10, 2017; n° 2015.490, Sept. 29, 2015; n°2015.228, May 21, 2015.

[10] Unless tax law explicitly deviates from the accounting treatment.

[11] S. Martin and P. Smet, "New tendencies in tax treatment of cross border interest of corporations," IFA, Cahiers, 2008, 93b, p. 138.

[12] D. Garabedian, "Form and Substance in Tax Law," IFA, Cahiers, 2002, 87a, p. 156.

[13] D. Garabedian, "Form and Substance in Tax la" IFA, Cahiers, 2002, 87a, pp. 154–6: "There is sham where the parties outwardly enter into an act whose effects they agree to modify or destroy by another contract, which remains secret. Sham thus presupposes two contracts, each contemporaneous with the other, but one of which is in-

tended only to lay a false scent. There exists only one real contract, the secret contract."; H. Lamon, F. Weynants and D. Berckmans, "Tax Treatment of Debt Instruments without Fixed Right to Redemption," D&FI, 2001, p. 144: "The legal classification should be analyzed based on essential features of the contract considering the real intention of the parties as opposed to the form given by the parties ("sham transaction" or apparent classification)."

[14] D. Wyntin, "International Aspects of Thin Capitalization," IFA, Cahiers, 1996, 81b, p. 349.

[15] Cass., September 5, 1961, Pas., 1962, I, p. 29; Cass., January 11, 1966, Pas., 1966, I, p. 611.

[16] For a detailed discussion of ITC, Art. 344, § 1er, as introduced in 1993, see D. Garabedian, "Form and Substance in Tax Law," IFA, Cahiers, 2002, 87a, pp. 157–67; for an illustration of the application of ITC, Art. 344, § 1 in a case of "fat capitalization," see D. Wyntin, "International Aspects of Thin Capitalization," IFA, Cahiers, 1996, 81b, p. 361:

> It seems quite paradoxical that tax authorities would requalify capital as loan because from an economic point of view, capital contributions are far better than loans. (. . .) Nevertheless, the Belgian Ruling Committee of the Tax Administration refused to give a ruling on the question whether capital contributions to an Irish IFSC company were economically or financially justified. The Ruling Committee said that the transaction was principally based on tax reasons and aimed to convert taxable interest as tax-free dividend according to the dividend exemption rule. The Ruling Committee said nothing about the fact of an excessive capitalization. Nor was an interpretation of the relation between article 344, § 1 ITC and the Belgian-Irish double tax treaty on "fat capitalization" mentioned.

[17] For a detailed discussion of ITC, Art. 344, § 1, as revisited in 2012, see S. Claes, "The Taxation of Foreign Passive Income for Groups of Companies," IFA, Cahiers, 2013, 98a, pp. 142–3.

[18] A proposal to recast Council Directive 2003/49/EC on the common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (the "interest and Royalties Directive") has been tabled by the Commission. One proposal is to insert a general anti-abuse provision similar to that in Directive 2011/96/EU. Another relates to the inclusion of a clause under which, when the effective tax rate was lower than a minimum specified tax rate threshold, the Member State of source would retain the right to impose withholding tax on an interest or royalty payment (i.e., the benefits of the Directive would be denied) (see, Ecofin report to the European Council on Tax issues, Fisc 108, Ecofin 640, 23 June 2016, pp.7–9). Further discussions concern the relation between the minimum effective tax rate and patent box regimes as modified using the OECD nexus approach.

[19] Although both Directives had to be implemented by December 31, 2015, the Belgian bill was not adopted until December 1, 2016. Nonetheless, the Belgian rules apply, for income tax purposes, with respect to income allocated or assigned on or after Jan. 1, 2016, and, for withholding tax purposes, with respect to income allocated or assigned on or after January 1, 2017. See P. Van den Berghe and S. Verdonck, "*Anti-hybride en antimisbruikbepalingen van moeder-dochterrichtlijn eindelijk omgezet*," Fisc. Act., 2016/43, pp. 4–8.

[20] Unlike under the domestic law implementation of some other EU Member States (e.g., Luxembourg).

[21] For the confirmation of the Belgian Minister of Finance, see Parliamentary Question 919 of April 13, 2016, (*Questions et Réponses,* Chambre, 54, n°089, pp. 319–21).

[22] In the past, the Belgian ruling commission has granted a number of rulings with respect to profit-participating loans, in which it accepted the deductibility of the interest payments at the level of the Belgian corporate issuer, even though such instruments were treated as equity for Luxembourg tax purposes under a substance-over-form approach.

[23] Ch., 54, n°2052/1, p. 5, Ch. 54, n°2052/2, p. 4:

> *Étant donné que la Belgique utilise, d'un point de vue fiscal, en comparaison avec d'autres pays, une définition relativement restrictive de la notion de "capital" et une définition relativement large de la notion de "créance", ce ne sera que dans des cas très exceptionnels qu'une somme octroyée ou payée à une société établie en Belgique ou à un établissement stable et qui est prise en considération pour la déduction à titre de RDT pourrait en même temps être déduite de la base imposable de la société qui a attribué ou mis en paiement cette somme.*

D. Gutman e.o., "The Impact of the ATAD on Domestic Systems: A comparative survey," E.T., 2017, p. 16: "Under Belgian domestic law, the definition of equity has a limited scope while the definition of debts is very broad. Consequently, situations where the 95% deduction for received dividends applies in circumstances in which those distributions were deductible at the level of the distributing company or PE should be very rare."

[24] Rulings (*Décisions anticipées*) n° 600.099, May 4, 2006, and n°700.065, June 5, 2007.

[25] Question n°919, April 13, 2016, M. Gilkinet (*Questions et Réponses, Chambre, 54, n°089,* p. 319).

[26] D. Garabedian, "Form and Substance in Tax Law," IFA, Cahiers, 2002, 87a, p. 153:

> One principle is that of the "legality of tax." The authors of the Belgian Constitution viewed tax as an infringement of individual freedom and the right of property; the principle is that persons and goods are generally exempt from any levy, and tax is an exception which can be established by the legislature only (Constitution, article 170). From this principle, it can be inferred that the tax laws should be interpreted and applied strictly. In the case of doubt as to the meaning of a tax provision, the interpretation favorable to the taxpayer must prevail and tax provisions cannot be applied by analogy.

[27] D. Garabedian, "Form and Substance in Tax Law," IFA, Cahiers, 2002, 87a, p. 154: "The other fundamental principle is that tax law is governed by private law, as a rule: concepts used in a tax statute should be interpreted in accordance with their private law meaning, and transactions entered into by taxpayers should be characterized in accordance with private law principles."

[28] ITC, Art. 49 and Art. 52, 10°: expenses that exceed professional needs in an unreasonable manner are not tax-deductible; S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 128:

> The fact that all income generated by a company is taxable business income, regardless of the link to the corporate purpose, does not mean that the expenses incurred or borne to generate this income will by definition be tax deductible. In addition, the borrower must have the legitimate expectation that the loan's purpose can generate an income in excess of the expected interest expense. The tax authorities require that this profit expectation is on a pre-tax basis: interest expenses linked to a transaction aimed at "destroying" the tax basis are not tax deductible ("cash drain" theory).

[29] S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 138:

For the deduction of interest no specific permission or advance ruling is required. However, the taxpayer bears the burden of proof in showing that all conditions allowing interest to be deducted have been fulfilled. The existence and amount of the interest must be evidenced by supporting documentation, or if this documentation is not available, by any other evidential method admitted under common law, except the oath. Expenses must in any case be recorded in the books of the taxpayer for the relevant financial year. Evidence that the interest relates to a *bona fide* business transaction also requires supporting documentation. In practice, supporting documentation does not need to be filed with the tax authorities (except for the financial statements that must be annexed to the tax return) and will only have to be provided to the tax authorities at their request (e.g. request for information, tax audit) or in the case that the deduction is challenged by them.

[30] ITC, Art. 52, 2°.

[31] S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations", IFA, Cahiers, 2008, 93 b, p. 134 ; M. Van Keirsbilck, "Artikel 49 WIB 1992: *een nieuwe algemene anti-misbruikbepaling*, T.F.R., 2004, n°257, pp. 223–43; S. Gnedasj, "*Negentig jaar cassatierechtspraak inzake kostenaftrek*," A.F.T., 2016, n°1, pp. 5-119; Ch. De Backere, "*Pleidooi voor een zuivere toepassing van artikel 49 WIB 1992 in de vennootschapsbelasting,*" T.F.R, 2016, n°500, pp. 368–88.

[32] ITC, Art. 185; S. Vanoppen, "The Debt Equity Conundrum," IFA, Cahiers, 2012, 97b, p. 117.

[33] S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 139.

[34] For a detailed description, see A. Haelterman and H. Verstraete, "The 'notional interest deduction' in Belgium," B.F.I.T., 2008, pp. 362–9; for assessment year 2007, the notional interest deduction was calculated using a reference rate of 3.442% (3.942% for small companies); the deduction has lost a great deal of its initial appeal due to a number of rate cuts (see T. de Clerck, "*De notionele interestaftrek-bis: geen verandering voor vooruitgang, maar wel stagnatie*," T.F.R., 2016, n°506, pp. 681–96); for assessment year 2018, the notional interest deduction rate is limited to 0.237 % (0.737 % for small companies).

[35] The Belgian tax authorities have issued a Circular Letter providing guidance on the application of the general and specific anti-abuse measures under which aggressive tax planning may be challenged: Circ. AEFR n°14/2008, April 3, 2008.

[36] W. Huygen and P. Vandenbussche, "No substance requirements for Belgian Notional Interest Deduction," D&FI, 2016, n°3; K. Bronselaer en S. Vanthienen, "*Notionele interestaftrek – De aanval op multinationale groepen die financieringsactiviteiten in België centraliseren*," T.F.R., 2016/2, n° 494, p. 87-92.

[37] S. Claes, "The Taxation of Foreign Passive Income for Groups of Companies," IFA, Cahiers, 2013, 98a, p. 150: "The general at arm's length principle is codified in article 185, § 2 ITC and is defined in a fairly similar manner to article 9 of the OECD model. The tax authorities can invoke this provision to prevent profit shifting to a FC of the same multinational group, the latter being a group within the meaning of article 11 Belgian Company Code. The tax authorities have to prove that the transaction is not at arm's length."

[38] ITC, Art. 55 and Art. 18, al. 1er, 4°; S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93 b, p. 137; D. Wyntin, "International Aspects of Thin Capitalization," IFA, Cahiers, 1996, 81b, p. 348:

The law refers to article 55 ITC which regulates the tax-deductibility of interest as a professional expense insofar as the interest is not higher than the normal market rate, taking into consideration the special facts related to the judgment of the risk linked to the loan and especially the financial situation of the debtor and the period of the loan. It is important to note that the law only requalifies the part of the interest exceeding the normal market rate. The other part, equal to the normal market rate, remains a tax-deductible interest expense.

[39] D. Van Stappen, "Financing : a global survey of thin capitalization and transfer pricing rules in 35 selected countries: Belgium," ITPJ, 2008, n°6, p. 289:

As a consequence, one should analyze other sources such as the administrative comments of the tax authorities on the Income Tax Code and court cases in order to determine which elements are (or should be) used by the tax authorities to assess the arm's length character of interest rates on intercompany loans. (. . .) The tax authorities further state that the amount of the advantage is to be determined by taking into account the specifics of each individual case, especially: the conditions under which the loan has been granted, such as the duration of the loan, the means of repayment and any guarantees given by the borrower; the interest rate to which the lender would have been entitled when the loan was granted; and the financial expenses resulting from the loan that has been entered into by the lender in order to be able to grant the low-interest loan or interest-free loan. Additional criteria that may be used in determining the arm's length nature of the interest rate include the following: the nature of the credit facility (e.g. loan, deposit or trade debt); the amount and duration of the loan; and the risks incurred by the lender resulting from the loan; whether or not guarantees have been given by the borrower (e.g. mortgage or security); the creditworthiness of the borrower (e.g. financial position, solvency ratio and existing debt burden); and the currency in which the loan is denominated (interest rate and inflation rate in country of issuance of the credit facility). This list of criteria is not exhaustive, and other elements may be taken into account in order to assess the arm's length nature of the interest rate applied on the intercompany loan.

[40] ITC, Art. 56.

[41] S. Claes, "The Taxation of Foreign Passive Income for Groups of Companies," IFA, Cahiers, 2013, 98a, pp. 150-1; D. Wyntin, "International Aspects of Thin Capitalization," IFA, Cahiers, 1996, 81b, pp. 353–4:

In relation to financial instruments, article 26 ITC has frequently been used to counteract borrowings with an interest rate too high or loans with an interest rate too low or loans without any interest payment. In the first situation, the Belgian enterprise paid too much interest according to an arm's length criterion and in the second situation, the Belgian enterprise received too little interest or no interest at all according to an arm's length analysis. Also the cancellation of claims by a Belgian company in favor of its foreign subsidiary has been tested on article 26 ITC and could sometimes be regarded as benevolent. It is generally agreed that a requalification of loan as equity cannot be based on article 26 ITC. Article 26 ITC is only able to add back a certain amount to the taxable profits of a Belgian enterprise due to the abnormal or benevolent character of an advantage. Surprisingly, thin capitalization has not been an issue in the area of Belgian tax regulations of transfer pricing.

Rather, it is "fat capitalization" in the context of the notional interest deduction that has been attacked by the Belgian tax authorities as constituting an abnormal or benevolent advantage in the hands of the Belgian equity-financed company; L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°145: "Belgium has introduced the "arm's

length" principle in its domestic legislation through the enactment of Art 185 (2) BITC."

[42] The Belgian Ruling Commission validated the use of profit participating loans and profit participating securities: for Belgian tax purposes, a Belgian corporate issuer could deduct the interest payable under such instruments, even though the interest was not taxed in the hands of the Luxembourg creditor. Ruling n°700.065 explicitly states that the fact that the interest payments to the Luxembourg company are not taxable in the hands of the Luxembourg creditor under the Luxembourg participation exemption does not trigger the application of the specific Belgian anti-abuse provision (i.e., ITC, Arts. 54 and 198, 11°).

[43] The participation exemption for dividends received will not be granted under Belgian domestic law if the dividends were deducted by the distributing company.

[44] A hybrid mismatch means:

> a situation between a taxpayer in one Member State and an associated enterprise in another Member State or a structured arrangement between parties in Member States where the following outcome is attributable to differences in the legal characterization of a financial instrument or entity: a) a deduction of the same payment, expenses or losses occurs both in the Member State in which the payment has its source, the expenses are incurred or the losses are suffered and in another Member State ('double deduction'); or b) there is deduction of a payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payment in the other Member State ("deduction without inclusion").

[45] ITC, Art. 18, al.1, 4°; for a comment on this, see S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 136.

[46] There is extensive case law on the question of which transactions are loans (*prêt d'argent/geldlening*) for purposes of the application of ITC, Art. 18, al.1er, 4°; Circulaire n° Ci.RH.231/543.949 (AEFR 2/2005), Jan. 11, 2005; Circulaire n° Ci.RH.231/543.949 (AEFR 2/2005), Sept. 12, 2007; Anvers, March 18, 2008, Courrier fiscal 2008/07, p. 436; Cass., May 20, 2010, Courrier fiscal, 2010/13, p. 589.

[47] Including liquidators and persons performing similar functions.

[48] ITC, Art. 18, al.1, 4° and Art. 55: the latter provides, *inter alia*, that interest on bonds, loans, claims, deposits and other financial instruments equivalent to loans is to be treated as a professional expense only to the extent to which it does not exceed an amount corresponding to the market rate having regard to the particular factors specific to the assessment of the risk connected with the transaction concerned and, in particular, the financial situation of the debtor and the duration of the loan.

[49] CJEU, Case C-105/07, *Lammers & Van Cleeff NV*, Jan. 17, 2008, ECLI:EU:C:2008:24: 27:

> The mere fact that a resident company is granted a loan by a related company which is established in another Member State cannot be the basis of a general presumption of abusive practices and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty (*Test Claimants in the Thin Cap Group Litigation*, paragraph 73 and the caselaw cited). (. . .) 33. As the Commission of the European Communities stated in its submissions, the limit laid down in the second indent of Article 18(1), point 3, of the ITC 1992 also affects situations in which the transaction concerned cannot be regarded as a purely artificial arrangement. If interest payments made to nonresident companies are reclassified as dividends as soon as they exceed such a limit, it cannot be ruled out that that reclassification will also apply to interest paid on loans granted on an arm's length basis.

Meanwhile, the Belgian tax administration has confirmed that ITC, Art. 18, al. 1er, 4° no longer applies where interest payments are made to a director that is a company established in an EU Member State (Circ. Nr. Ci.R.H.231/543.A49 (AOIF 2/2005), January 11, 2005).

[50] ITC 92, Art. 198, § 1er, 11°; "*Apercu des dispositions fiscales de l'année*", Cour. Fisc., 2013, n°1–3, pp. 53–9.

[51] A group is defined by reference to Companies Code, Art. 11, for intra-group loans. Subject to certain conditions, the ratio does not apply with respect to loans contracted by leasing or factoring companies or to companies in the context of public-private cooperation. In addition, there are specific rules for companies responsible for their group's centralized treasury management (for further developments see I. Verlinden, D. Ledure and M. Horemans, "Recent Developments in Thin Capitalisation Rules: A cloud with a clear silver lining," I.T.P.J., 2012, pp. 417–9).

Regarding compatibility with EU law, see S. Claes, "The Taxation of Foreign Passive Income of Groups of Companies," IFA, Cahiers, 2013, 98a, p. 150:

> The law provides that the commonly applicable tax rules in Member States of the European Economic Area cannot be considered as substantially more beneficial than in Belgium. One can, however, rightfully question whether the exclusion from the netting of interest payments from a payer in a third country that is not an artificial construction, but with a substantially more beneficial tax regime, could be contrary to the freedom of capital. There is no possibility for the taxpayer to prove in a given case that, although its debt exceeds the 5:1 ratio, its debt level and interest expense are still at arm's length and consequently should not be disallowed. The impossibility of proving the contrary appears to breach the EU treaty freedoms.

[52] Unlike under the 1:1 debt-to-equity ratio, under the 5:1 debt-to-equity ratio the excessive interest is not recharacterized as a dividend.

[53] I. Verlinden, D. Ledure and M. Horemans, "Recent Developments in Thin Capitalisation Rules: A cloud with a clear silver lining," I.T.P.J., 2012, pp. 417–9:

> The latter condition indicates that this is a specific anti-abuse measure which does not target third-party debt secured by a related party in general (as is the case in certain other European countries), but only structures the main purpose of which is tax avoidance. Therefore, this specific anti-abuse measure should generally not apply to e.g. bank debt secured by a guarantee from a related party, where sound economic drivers for the set-up will be available (e.g. less stringent covenants). The beneficial ownership clause could, however, apply in cases where an existing intra-group loan is e.g. simply "routed" through an external bank going forward to avoid application of the new thin capitalization rules.

[54] S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 136; N. Reypens, "Cross-Border Outsourcing — Issues, Strategies and Solutions," IFA, Cahiers, 2014, 99a, p. 137; S. Claes, "The Taxation of Foreign Passive Income for Groups of Companies," IFA, Cahiers, 2013, 98a, p. 147:

> There are no detailed guidelines as to when income is subject to a "substantially more beneficial tax regime" than the Belgian regime for the purposes of article 54 ITC, and how the comparison with the Belgian regime should be made. The official guidelines state that it is practically impossible to determine a general rule and that the tax authorities will consider the facts of each case separately. The Minister of Finance has declared

that the list of countries which are indicated on the blacklist for participation exemption purposes (see below) as countries the common tax regime of which is considered to be more beneficial than the Belgian regime can be used as a guideline for the tax authorities. This lack of clear rules to determine when income has to be considered as being taxed substantially more beneficially than in Belgium has led the ECJ to condemn article 54 ITC as being in breach of the EU treaty freedom of services (C-318/10, July 5, 2012, SIAT). According to established case law of the ECJ, a measure to combat tax evasion and avoidance is allowed if its specific objective is to prevent the creation of wholly artificial arrangements (see above) which do not reflect economic reality, with a view to escaping the tax normally due on the profits. By just referring to the level of taxation, the anti-abuse provision does not provide sufficient guarantees that only such artificial constructions fall within its scope.

[55] As modified by the Program Law of July 1, 2016; Circulaire 2017/C/14, March 23, 2017; S. Claes, "The Taxation of Foreign Passive Income for Group Companies," IFA, Cahiers, 2013, 98a, p. 148:

> Again, the law creates a reversal of the burden of proof because even if the payments are duly notified the deduction is only allowed if the taxpayer shows that the payments are related to "genuine and legitimate" (see article 54 ITC) transactions with persons other than "artificial constructions." Transactions are considered genuine and legitimate if they have a business purpose and are at arm's length. 48 The explanatory notes refer to the ECJ case law regarding artificial constructions and define it as a construction that has no connection to economic reality and is aimed at "evading" (read also "avoiding") Belgian tax. The TA indicate that even if there is no real economic activity at the level of the beneficiary, the deduction is still allowed provided the payments have occurred within a "framework that was not aimed (by the parties or at least one of them) at avoiding directly or indirectly Belgian income tax." This mitigation is aimed at the situation where the Belgian taxpayer pursuant to a third party contract pays to an unrelated person that has set up a low-tax structure for its own tax planning needs. In such a situation the Belgian taxpayer has no intention of avoiding Belgian taxes.

[56] To be considered a tax haven, a country must appear either on the list established by the Global Forum on Transparency and Exchange of Information of countries that do not meet the OECD standard on transparency and exchange of information or on the Belgian list, established by Royal Decree. Such countries include countries outside the European Economic Area (EEA) in which companies are not subject to corporate tax on domestic or foreign income, and countries that have a nominal corporate tax rate lower than 10% or that have a "normal" tax rate for domestic income but an actual tax rate lower than 15% for non-domestic income ("offshore jurisdictions").

[57] ITC, Art. 18, al. 1er, 4°.

[58] Characterization as a dividend might trigger additional adverse tax consequences for the Belgian borrower (exclusion from the benefit of a reduced corporate tax rate, etc.).

[59] ITC, Art.198, § 1, 11°.

[60] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°176:

> If the debt/equity ratio is exceeded, that part of the interest that relates to the tainted debt in excess of the ratio is treated as a disallowed business expense. It is not treated as a dividend, [n]either for purposes of imposing the corporate tax [n]or for levying withholding tax. The text of statutes makes it clear that even if the debt/equity ratio is not exceeded, that part of the non-excessive interest can be a disallowed expense if it fails to meet the test laid down in art. 54 BITC or 55 BITC (non "arm's length interest").

[61] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°168: "If the taxpayer fails to establish that the payments relate to genuine and sincere operations, the tax authorities are entitled to disallow the deduction of the entire expense"; Court of Appeals, Gent, June 20, 1986, AFT, 1987, 195 (note Vanhoute, P.), where the Court concluded that a loan from a Swiss company was fictitious and then disallowed the deduction of the interest under ITC, Art. 54. The tax authorities are, however, prepared to reimburse withholding tax that a Belgian payor has withheld on tainted payments and paid to the Treasury. This concession is justified by the desire to avoid juridical double taxation (Com. BITC 54/31). However, it would seem that this is rather an issue of economic double taxation since the withholding tax is retained by the Belgian payor on account of the foreign beneficiary, while the disallowed expenses are taxed in the hands of the payor.

[62] L. De Broe, "International Tax Planning and Prevention of Abuse, IBFD Doctoral Series, 2008, n°169:

> The literal text of the statute does not support that conclusion, but it has been confirmed by the Minister of Finance and Supreme Court case law. Here again, the tax authorities are prepared to reimburse the withholding tax withheld on the excessive payments. This concession is surprising because it is totally opposite to the internationally accepted rule under tax treaties that in case of excessive interest and royalties the source State should not even grant a reduction of withholding tax (see Art. 11 (6) and 12 (4) OECD MC). It is suggested that where the tainted beneficiary is a resident of a treaty country and the relevant treaty is in accordance with Art. 11 (6) and 12 (4) OECD MC, Belgium should instead of reimbursing the withholding tax levy supplementary withholding to level it to the domestic withholding tax rate.

[63] L. De Broe, "International Tax Planning and Prevention of Abuse, IBFD Doctoral Series, 2008, n°8: ". . . even if the domestic law provision has been enacted later or even if the domestic provision purports to counter abuse of the treaty. In case of such a conflict, the domestic provision must remain without effect. Accordingly, treaty overrides are not possible in Belgium."

[64] For a detailed description of Belgian tax treaties expressly allowing the application of domestic anti-avoidance provisions and regarding the implication of tax treaties not expressly allowing the application of domestic anti-avoidance provisions, see L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°214–25.

[65] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°257:

> According to article 9 (1) OECD MC, business profits must be taxed in the State where they originate economically. Where items of profit have been diverted from an enterprise in one State to associated enterprise in another State because such enterprises do not operate on arm's length terms, art. 9 (1) allows the tax authorities of the first State to adjust the profits of the enterprise established there and to attribute the diverted profit to the enterprise's tax base. As such item of profit is normally also taxed in the residence State of the other enterprise economic double taxation occurs. Art. 9 (2) aims at eliminating such double taxation.

[66] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°256.

[67] ITC, Art. 18, al. 1er, 4°.

[68] For a detailed comment, see L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°275-7.
[69] D. Wyntin, "International Aspects of Thin Capitalization," IFA, Cahiers, 1996, 81b, p. 359: "A requalification of loan as equity which is solely based on a debt to equity ratio, while the characteristics of the financial instrument indicate a real loan, is contrary to articles 10 and 11 of the double tax treaties."
[70] For a detailed discussion see L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°275-7.
[71] ITC, Art.198, § 1, 11°.
[72] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°281–3.
[73] L. De Broe, "International Tax Planning and Prevention of Abuse," IBFD Doctoral Series, 2008, n°529.
[74] ITC, Art. 227, 2°.
[75] Ph. Hinnekens, "International Tax Problems of partnerships," IFA, Cahiers, 80a, p. 89.
[76] P. Faes, "Qualification of taxable entities and treaty protection," IFA, Cahiers, 99b, p. 159.
[77] Ph. Lion, "Conflicts in the attribution of income to a person," IFA, Cahiers, 92b, p. 115.
[78] Cass., September 29, 2016, obs; J. Malherbe, Droit fiscal, 2016, nr. 45, Actualités 619, p. 5, reversing Cass., December 2, 2014, JDF, 2004, p. 7, obs. C. Docclo, cited, P. Faes, *op. cit.*, p. 159.
[79] S. Martin and P. Smet, "New Tendencies in Tax Treatment of Cross Border Interest of Corporations," IFA, Cahiers, 2008, 93b, p. 129.
[80] Mons, June 28, 2013, RG 2011/RG/346, www.monkey.be.
[81] ITC, Art. 261.
[82] The "Belgian establishment" concept is similar to the "permanent establishment" concept in OECD Model Convention, Art. 5; see L. Denys, "Belgium: The Concept of Permanent Establishment Revisited and Other Reflections Beyond," Bull. Int. Tax., 2008, p. 443.
[83] T. Wustenberghs, "The Attribution of Profits to a Permanent Establishment," IFA, Cahiers, 2006, 91b, p. 178: "If a company realizes a profit in Belgium without the involvement of the BE, this profit should not be attributed to the BE."
[84] This is in line with case law, see L. Denys, "Belgium: The Concept of Permanent Establishment Revisited and Other Reflections Beyond," Bull. Int. Tax., 2008, p. 451.
[85] D. De Crem and I. Verlinden, "The applicability of transfer pricing rules to 'transactions' between a head office and its foreign permanent establishment," ITPJ, 1996, p. 47.
[86] Directive 2016/1164 covers only hybrid mismatch arrangements that arise in the interaction between the corporate systems of EU Member States. A Proposal for a Council Directive amending Directive 2016/1164 to address hybrid mismatches involving third countries is currently under discussion (6337/17 FISC 46 ECOFIN 95).
[87] For a comparison between OECD BEPS and the EU interest limitation rule, see A. Rigaut, "Anti-tax avoidance directive (2016/1164): New EU Policy Horizons," E.T., 2016, pp. 497–505.
[88] For a comparison between the general avoidance rule under Directive, Art. 6 and the general anti-abuse provision under ITC, Art. 344, § 1, see, D. Gutman e.o., "The Impact of the ATAD on Domestic Systems: A comparative survey," E.T., 2017, p.9 :

> The Belgian GAAR is similar to the Directive but not identical. One of the main differences between the Belgian GAAR and article 6 of the Directive is that no reference is made to an arrangement being regarded as non-genuine to the extent that it is not put into place for valid commercial reasons that reflect economic reality. Instead, the Belgian GAAR obliged the taxpayer to show that a legal act was based on motives other than tax avoidance.

[89] On the genesis of this Article, see A. Rigaut, "Anti-tax avoidance directive (2016/1164): New EU Policy Horizons," E.T., 2016, p. 502:

> The most debated topic in the last phase of negotiations was, however, related to targeted rules. The OECD Report is explicit that such targeted rules (such as thin capitalization rules) can only be in addition to and not in substitution for the EBITDA-based fixed ratio rule, but some Member States [in particular, Austria, Belgium, Lithuania and Malta at the Council meeting of 17 June 2016] insisted on additional flexibility in this respect until the end of negotiations. This resulted in paragraph 6 of article 11, whereby Member States that have national targeted rules that are "equally effective to the interest limitation rule set out in this Directive" may continue to apply them instead of article 4 until there is an OECD agreement on a minimum standard with regard to BEPS Action 4 (it is currently only a best practice recommendation). Although it is possible that the OECD may propose a minimum standard after the 2020 review mentioned in paragraph 193 of its Report, it is quite improbable that this will happen. Nevertheless, the deadline of 1 January 2024 makes it clear that this is only a transitional measure and not an indefinite derogation. Further, recital 6 reiterates that targeted rules only complement the interest limitation rule set out in the ATAD. It remains to be seen how the "equally effective" criterion will be interpreted by the Commission in monitoring national transposition.

[90] D. Gutman e.o., "The Impact of the ATAD on Domestic Systems: A comparative survey," E.T., 2017, p.19:

> The implementation of article 11.6 raises important concerns among practitioners because of the very vague wording of this provision. If a domestic system currently departs from the logic of article 4 (and, therefore, allows for an interest deduction even if higher than 30% of the EBITDA), is it, however, possible to consider that, from a more general perspective, this system is "equally effective" in preventing BEPS risks as long as other anti-avoidance rules (maybe even beyond corporate income tax rules) apply in the field of interest limitation? The answer seems to be positive, but it is hard to predict which criteria the European Commission (which is in charge of monitoring implementation of the Directive) will apply in assessing the "equally effective" requirement.

[91] G. Smet and Ch. Bihain, "*EBITDA-interestaftrekbeperking : uiterlijk van toepassing op 1 januari 2019 (?)*," Fisc. Act., 2016/28, pp. 13-4; P. Delacroix, "*La directive visant à lutter contre l'évasion fiscale (1re partie). Quand l'Europe s'attaque à la planification fiscale agressive!*," R.I.S.F., 2016/3, p. 88; B. Peters en S. Seré, "*Recente initiatieven tegen belastingontwijking. Impact op multinationale ondernemingen*," T.F.R., 2016, nr.510, pp. 889-90; P. Smet and D. De Wolf, "*Directive UE contre l'évasion fiscale: à partir de 2019*," Fisc., 2016, n°1482, p. 2.

BRAZIL

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I. Possibility of Brazilian Tax Authorities Recharacterizing Advance of Funds by FCo to BrazilCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

It should be noted that, in practice, the scenario envisaged here would not be feasible under Brazil's foreign exchange/regulatory framework.

Generally, every inflow (or outflow) of funds into (or out of) Brazil requires the execution of a "foreign exchange agreement" (*contrato de câmbio*), which must comply with certain strict terms established by the Brazilian Central Bank (*Banco Central do Brasil* — BACEN) and must clearly identify the beneficiary, as well as the nature and purpose of the transaction concerned.[1] A person in breach of these requirements may even be subject to criminal charges.[2]

In the case of a loan granted by a foreign company (here, FCo) to a Brazilian company (here, BrazilCo), the relevant foreign credit transaction would also be subject to registration with BACEN under an electronic declaration system known as the "Electronic Declaratory Registration — Financial Transactions Registration" system (*Registro Declaratório Eletrônico — Registro de Operações Financeiras* — RDE-ROF).[3]

Under the applicable RDE-ROF regulation, a foreign credit transaction must be registered, with the agreed currency and conditions being stipulated. The costs and other terms of the loan must be fixed in accordance with those typically observed in international markets and must be clearly described. An open maturity date would generally not be allowed; nor would undefined charges or charges related to the financial results or corporate performance of the Brazilian borrower or a third party. In addition, the Brazilian borrower would be authorized to remit funds only in accordance with the schedule of payments set forth in the registration. Any payment not made in accordance with this schedule (including a prepayment) would require the specific prior authorization of BACEN, requests for such authorization being reviewed on a case-by-case basis, with no assurance that they will be granted.

In the case of a loan granted by a Brazilian company to a foreign company, the relevant credit transaction would not be subject to registration under the RDE-ROF system. However, the Brazilian creditor would be required to inform BACEN of the transaction in a "Statement of Brazilian Capital Held Abroad" (*Declaração de Capitais Brasileiros no Exterior*). This statement would have to be presented on a quarterly or annual basis, depending on the total amount of credit held with nonresidents (as well as assets/rights held outside Brazil).[4]

It should be clear from the above that, in Brazil, every international credit transaction involving a Brazilian party must be properly documented, identified and disclosed to the relevant authorities. Consequently, as indicated above, the scenario envisaged here would be very unlikely to occur under Brazil's current foreign exchange/regulatory framework. For FCo to be able to advance funds to BrazilCo, a foreign exchange agreement would have to be entered into between BrazilCo and a Brazilian financial institution, which would only execute the agreement after receiving documentation of the loan transaction to be carried out.

The only scenario in which the transaction might take place is one in which FCo made the advance to BrazilCo indirectly — for example, if FCo paid an invoice issued by a third party on behalf of BrazilCo. In any event, any undocumented loan transaction would be in breach of the regulations and, in the absence of documentation, BrazilCo would face difficulties repaying the cash advances made to it by FCo.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

In these circumstances too, the relevant credit transaction would have to be registered with BACEN, as described in I.A., above, and in practical terms this scenario would also not be feasible in practice. Assuming it were feasible, the Brazilian tax authorities would not give much weight to the tax treatment of the advance under FC rules. That is, Brazil's domestic rules would apply — for both tax and regulatory purposes — in determining whether the transaction is to be regarded as a loan, irrespective of how FC regards the transaction.

C. Difference if a Loan Agreement of Some Sort Exists

Given the position set out in in IA. and B., above, it would not be possible for BrazilCo and FCo to enter into the arrangement concerned without a written loan agreement.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Brazilian tax law lays down general standards that must be met by any expense item if it is to be considered deductible for purposes of corporate income tax (*Imposto de Renda da Pessoa Jurídica* — IRPJ) and the social contribution on net profits (*Contribuição Social sobre o Lucro Líquido*).[5] In the case of interest payable on a loan made by a foreign lender, the application of the rules on deductibility is generally unaffected by whether or not it is known that the lender includes or does not include the corresponding interest income in its taxable income in its foreign country of residence.

An expense is deductible if it qualifies as: (1) necessary and required for the activities of the company incurring the expense or for the maintenance of its productive sources of income; and (2) usual or normal given the kind of transactions carried out by the company ("General Deductibility Test"). No further details or instructions are provided as to how to determine whether an expense item is "necessary" or "usual" (or the cases in which an expense item is nondeductible). Thus, the analysis with regard to the deductibility of expenses is made on a case-by-case basis.[6]

Interest payments are generally accepted as fully deductible under the General Deductibility Test, provided the loaned funds are used in the ordinary course of business of the borrower.[7]The tax authorities may challenge the deductibility of an interest expense only if they suspect that, in a particular instance, the relevant interest expense was not actually incurred, or was incurred in connection with, or to fund or finance, an "atypical" transaction that is clearly incapable of generating a positive result for the company concerned. An expense that is successfully challenged will not qualify as necessary to, and usual/normal in, the entity's business.

In addition to the General Deductibility Test described above, in instances where interest is paid to a foreign related party, other more specific sets of rules must also be considered, specifically those relating to: (1) thin capitalization;[8] and (2) transfer pricing.[9]

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

Brazil's thin capitalization rules generally impose limitations on the deductibility of Brazilian-source interest payments made in favor of related individuals or legal entities resident or domiciled abroad. Arguably, thin capitalization rules can be characterized as anti-abuse measures adopted by countries to prevent companies from becoming undercapitalized because of excessive leverage.

Brazilian-source interest payments made to related individuals or entities resident in countries or dependent territories/areas not deemed to be "tax havens" or that do not offer "privileged tax regimes"[10] are fully deductible if the indebtedness of the Brazilian borrower to foreign related individuals or legal entities does not exceed:

- 2 × the equity interests held by such foreign creditors in the net equity of the Brazilian borrower; or
- 2 × the net equity of the Brazilian borrower (if the foreign creditors do not directly hold any equity interests in the borrower).[11]

Stricter deductibility standards apply to interest payments made in favor of residents of "tax havens" or beneficiaries of "privileged tax regimes." Such Brazilian-source interest payments are fully deductible only if the indebtedness of the Brazilian borrower to the foreign related companies or individuals does not exceed 30% of the borrower's net equity.[12]

B. Limits on Interest Deductions Based on Other Factors

In addition to the thin capitalization rules described above, Brazil's transfer pricing rules may restrict the deductibility of interest expenses incurred by a Brazilian borrower in connection with foreign loan agreements.[13]

Under the transfer pricing rules, the deductibility of interest payments made by a Brazilian borrower to a foreign related-party lender is limited to (or, in the converse situation, the minimum interest income to be included in a Brazilian lender's taxable income is determined by the application of: (1) a particular rate, plus (2) a spread established by the Brazilian Ministry of Finance.

The rate referred to above varies as follows:

- In the case of a foreign loan agreement denominated in U.S. dollars with a pre-fixed interest rate, the rate corresponds to the market rate for Brazilian sovereign bonds issued on the international market in dollars;
- In the case of a foreign loan agreement denominated in Brazilian reais with a pre-fixed interest rate, the rate corresponds to the market rate for Brazilian sovereign bonds issued on the international market in reais; and
- In any other case, the rate corresponds to the LIBOR for six-month deposits in dollars.

The annual spread is currently set at 3.5% for a foreign loan agreement under which the Brazilian resident is the borrower.[14]

In the case at hand, where BrazilCo is the borrower of funds and FCo is *not* a related-party lender, the interest paid by BrazilCo would be considered deductible for income tax purposes provided the loaned funds were used in the ordinary course of BrazilCo's business and thus met the General Deductibility Test described above. Where FCo *is* a related party lender, in addition to the General Deductibility Test, the transfer pricing and thin capitalization rules might impose limitations on the deductibility of the interest payments made by BrazilCo to FCo, since such payments would be considered deductible only up to an amount that does not exceed the thresholds calculated in accordance with those rules.

Besides those described above, there are no other limitations that would affect the deductibility of the interest payments made by BrazilCo to FCo.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

As discussed in II.A. and B., above, where a Brazilian company borrows funds from a foreign related lender, thin capitalization and transfer pricing rules may apply with the result that the interest payable to the foreign lender is deductible only to the extent it does

not exceed certain thresholds. In all other cases, especially in purely domestic situations (i.e., where both the lender and the borrower are domestic entities — irrespective of whether they are related parties), the General Deductibility Test would generally seek to ascertain deductibility on an "all or nothing" basis.

D. Effect of an Income Tax Treaty Between Brazil and FC

Even though Brazil is not a member of the Organisation for Economic Cooperation and Development (OECD), Brazil's tax treaties[15] tend to follow, at least to some extent, various older versions of the OECD Model Convention.

That being said, Brazil's tax treaties generally do not contain provisions that allow full or partial ("bifurcated") recharacterization of interest payments. This derives from the fact that Brazil retains source-country taxation rights with respect to a number of types of income, including interest, usually at rates as high as 15% (which is the general rate of withholding tax applicable to income paid to nonresidents under Brazil's domestic law). Since they already allow Brazil source-country taxing rights with respect to interest income (which are exercised by way of withholding tax), Brazil's treaties do not seek to impose any limitation on the deductibility of the corresponding interest expense.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

This question has no relevance in a Brazilian context, since Brazil does not apply the partnership/corporation distinction in its taxation treatment of business organizations.

IV. Withholding Tax Issues

As discussed above, under Brazil's income tax rules, interest payments are usually deductible for the payor, assuming the payments qualify under the General Deductibility Test (and under the transfer pricing/thin capitalization rules, where the payments are made to a foreign related party). At the same time, the corresponding interest income is taxable in the hands of the recipient.

Interest payable to a nonresident beneficiary is generally subject to withholding at the rate of 15%[16] if the nonresident is not located in a tax haven. Where the interest is payable to a beneficiary resident in a tax haven, withholding tax is generally levied at an increased rate of 25%.[17] A tax treaty would potentially reduce the withholding tax rate on such payments to the 15% level referred to above, but Brazil has not yet signed any tax treaties with tax haven jurisdictions.

In any event, the deductibility of interest expenses is not conditioned on the collection of withholding tax on the corresponding interest income.

V. Difference if FCo Has a Permanent Establishment in Brazil

Although Brazil's tax treaties recognize the concept of a "permanent establishment" (PE), Brazil seldom imposes net basis taxation on income derived by a foreign entity through a Brazilian PE, under either Brazilian administrative or judicial tax case law. Instead, Brazilian income derived by nonresidents is generally subject to Brazilian source taxation on a gross basis, levied by way of withholding tax.

The above does not mean, however, that the existence of a Brazilian PE is never recognized or that such a PE is never subject to Brazilian net basis taxation: Brazil's domestic legislation does contain provisions that allow the PE concept to be properly utilized.[18] One example of such provisions is to be found in the rules on the operation of foreign companies in Brazil through branches, agencies or representative offices.[19] These rules date back to 1940, when Decree-Law no. 2,627, of September 26, 1940, was enacted to govern corporations. Although Decree-Law no. 2,627/40 was later repealed by Federal Law no. 6,404/76, the provisions governing foreign and other companies that require the authorization of the Brazilian Government to operate in Brazil were excluded from the repeal and are still in force. A foreign company can only operate in Brazil through a branch, etc. after it has obtained a permit from the President. To obtain a permit, the applicant must submit a number of documents together with its request to the President. The Government of Brazil then has the discretion to grant or refuse a permit. In view of the bureaucracy associated with obtaining such a permit, very few such business organizations are currently active in Brazil (and then only in selected industries, such as banking and insurance). When doing business in Brazil, the vast majority of multinational groups prefer to incorporate local legal entities (in the form of corporations or limited liability companies).

If, in the case at hand, FCo were nonetheless to set up a local branch, the branch itself would have to file tax returns/statements with the Brazilian tax authorities[20] in connection with the business carried on in Brazil, since it would be considered a "separate" taxpayer and, as such, would be subject to corporate income tax in Brazil. Accordingly, any loan transaction entered into between the PE and BrazilCo would probably be viewed as a purely domestic transaction for Brazilian income tax purposes. Thus, the deductibility of interest payments made by BrazilCo would depend on the payments passing the General Deductibility Test — without regard to the transfer pricing or thin capitalization rules.

VI. Legislative Changes

The authors are not aware of any legislative changes (either proposed or in legislative process) that would affect the matters discussed above.

NOTES

[1] Federal Law no. 9,069, of June 29, 1995, art. 65.

[2] Federal Law no. 7,492, of June 16, 1986, art. 22.

[3] Federal Law no 4.131, of March 9, 1962, which is currently regulated by Resolution no. 3.844, of March 23, 2010, issued by the National Monetary Council (CMN), reproduced in Regulation (*Circular*) no. 3,689, of December 16, 2013.

[4] Resolution no. 3,854, of May 27, 2010, issued by the CMN; Regulation (*Circular*) no. 3,624, of February 6, 2013, issued by BACEN.

[5] Income Tax Regulations (ITR), art. 299, enacted by Decree no. 3,000, of March 26, 1999, as amended, the contents of which are based on Law no. 4,506, of Nov. 30, 1964, art. 47.

[6] If an expense seems unnecessary or atypical *vis-à-vis* the business of the entity incurring the expense, the Brazilian tax authorities may challenge its deductibility; in this case, the entity will have to demonstrate that the expense was effectively incurred/paid and justify the necessity of incurring it.

[7] Decree-Law no. 1,598, of December 26, 1977, art. 17; ITR, art. 374.

[8] Law no. 12,249, of June 11, 2010, arts. 24 and 25.

[9] Law no. 9,430, of December 27, 1996, art. 22.

[10] The terms "tax haven" and "privileged tax regime" are defined in Law no. 9,430/96, arts. 24 to 24-B and Ordinance (*Portaria*) no. 488, issued by the Ministry of Finance on November 28, 2014.

A "tax haven" includes: (1) a country that does not impose income tax or imposes income tax at a rate lower than 17%; and (2) a jurisdiction whose legislation does not allow access to information relating to company shareholding structures, to persons holding shareholder's rights or to the identity of the beneficial owners of income attributable to nonresidents.

A "privileged tax regime" is a tax regime under which: (1) income is not taxed or is taxed at a maximum rate lower than 17%; (2) tax benefits are granted to nonresident entities or individuals: (a) without requiring the exercise of a substantial economic activity in the country or location; or (b) contingent on the non-exercise of a substantial economic activity in the country or location; (3) in particular, income earned outside the country or location concerned is not taxed or is taxed at a maximum rate lower than 17%; or (4) access is not allowed to information relating to shareholding composition, the ownership of assets and rights, or economic transactions.

[11] Federal Law no. 12,249/10, art. 24.

[12] Federal Law no. 12,249/10, art. 25.

[13] The transfer pricing rules also apply to determine the minimum amount of income to be included in the taxable income of a Brazilian lender of funds to a foreign related-party borrower.

[14] And at 2.5% for a foreign loan agreement under which the Brazilian resident is the lender. *See* Ordinance no. 427, of July 30, 2013, arts. 1 and 2.

[15] Brazil currently has tax treaties with the following 32 countries: Argentina, Austria, Belgium, Canada, Chile, China (PRC), the Czech Republic, Denmark, Ecuador, Finland, France, Hungary, India, Israel, Italy, Japan, Korea (ROK), Luxembourg, Mexico, the Netherlands, Norway, Peru, the Philippines, Portugal, Slovakia, South Africa, Spain, Sweden, Trinidad and Tobago, Turkey, Ukraine and Venezuela. Brazil had a tax treaty with Germany that was terminated in 2006. Finally, a treaty has been signed with Russia and is currently undergoing the internal legislative ratification process.

[16] ITR, arts. 682 and 685, I.

[17] *Id.*

[18] Carvalho, André de Souza. Brazilian Report on "Is There a Permanent Establishment?" (2009). 94a Cahiers de Droit Fiscal International, p. 151.

[19] Decree-Law no. 2,627/40, arts. 59 to 73.

[20] Beginning in 2015, the Tax Accounting Bookkeeping (*Escrituração Contábil Fiscal* — ECF) is an electronic replacement for the Corporate Income Tax Return (*Declaração de Informações Econômico-Fiscais da Pessoa Jurídica* — DIPJ). The ECF is a comprehensive accounting and tax reporting filing obligation for corporate income tax that integrates accounting, tax and economic information, and applies to most legal entities.

Companies are required to prepare and submit the ECF electronically via the Public Digital Bookkeeping System (*Sistema Público de Escrituração Digital* — SPED); the former DIPJ had to be prepared using tax preparation software provided by tax authorities. The new reporting obligation is more complex than the DIPJ, and allows the Brazilian tax authorities the ability to perform faster consistency reviews, thus increasing the efficiency of tax audits.

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CANADA

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I. Possibility of Canadian Tax Authorities Recharacterizing Advance of Funds by FCo to CanCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Canadian tax rules applicable to shares and dividends differ greatly from those applicable to debt instruments and interest. Consequently it is important to *characterize* a given instrument as either equity or debt — i.e. to determine the character of a given instrument as either equity or debt. This characterization is made under the applicable general law.

Under Canadian law:

- The essential nature of a loan (i.e., debt) is a promise or obligation to repay;[1] and
- The essential nature of equity is the combination of the rights to vote, dividends and participation in net assets on the final dissolution of a company (although it is not necessary that all of these rights be reflected in each class of a company's shares), and the subordination of dividend and participation rights to creditors.[2]

However, Canadian tax rules do not generally permit *recharacterization* of an instrument for tax purposes — i.e., treating as equity for tax purposes an instrument or transaction that is characterized as debt under the general law, or vice versa — except in very limited circumstances of sham or fraud, or where the general anti-avoidance rule (GAAR) applies. Indeed, the overall tenor of Canadian tax jurisprudence is that the legal relationships created by taxpayers must be respected and taxed accordingly. This principle was clearly stated by the Supreme Court of Canada in *Shell Canada v. Canada*:

> This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form. . . . But there are at least two caveats to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's bona fide legal relationships. *To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.*[3]

Of course, debt and equity are not so much distinct concepts as points on either end of a broad continuum. In between lie nearly infinite variations, especially in complex transactions where a single instrument may include terms that are characteristic of both debt and equity. Even in this case, however, the correct approach under Canadian jurisprudence is to characterize the instrument as either debt or equity based on a determination of parties' intentions through careful contractual interpretation and weighing of the competing features.[4] Once the character of the hybrid is determined to be debt or equity, the tax rules applicable to that form of instrument should generally apply.

As a general rule, there is no requirement under the Income Tax Act (Canada) (the "Canadian Act") that an obligation to repay an amount be in writing in order to be a "loan" for Canadian income tax purposes. Therefore, the absence of a written agreement between CanCo and FCo would not, in and of itself, be a factor in determining whether the arrangement between them is debt (although the absence might create evidentiary issues in proving the character of that relationship). Similarly, the fact that FCo and CanCo are related would not, in and of itself, be a factor in characterizing the advance as debt or equity (assuming that that relationship is not founded on a fraud, sham, or abusive tax avoidance).

B. FCo Does Not Treat the Transaction as a Loan For FC Accounting and Income Tax Purposes

From a Canadian perspective, the same rules as those discussed under I.A., above would apply. In particular, the legal character of the transaction as either debt or equity would be determined, and then the applicable tax rules applied. The fact that CanCo and FCo are related should not, in and of itself, alter the analytical framework or results.

C. Difference if a Loan Agreement of Some Sort Exists

The existence of a written loan agreement would not, in and of itself, change the legal characterization principles applicable to the transaction but could simplify the evidentiary aspect of *proving* the nature of the relationship between FCo and CanCo.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

The Canadian Act requires that, to be deductible in computing income from a business or property, any expense (including an interest expense) must:

- have been incurred for the purpose of earning income from a business or property,[5]
- not be on account of capital, [6] and
- be "reasonable."[7]

Under Canadian jurisprudence, interest is generally considered to be on account of capital,[8] and therefore not deductible in computing business or property income except to the extent permitted by statute. Section 20(1)(c) provides such a statutory rule. The rule expressly permits a taxpayer, in computing income from a business or property, to deduct interest that is paid or payable in a year (depending on the method that the taxpayer regularly follows in computing its income) if the interest:

- Is paid or payable pursuant to a legal obligation to pay interest; and
- Accrues on either:
  - borrowed money used for the purpose of earning income from a business or property; or
  - an amount payable for property that is acquired for the purpose of earning income from the property or a business.[9]

Deductibility in Canada of a cross-border interest payment is not predicated on the recipient's including the amount in income.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

Canada has not adopted the OECD's proposed worldwide debt-to-equity ratio test.[10] Section 18(4) of the Canadian Act, however, is a thin capitalization rule that limits the interest deduction available to a Canadian resident corporation or trust with respect to cross-border interest payable to a related non-resident.

In general, § 18(4) and related provisions will deny an interest deduction to the Canadian corporation or trust to the extent the cross-border debt that the corporation or trust owes to one or more "specified non-resident shareholders" or "specified non-resident beneficiaries"[11] of the corporation or trust, as applicable, exceeds 150% (equivalent to a 60:40 debt-to-equity ratio) of the "equity amount"[12] of the corporation or trust.

The amount of any denied interest deduction is:

- If the payor is a corporation, deemed to be a dividend and therefore subject to Canadian withholding tax;[13] or
- If the payor is a trust, either taxable in the trust as income at the top personal tax rate or, if the trust makes an appropriate designation, deemed to be an income distribution to the payee and therefore subject to Canadian withholding tax.[14]

For the purpose of applying these rules to a partnership, partners are deemed to owe partnership debts and own partnership property in proportion to their interests in the partnership.[15] Various look-through and back-to-back anti-avoidance rules are provided that generally shut down most attempts to circumvent the thin capitalization rules.

B. Limits on Interest Deductions Based on Other Factors

Section 20.3 of the Canadian Act contains rules that limit the interest deduction and other tax benefits in respect of a "weak currency debt."[16] The technical definition of this term is lengthy, but in general a weak currency debt may be thought of as a debt incurred in a currency (the weak currency) where the proceeds are then converted into funds of another currency (the final currency), which are then used for an income-earning purpose.[17] Prior to the enactment of § 20.3, a debtor's tax benefits associated with a weak currency debt included:

- An increased interest deduction compared to the interest deduction that would apply with respect to an equivalent debt incurred denominated in the final currency,
- Deferred recognition of any foreign exchange gain arising on settlement of the weak currency debt until settlement; and
- Very often, taxation of the foreign exchange gain at favorable capital gains rates.

Section 20.3 eliminates these tax benefits by:

- Limiting the interest deduction to the amount of interest that would be charged on an equivalent debt denominated in the final currency; and
- Requiring any foreign exchange-derived gain or loss realized on settlement of the weak currency debt (less the amount of any denied interest deduction) to be dealt with on income rather than capital account.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Except as noted under II.A. and B., above, the Canadian Act does not generally grant the Canada Revenue Agency (CRA) the authority to make a "bifurcation" in this sense.

D. Effect of an Income Tax Treaty Between Canada and FC

Canada's tax treaties generally do not permit such full or partial recharacterization. However, Canada's tax treaties in some circumstances can affect the amount of Canadian withholding tax applicable to a cross-border interest payment.

For example, Canada does not levy withholding tax on payments of interest by a Canadian resident to a non-resident with whom the payor deals at arm's length.[18] However, the 25% statutory rate applies if the payor does not deal at arm's length with the non-resident payee, subject to any applicable tax treaty relief.

In line with the OECD Model Convention, Canada's tax treaties generally provide for a reduced withholding tax rate on cross-border interest payments, generally of 10-15%.[19] This is typically coupled with a provision substantially identical to Article 11(6) of the OECD Model, which reads as follows:

> Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is

paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Consequently, if FCo were entitled to the benefits of a tax treaty that contained such a provision, and because of a special relationship with CanCo charged an excessive interest rate on its advance to CanCo, FCo would be entitled to the reduced treaty withholding rate on the amount of interest that FCo would have charged in the absence of the special relationship, and subject to the 25% statutory withholding on the balance.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The Canadian rules that govern the deductibility of cross-border interest that is paid or payable by a Canadian resident debtor are not generally affected by the fiscal transparency of the payee.

If Canada regards FCo as a partnership, FCo will be considered to be a non-resident person for purposes of applying Canadian withholding tax to any payment of interest or dividends made to it by CanCo unless all of the partners of FCo are resident in Canada.[20]

To date Canada's only response specifically aimed at the issue of hybrid entities has been limited to the enactment of anti-hybrid rules in Articles IV(6) and IV(7) of the Canada-United States tax treaty. The Canadian government has not given any indication that it intends to introduce further anti-hybrid rules in line with the OECD's Final Report with respect to BEPS Action Item 2.

IV. Withholding Tax Issues

See II.D., above. As noted, Canadian tax law does not include recharacterization rules, and therefore there are no Canadian recharacterization rules that would affect withholding. In particular, there is no requirement in Canadian law that withholding tax be paid on cross-border interest in order for the payment to be deductible in Canada. Indeed, as noted above, Canada generally does not levy withholding tax on cross-border interest payments between arm's-length parties and yet permits the payor to deduct the interest payment, subject to the various limitations and restrictions discussed.

V. Difference if FCo Has a Permanent Establishment in Canada

The fact that FCo has a permanent establishment (PE) in Canada would have no bearing on CanCo's ability to deduct any interest payments in computing its income.

If the interest income is attributable to a business that FCo carries on in Canada through a Canadian PE, it will be subject to Canadian income tax under Part I of the Canadian Tax Act rather than Canadian withholding tax on the interest income.[21] For this purpose the term "permanent establishment" will take its meaning from an applicable tax treaty, if any, and otherwise will have the meaning set out in § 8201 of the Canadian Tax Regs.[22] CanCo would nevertheless still be required to withhold the Canadian withholding tax on the payment (if any) and remit it to the CRA for FCo's account,[23] unless CanCo has applied for and obtained a certificate from the CRA confirming that the interest amount is an amount that may reasonably be attributed to FCo's business carried on through a Canadian PE.[24] Any withholding tax remitted to the CRA would then be credited against FCo's liability for Part I tax. Whether FCo's interest income would be reasonably attributable to its PE in Canada would be an issue of fact, dependent on the particular circumstances.

VI. Legislative Changes

There are currently no proposals to introduce legislation in Canada that would change the foregoing responses.

NOTES

[1] *Wilson v. Ward*, [1929] 3 D.L.R. 209 (S.C.C.).

[2] See generally *Dexior Financial Inc., Re*, 2011 BCSC 348, at 14; McGuinness, *Canadian Business Corporations Law*, 2d ed. (Markham: LexisNexis at 540, § 8.9).

[3] [1993] 3 S.C.R. 622, at para 39. [Emphasis added.]

[4] *Canadian Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558.

[5] § 18(1)(a). All statutory references are to the Income Tax Act (Canada), as currently proposed to be amended, unless otherwise indicated.

[6] § 18(1)(b).

[7] § 67.

[8] *Bowater Canadian Ltd. v. R.*, 12 F.T.R. 318 (F.C.A.); *Shell Canada*, note 3, above.

[9] § 20(1)(c)(i) and (ii).

[10] The federal government made no mention of acting on Action Item 4 in either its 2016 or its 2017 budget.

[11] Roughly, non-resident shareholders or beneficiaries that hold a 25% or greater interest in the corporation or trust. See definitions in § 18(5).

[12] Roughly: (1) in the case of a corporation, share capital and contributed surplus of specified non-resident shareholders plus the corporation's unconsolidated retained earnings; and (2) in the case of a trust, equity contributions by specified non-resident beneficiaries plus tax-paid earnings of the trust, less the portion of those amounts that are taxable to those beneficiaries.

[13] § 212(2) and § 214(16)(a)(i).

[14] § 18(5.4) and § 212(1)(c).

[15] § 18(7).

[16] § 20.3.

[17] *Id.*

[18] 212(1)(b).

[19] To date, the Canada-United States tax treaty is the only Canadian tax treaty that extends the full exemption from Canadian withholding tax to interest payments between non-arm's-length parties.

[20] § 212(13.1)(c).

[21] Income Tax Regulations (Canada) (the "Canadian Tax Regs") § 805(a).

[22] Generally, a fixed place of business of FCo or, if there is no fixed place of business, the principal place at which FCo carries on its business.

[23] § 215(1); see also CRA Doc. #2002-0132815, albeit issued under a previous version of the Canadian Act and Canadian Tax Regs.

[24] Canadian Tax Regs § 805.1.

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PEOPLE'S REPUBLIC OF CHINA

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I. Possibility of Chinese Tax Authorities Recharacterizing Advance of Funds by FCo to ChinaCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

China has a limited hybrid rule under which an investment would be characterized as a loan rather than an equity investment if all of the following conditions are fulfilled:[1]

- In accordance with the terms of the relevant contract or agreement, the recipient of the funds is required to pay a fixed amount or an amount at a fixed rate to the provider of the funds on a regular basis;
- The contract/agreement provides for a specific term or specific conditions, such that when the term matures or the conditions fulfilled, the recipient company is required to repay the principal or redeem the investment;
- The provider of the funds has no claim on the net assets of the recipient company;
- The provider of the funds has no voting right with respect to the recipient company and no right to be elected to anybody of the recipient company; and
- The provider of the funds is not involved in the operations of the recipient company.

Based on the above, if there is no documentation such as a loan agreement specifying the terms and conditions of the financing arrangement, interest payments under the arrangement may not be deductible. The limited hybrid rule appears not to differentiate between related party and non-related party transactions. Nor does it differentiate between the use of a hybrid investment in a cross-border transaction and its use in a purely Chinese domestic transaction. However, in view of the fact that the current PRC Income Tax Law covers both foreign invested companies and Chinese domestic companies, the rule would presumably apply in both contexts.

If the financing arrangement concerned is treated as a loan rather than an equity investment under the limited hybrid rule, the recipient of the funds will be able to account for the payments under the arrangement as interest expenses and accordingly deduct them for tax purposes.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The limited hybrid rule discussed in I.A., above does not appear to indicate that the characterization of an arrangement as either a loan or equity would depend on the accounting treatment of the provider of the funds. Rather, such characterization would depend on whether the financing arrangement fulfilled the five conditions set out in I.A., above.

C. Difference if a Loan Agreement of Some Sort Exists

As noted in I.A., above, for a financing arrangement to be treated as a loan and the interest paid on the loan to be deductible for Chinese tax purposes, the terms and conditions of the loan need to be specifically agreed in the loan contract/agreement. Other factors will also have to be considered in determining the nature of the payments under the financing arrangement and accordingly their deductibility for tax purposes.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Under the Chinese Income Tax Law and its Implementing Regulations, an interest payment made by one non-financial institution to another non-financial institution is only deductible for tax purposes to the extent the interest rate is in line with the interest rate that would be charged by a financial institution on a loan for the same period on the same terms, and the interest payment is relevant to the business of the payer. There are no specific rules for interest payments made to a nonresident company in this regard, except that — unlike interest payments made to a Chinese domestic lender — such interest payments would be subject to Chinese withholding tax. The tax treat-

ment of the nonresident lender with respect to the interest income in its country of residence appears not to be relevant for the deductibility for Chinese tax purposes of the corresponding interest expense. Should the lender and borrower be related parties, the interest deduction would be subject to China's thin capitalization rules (see II.B. below).

A. Specific Limits on Interest Deductions Based on the Ratio of Debt To Equity

While there are generally no specific limits on interest deductions based on the ratio of the borrowing company's debt to its equity, China has introduced thin capitalization rules in relation to related party borrowing that require a debt-to-equity ratio of no more than 5:1 where the borrower is a financial enterprise and of no more than 2:1 where the borrower is a non-financial enterprise.[2] Where a company's leverage exceeds these ratios, an arm's-length interest rate needs to be substantiated via transfer pricing documentation if the interest is to be deductible for tax purposes. It should be noted that these rules are different from the OECD's proposed worldwide ratio test.

B. Limits on Interest Deductions Based on Other Factors

An interest deduction is only available if the interest expense is associated with the business operations of the company concerned. The following kinds of interest expense incurred in the course of the production and operational activities of an enterprise are deductible:[3]

- Interest paid by a non-financial enterprise to a financial enterprise, various kind of deposit interest and inter-bank loan interest paid by a financial institution, and interest paid by an enterprise on corporate bonds that it is officially approved to issue; and
- Interest paid by a non-financial enterprise to another non-financial enterprise to the extent the interest does not exceed the amount of interest calculated on the same type of loan granted for the same period by a financial institution.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

There is no rule permitting the bifurcation of a transaction into an interest-generating portion and a non-interest-generating portion, although, under the thin capitalization rules, if the interest payments concerned are related to both financial institution and non-financial institution activities, different debt-to-equity ratios (see II.A., above) may apply. In the same spirit, whether part of the interest under a financing arrangement is deductible and part non-deductible may depend on whether there is a clear division between the two parts and the existence of documentation to substantiate the nature of the payments. Interest payments made to a foreign related party that exceed the amount deductible under the thin capitalization rules will be deemed to be dividends and will be subject to the withholding tax applicable to distributions of dividends.[4]

D. Effect of an Income Tax Treaty Between China and FC

Some of China's tax treaties, such as the China-Singapore tax treaty, provide that treaty benefits may not be granted with respect to the part of an interest payment that exceeds an arm's-length interest payment. At the same time, an "interest" payment that is in the nature of distribution may not be covered by the Interest Article of the treaty concerned, i.e., it may not be recognized as interest for purposes of the treaty.[5]

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Under current Chinese tax law and regulations, it would seem that the legal structure of the lender under a financing arrangement would makes no difference to the characterization of the arrangement for Chinese tax purposes. At the same time, while a Chinese domestic partnership is treated as transparent for tax purposes, it is not clear how a foreign partnership is to be treated for Chinese tax purposes, although in practice a foreign partnership could be treated as transparent. Generally, a partnership would not be eligible for benefits under the tax treaty between China and the country of which it is a partnership and usually it will be necessary to look through the partnership to the level of the individual partners to determine entitlement to treaty access and the taxation consequences thereof.

IV. Withholding Tax Issues

According to Chinese tax rules, if interest has been accounted for as an expense in the books of the payer and accordingly deducted for income tax purposes, the payer must account for withholding tax on the interest payments.[6] Also, as noted under II.C., above, interest that is not deductible as a result of the application of the thin capitalization limitations would be re-characterized as dividends, which could be subject to withholding tax at a different rate from interest.

V. Difference if FCo Has a Permanent Establishment in China

A foreign enterprise with a permanent establishment (PE) in China is only taxable in China on the income that is attributable to the activities of the PE in China. Income is deemed to be attributable to a PE when the activities giving rise to the income are deemed to be connected with the PE, i.e., the income is derived as a result of equity or credit rights, or via the ownership, management or control of property connected with the PE. In the case at issue here, if the loan were advanced via FCo's PE in China, the interest could be deemed attributable to the PE and the payer of the interest (i.e., ChinaCo) entitled to a deduction for income tax purposes. However, since PEs are generally taxed on a deemed income basis, the actual deduction and withholding tax implications would be determined on a case-by-case basis.

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VI. Legislative Changes

Combating hybrid mismatch arrangements does not yet seem to be a top priority of the Chinese tax authorities, and it is not expected that new legislation in this regard will be proposed in the near future.

Disclaimer

This article represents the authors' personal understanding and does not represent Ernst & Young's technical opinion.

The article is based on the Chinese tax law and regulations as well as tax treaties that entered into force as of the May 31, 2017, which is subject to development and updates by the Chinese tax authority.

NOTES

[1] SAT Bulletin No. 41, 2013 — Income tax treatment of hybrid investment.

[2] SAT Circular No. 121, 2008. The Ministry of Finance and the State Administration of Taxation on the tax policy issues related to the pre-tax deduction of interest expense of a related party.

[3] Implementing Regulations of the Law of the People's Republic of China on Enterprise Income Tax.

[4] SAT Circular No. 2, 2009 — Implementing Measures for Special Tax Adjustment (Trial).

[5] China-Singapore tax treaty, Art. 11(7) and (8).

[6] Circular No. 24, 2011 — Certain issues related to non-resident company income tax administration.

DENMARK

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I. Possibility of Danish Tax Authorities Recharacterizing Advance of Funds by FCo to DanishCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Since there is no statutory definition of debt in Danish tax law, the definition that applies for tax purposes is the ordinary (non-tax) definition of debt by reference to the obligation of a borrower (debtor) to repay a monetary amount to a lender (creditor).

While debt is not defined by reference to whether a written loan agreement exists, a lack of documentation may influence the burden of proof if debt characterization is challenged by the tax authorities.

The overall starting point is that the Danish tax authorities are generally not able to recharacterize debt as equity if the parties to the arrangement concerned have agreed that the arrangement is a loan. However, the tax authorities may apply the substance-over-form doctrine/abuse of law rule when assessing whether or not an instrument should be regarded as debt. In the case at hand, the fact that the advance is recorded as a loan in the accounts of FCo and DanishCo would support its treatment as debt in the hands of DanishCo for tax purposes.

Case law on the definition of debt is scant. Such case law as there is primarily concerns situations in which the borrowing entity or shareholder was unable to repay the funds advanced to it. Instead, case law has primarily focused on the definition of interest, which is defined in relatively narrow terms as an amount charged by a lender for the use or retention of money, expressed as a percentage per annum of the principle amount borrowed over a certain period. The concept of debt is thus not defined by reference to the concept of interest, since an interest payment with respect to a debt instrument may be recharacterized as gain/loss on the debt without the debt itself being recharacterized.

Interest is generally deductible against ordinary corporate income provided the debt with respect to which it is payable entails a genuine legal commitment to repayment. There are, however, a number of rules that place limitations on the deduction of interest (see further below).

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Danish tax law contains a specific anti-avoidance provision (Section 2B of the Corporate Tax Act) aimed at structures using hybrid loan instruments. The objective of the provision is to eliminate the potential asymmetrical tax treatment of hybrid loan instruments. To achieve this objective, the provision employs the principle that a prerequisite for the deduction of interest in Denmark is that the corresponding income should be taxable in the hands of the interest recipient. An interest deduction is denied if the debt instrument concerned is treated as equity under the tax legislation of the creditor's country of residence. In the case of back-to-back loan arrangements, the provision applies if the country of residence of even one of the creditors in the chain treats the instrument as equity. In essence, the result of Section 2B is that different Danish tax treatment may be afforded to an inbound hybrid financial instrument depending on its tax treatment in a foreign country.

The requirements for the application of Section 2B of the Corporate Tax Act are as follows:

- The borrower must be either a Danish company fully liable to tax in Denmark or a foreign entity subject to limited tax liability in Denmark due to its having a permanent establishment (PE) in Denmark or real property situated in Denmark (and the debt must be attributed to this "Danish tax entity"). The Danish tax entity must be "indebted" to a creditor. The hybrid financial instrument concerned must thus be classified and treated as debt according to the general definition of debt applying for Danish tax purposes.
- The foreign creditor (whether an individual or a company) must have "decisive influence"[1] over the Danish tax entity or be considered a group-related company of the Danish tax entity.
- The Danish debt instrument must be treated as equity under the tax legislation of the "creditor's" country of residence.

Where debt falls within the scope of Section 2B of the Corporate Tax Act, it is fully recharacterized as equity for tax purposes, with the consequence, for example, that related interest payments, foreign exchange losses and capital losses are considered to be non-deductible dividend payments or gifts.

C. Difference if a Loan Agreement of Some Sort Exists

See I.A., above.

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II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

In general, all interest expenses are deductible irrespective of the origin of the lender/income recipient and whether or not the corresponding interest income is taxable. Interest may be recharacterized as described in I.B., above, if the lender is a related party of the borrower and the debt instrument is treated as equity under the tax legislation of the lender's country of residence.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

Denmark has thin capitalization rules but has not implemented the OECD's worldwide ratio.

The Danish thin capitalization rules apply to a legal entity that is tax resident in Denmark and a nonresident legal entity that is subject to limited Danish tax liability because it has a PE in Denmark. In the discussion below, for the sake of convenience, both types of entity are referred to as a "Danish Debtor."

The thin capitalization restrictions apply to a Danish Debtor if the following four criteria are satisfied:

- The Danish Debtor owes a debt to a group-related legal entity ("controlled debt");
- The amount of the controlled debt exceeds DKK 10 million;
- The Danish Debtor's debt-to-equity ratio exceeds 4:1 at the end of the tax year; and
- The Danish Debtor cannot prove that a "matching debt" would be available from an unrelated party.

If the thin capitalization restrictions apply, the Danish Debtor may not deduct interest expenses and capital losses relating to the controlled debt exceeding the 4:1 ratio. Irrespective of this restriction, capital losses incurred on controlled debt can be carried forward indefinitely and set off against capital gains on the same debt realized in future tax years. The deductibility of interest expenses and capital losses on (unsecured) debts owed to third parties are not affected by the application of the thin capitalization regime rules. Regardless of whether the 4:1 debt-to-equity ratio is exceeded, the thin capitalization restrictions do not apply to interest payments that are subject to Danish withholding tax.

If the deductibility of a Danish Debtor's financial expenses is limited as a result of the application of the thin capitalization regime, the Danish Debtor's controlled debt owed to third parties is considered precluded first followed by its controlled debt owed to group-related entities. Also, the Danish Debtor's controlled debt owed to Danish entities is considered precluded first followed by its controlled debt owed to foreign entities.

The non-deductible interest expenses are not recharacterized as a distribution of profits either for domestic law or for tax treaty purposes. Accordingly, dividend withholding tax is not imposed on the non-deductible interest under either Danish domestic law or an applicable treaty.

The application of the thin capitalization rules may be illustrated by the following example:

> A Danish Debtor has equity of DKK 1 million and debt of DKK 20 million, which is owed to a foreign group-related company (i.e., it is controlled debt). Assuming the Danish Debtor is not a part of a group with other Danish entities, the debt-to-equity ratio of the Danish Debtor is therefore 20:1.
>
> In the tax year in question, the Danish Debtor pays DKK 1.5 million interest on the controlled debt to the foreign group-related company.
>
> DKK 3.2 million of the DKK 20 million debt would have to be converted into equity in order to meet the 4:1 debt-to-equity ratio requirement (i.e., 16.8:4.2).
>
> Accordingly, the application of the thin capitalization rules precludes the Danish Debtor from deducting the expenses relating to DKK 3.2 million of the DKK 20 million controlled debt, i.e.: DKK 0.24 million of the DKK 1.5 million interest expenses.
>
> Interest expense of DKK 1.26 million remains deductible for the Danish Debtor.

The four conditions listed above are described in further detail in II.A.1.-4., below.

Condition 1: Controlled Debt

The term "controlled debt" means debt owed by a Danish Debtor to a Danish or foreign legal entity that: (1) is controlled by the Danish Debtor; (2) controls the Danish Debtor; or (3) is under common control with the Danish Debtor. "Control" for these purposes generally means direct or indirect ownership or control of more than 50% of the shares or voting rights in the controlled entity.

Further, "controlled debt" includes debt owed to a third party if a related legal entity has, directly or indirectly, provided security for the debt. Indirect security includes back-to-back arrangements under which an affiliated company agrees to provide security to a third party that has provided a loan to the Danish Debtor. Indirect security will also be regarded as having been provided if the related legal entity deposits an amount with a bank corresponding to a loan provided by the bank to the Danish Debtor. Letters of intent and similar instruments issued to a third-party lender providing financial security will also result in a loan being considered controlled debt. The crucial question is whether there is a connection between the loan provided to the Danish Debtor and the security provided by a related legal entity.

Where the Danish debtor is a PE of a foreign company, debt owed by the PE to a third party is considered "controlled debt" if the main office of the foreign company is (also) liable to pay the debt. Accordingly, most debt owed by a Danish PE of a foreign company is considered "controlled debt".

Condition 2: Debt Threshold

For purposes of determining whether the debt threshold has been exceeded (and of determining the debt-to-equity ratio — see II.A.3., below), the definition of "debt" includes the items identified in the Law on Taxation of Gains and Losses on Debt Claims (in essence, all monetary claims) and convertible bonds.

The debt is assessed at market value at the end of the Danish Debtor's tax year and is calculated as the aggregate sum of the controlled debt and all other debts.

Debt denominated in foreign currency is converted into Danish kroner at the exchange rate applicable at the end of the Danish Debtor's tax year. However, it should be noted that both Danish companies and Danish PEs of foreign companies may choose to use a functional currency (other than Danish "kroner") for Danish income tax purposes.

Condition 3: Debt-to-Equity Ratio

For purposes of establishing the debt-to-equity ratio, "equity" means assets less debt. Assets are assessed at their market value at the end of the Danish Debtor's tax year. Equity contributed by foreign shareholders is only included to the extent it remains in the Danish Debtor for at least two years. This rule prevents the owners of a Danish Debtor from making a contribution to the Danish Debtor at the end of a tax year and then withdrawing the contribution at the beginning of the following tax year with the sole purpose of meeting the debt-to-equity ratio requirement for a short period of time.

In the case of a PE of a nonresident company, only assets and liabilities that are related to the PE are taken into account for purposes of computing the debt and equity of the PE.

The debt-to-equity ratio is calculated on a consolidated basis for the Danish Debtor and other controlled Danish entities that can be considered part of the same group. However, the foreign parent company or, if applicable, the ultimate Danish parent company of the group is disregarded for purposes of this consolidation.

Condition 4: No Matching Debt Available

Even if the Danish Debtor has controlled debt in excess of the 4:1 ratio, the limitation on interest deductions will not apply if such debt would be available from unrelated parties under arm's length conditions ("matching debt"). The burden of proof in this respect lies with the Danish Debtor: the Danish Debtor must demonstrate that without the credit support of a party related to the Danish Debtor, an unrelated party would be willing to grant debt on similar terms to the Danish Debtor, taking into account the commercial and economic situation of the Danish Debtor. This assessment is made on a case-by-case basis.

B. Limits on Interest Deductions Based on Other Factors

1. Limitation on Financial Expenses Regime (Asset and EBIT Limitation Rules)

As noted above, interest expenses are generally deductible for Danish corporate income tax purposes. However, deductibility may be restricted under the asset and (EBIT) limitation rules (the "Asset Limitation Rule" and the "EBIT Limitation Rule") of the limitation on financial expenses regime.

Unlike the thin capitalization rules, the Asset Limitation Rule and the EBIT Limitation Rule apply not only to controlled debt but also to debt owed to unrelated parties. As under the thin capitalization rules, non-deductible financing expenses are not reclassified as dividends under the Asset Limitation Rule and the EBIT Limitation Rule. Also, the Asset Limitation Rule and EBIT Limitation Rule apply to the resident company's net financing expenses ("Net Financing Expenses"), not only the company's isolated interest expenses.

Net Financing Expenses include:

- Interest income and expenses (excluding interest income and expenses deriving from trade creditors and debtors).
- Net loan commissions and similar expenses/income (excluding commissions related to trade accounts payable/receivable).
- Taxable capital gains and losses on receivables, debts and financial instruments except the following:

  (1) Gains and losses on trade accounts payable/receivable;

  (2) A lender's gains and losses on loans, if the lender is a trader in receivables or carries on financing activities as part of its business (and the counterparty is not a group member);

  (3) Gains and losses on bonds issued for purposes of the financing activities referred to above in (2) and gains and losses on financial instruments related to such activities;

  (4) Gains and losses on futures (and similar instruments) entered into to hedge risks with respect to operating income and operating expenses of the company or other companies in the same tax consolidation group (however, if the company is a trader in receivables or financial contracts or carries on financing activities as part of its business and the counterparty is a group member, this exclusion does not apply); and

  (5) Unrealized gains on an interest swap with respect to loans secured by real estate (however, such gains can be carried forward and offset by any prospective future losses incurred with respect to the same interest swap).

Estimated finance costs (where the company is a lessee) or estimated finance income (where the company is a lessor) relating to financial leasing arrangements.[2]

Taxable capital gains and utilized losses on shares or other items taxed under the Capital Gains Tax Act, taxable dividends and taxable gains on sales to the issuing company. However, if the net amount is negative, it is not included in the calculation of the net financing expenses of the year in question. Instead the negative amount is carried forward. This does not apply with respect to equities purchased by a trader for trading purposes and taxed on a mark-to-market basis.

Notwithstanding the inclusions listed above, financial income and expenses are always excluded if derived from controlled foreign company (CFC) taxation or if derived from the special recapture provision applied under the Danish tax consolidation scheme for corporate entities.

In the case of companies that are part of a Danish tax consolidation, the calculation of net financing expenses is made on a consolidated basis.

Net financing expenses of less than DKK 21.3 million (2017) will always be deductible under the Asset Limitation Rule and/or the EBIT Limitation Rule, but may be subject to limitation under the thin capitalization rules (it should be noted, however, that the thin

capitalization rules only apply to controlled debt in excess of DKK 10 million). This threshold is adjusted annually and is calculated on a group basis.

a. Asset Limitation Rule

Net financing expenses (as defined in II.B.1., above) are not deductible if they exceed a cap computed by applying a standard rate of return (3.2 % for 2017) to the tax base of the company's (or tax consolidation group's where applicable) qualifying assets ("Qualifying Assets"). Notwithstanding this general limitation rule, the deductibility of finance expenses is not limited to the extent the net financing expenses comprise net capital losses on receivables that exceed positive interest income of the tax year.

If the net financing expenses are limited under the above limitation rule, net losses on debt and financial contracts are considered to be reduced before other expenses (i.e., interest expenses).

Qualifying Assets include:

- The tax basis of depreciable assets;
- The acquisition price of non-depreciable assets together with the cost of improvements to the assets concerned;
- The value of any tax losses carried forward (losses carried forward at the end of the accounting period are included before taking into account any limitations under the Asset Limitation Rule and/or the EBIT Limitation Rule);
- The book value of leased assets where the company is the lessee in a financial leasing arrangement (however, in the case of assets subject to financial leasing between group companies, the tax basis value is used rather than the book value);
- The tax basis of assets contributed to the Danish tax consolidated group by a foreign group company if the assets remain in the Danish tax consolidated group for more than two years (however, if the group has elected for international tax consolidation, the two-year ownership requirement does not apply);
- The value of work-in-progress, assets bought by a trader for trading purposes (with regard to shares, only shares taxed on a mark-to-market basis are included), inventory and receivables, if his value exceeds debt related to acquired work-in-progress, inventory and receivables;
- The net value of work-in-progress carried out at another party's expense; and
- The value (acquisition price) of financial contracts acquired to hedge risks with respect to trade receivables and trade payables.

The balance is made up on a consolidated basis by the administrative company of a tax consolidation group. The balance is reduced by various income items and assets (for example, by any dividend distributions and contributions from the group's foreign subsidiaries).

The following are excluded from Qualifying Assets:

- Shares in Danish companies (however, shares forming part of a financial trading activity may be included in the calculation if they are taxed on a mark-to-market basis);
- Receivables;
- Cash;
- Bonds and financial instruments (futures, swaps, etc.);
- Assets held and leased out by a lessor under a finance lease agreement;
- Assets contributed to the Danish tax consolidated group by a foreign group company if the assets remain in the Danish tax consolidated group for less than two years; and
- Assets subject to taxation under the Danish Tonnage Tax Act.[3]

The value of the assets must be determined at the end of each tax year.

As a general rule, net financing expenses the deduction of which is restricted as a result of the application of the Asset Limitation Rule may not be carried forward. However, net capital losses relating to debts (including foreign exchange losses) and financial instruments reduced under the Asset Limitation Rule may be carried forward for three fiscal years and set off against gains on debts (including foreign exchange gains) and financial instruments. Irrespective of this, unrealized losses on interest swaps with respect to debt secured with collateral in real property can be carried forward during the term of the interest swap and set off against any future realized or unrealized gains on the same interest swap. Net capital losses on receivables that exceed positive interest income of the tax year can be carried forward indefinitely and set off against future gains on receivables and interest earnings in calculating the net financing expenses of future income years.

Where the company has capital losses relating to claims, debts, bonds, financial instruments and foreign currencies as well as interest expenses, the capital losses are reduced first followed by the interest expenses.

When setting off carried forward losses against future gains, the oldest losses are set off first. When restricting the deductibility of net financial expenses, losses relating to net debts and financial instruments are reduced first. For companies that are part of a Danish tax consolidation, the calculation of the tax base of the assets is made on a consolidated basis. Danish group companies are subject to a mandatory tax consolidation regime.

b. EBIT Limitation Rule

In addition to any limitations triggered by the thin capitalization rules and/or the Asset Limitation Rule, net financing expenses must comply with the EBIT Limitation Rule. Under the EBIT Limitation Rule, net financing expenses (as defined in II.B.1., above) may not exceed more than 80% of a resident company's earnings before interest and tax (EBIT).

Net financing expenses the deductibility of which is restricted under the EBIT Limitation Rule may be carried forward in accordance with specific rules. The net financing expenses of tax consolidated companies are reduced proportionally under the EBIT Limitation Rule.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Except in the context of the interest deduction limitations described above (i.e., the thin capitalization rules, and the Asset and EBIT Limitation Rules), Danish tax law does not permit partial recharacterization.

D. Effect of an Income Tax Treaty Between Denmark and FC

Danish tax treaties are generally based on the OECD Model Convention and do not contain any rules on recharacterization. As noted above, interest expenses are deductible regardless of the origin of the lender. Further, interest determined by the free market is regarded as interest for tax purposes, regardless of whether the interest rate is considered high or low. Interest rate differentials are simply subject to assessment by the tax authorities if the loan concerned is entered into between related parties (under the transfer pricing rules) and the tax authorities may well reduce interest rates in such transfer pricing cases. The consequence of such a reduction is that the excess interest is (for both domestic and tax treaty purposes) deemed to be a non-deductible dividend or gift to the lender.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Generally, the position described above would not change if FCo were considered a transparent entity for FC tax purposes, as the definition of debt and deductible interest is not contingent on the foreign tax classification of the lender.

It should, however, be noted that Danish tax law contains measures targeted at U.S. check-the-box structures.

Section 2A of the Corporation Tax Act limits the deductibility of certain cross-border payments made to foreign group-related entities resident in an EU/European Economic Area (EEA) Member State or a treaty partner country. The primary target of Section 2A is Danish–U.S. holding structures, where a U.S. parent company has made an election under the U.S. check-the-box rules to treat a Danish subsidiary as a disregarded entity for U.S. tax purposes. Unless the Danish subsidiary is held by the U.S. parent company through one or more intermediate holding companies that are not treated as fiscally transparent for U.S. tax purposes, the Danish subsidiary is reclassified as a branch under Section 2A.

Section 2C of the Corporate Tax Act seeks to prevent the use of U.S. check-the-box elections with respect to Danish transparent entities (reverse hybrids) by reclassifying such entities as non-transparent corporations for Danish tax purposes.

A. Section 2A of the Corporation Tax Act

Under Section 2A of the Corporation Tax Act, a Danish company, or a foreign company with a PE in Denmark, is deemed transparent for Danish tax purposes if:

The Danish company is treated as a fiscally transparent entity under the laws of a foreign country with the result that the income of the Danish company is included in the taxable income of a controlling foreign legal entity (i.e. generally an entity that owns more than 50% of, or holds more than 50% of the voting rights in, the Danish company); and

The foreign country in question is an EU/EEA Member State or a treaty partner country.

If these conditions are fulfilled, the Danish company is classified as a "transparent entity" (referred to as a "Section 2A Company") for Danish tax purposes and is consequently treated as a branch of the controlling foreign entity, with the result that the Danish company is not considered a Danish tax resident and is thus not entitled to the benefits of EU Directives or Denmark's tax treaties.

Since it is treated as a branch, a Section 2A Company is not entitled to deduct payments made to its foreign parent company or to other group-related entities that are (also) treated as fiscally transparent under the laws of the country of residence of the foreign parent company (subject to the exception noted below), as such payments are regarded as made within the same legal entity.

By way of an exception to the above general rule, payments made by a Section 2A Company to another group-related entity that is also treated as fiscally transparent under the laws of the country of residence of the parent company remain tax deductible if the group-related entity is a tax resident of an EU/EEA Member State or a treaty partner country, and that country is a country other than the country of residence of the parent company.

Section 2A applies only if the Danish company and all intermediate holding companies above the Danish company are treated as fiscally transparent under the laws of the country of residence of the foreign parent company. The rule does not apply if the Danish company is owned by the foreign parent company through an intermediate holding company resident in a third country and the intermediate holding company is not treated as fiscally transparent under the laws of the country of residence of the foreign parent company.

B. Section 2C of the Corporation Tax Act

Under Section 2C of the Corporation Tax Act, a Danish registered branch of a foreign entity, and a tax-transparent entity that: (1) is incorporated in Denmark; (2) has its corporate seat in Denmark; or (3) has its effective seat of management in Denmark is classified as a non-transparent entity for Danish tax purposes if:

More than 50% of the votes or the capital interest in the Danish entity is held directly by foreign investors; and

Those foreign investors are tax resident in a foreign country that: (1) regards the Danish entity as non-transparent; or (2) has not concluded a tax treaty or an exchange of tax information agreement with Denmark.

If these conditions are fulfilled, the Danish transparent entity is reclassified as a non-transparent entity (i.e., as a corporate body), which has the following consequences for its tax treatment:

   ISSN 0143-7941

- In certain respects, the Danish entity assumes the tax position of the investors;
- The disposal of an ownership share in the Danish entity is treated as a disposal of shares;
- Income derived by the Danish entity is subject to ordinary Danish corporation tax (at a flat rate of 25%);
- Distributions made by the Danish entity to its investors are treated as dividends and may consequently be subject to Danish withholding tax; and
- A subsequent cessation of the reclassification will be treated as a liquidation of the Danish entity. This may result in capital gains taxation at the level of the Danish entity and the taxation of liquidation proceeds at the level of the investors.

Interest payments may be deducted by the reclassified entity unless the foreign owners of the entity treat such payments as made within the same legal entity (because the owners treat the Danish entity as transparent). If interest expenses are not deductible, the corresponding interest payments cannot be subject to withholding tax.

IV. Withholding Tax Issues

Interest payments are generally not subject to withholding tax. However, interest payments made to a foreign related lender (i.e., interest payments on controlled debt) are subject to interest withholding tax at a rate of 22% (2017). Interest payments on controlled debt are, however, exempt from Danish withholding tax if the tax would be waived or reduced pursuant to the Interest and Royalties Directive[4] ("directive exemption") or a tax treaty between Denmark and the country of residence of the interest recipient ("treaty exemption"). Thus, interest payments will be exempt from Danish withholding taxes if the tax would be reduced (or waived) under either the EU Directive or one of Denmark's treaties.

The Danish tax authorities have initiated a number of cases claiming that an intermediary company resident in an EU Member State is not entitled to the treaty or directive exemption because it is not the beneficial owner of the income concerned. The position of the tax authorities is generally as follows:

To qualify for withholding tax exemption, the intermediary holding company must qualify as the "beneficial owner" of the income under a tax treaty, meaning that:

- The intermediary holding company must have the independent power to dispose of income it receives; and
- The intermediary holding company must carry on genuine activities in its EU Member State of residence, i.e., it cannot be a mere "mail-box company."

The application of the directive exemption may be denied if the interposition of the intermediary holding company represents a wholly artificial arrangement.[5] The interposition of an intermediary constitutes a wholly artificial arrangement if the intermediary has been established with the sole purpose of avoiding withholding taxes and has no commercial purpose.

The position of the Danish tax authorities has evolved over the course of these cases and they now generally appear to focus more sharply on the question of whether the funds flow through the initial recipient (i.e., the intermediary holding company) than the issue of substance/genuine economic activities.

It should be noted that whether or not interest payments are subject to withholding tax has no impact on the deductibility of the corresponding interest expense.

Recharacterization of the debt on which the interest is payable may have withholding tax consequences. Interest withholding tax is not levied if the payments concerned are not considered to be interest payments. However, if the payments are reclassified as either dividend or royalty payments, withholding tax may still apply as these types of payments are also subject to withholding tax.

V. Difference if FCo has a Permanent Establishment in Denmark

None of the above answers would change merely due to the fact that the lender (FCo) had a Danish PE, unless the debt claim could be attributed to the PE. If the claim could be attributed to the Danish PE, Danish tax law would govern both the expense side and the income side of the debt, so that, at first blush, no hybrid issues would arise. However, there are circumstances in which such a Danish PE might be recharacterized for Danish tax purposes (see III., above).

Interest income will be allocated to a Danish PE only if the debt claim is also allocated to the PE. Denmark applies the OECD definition of a PE as well as the OECD principles for the attribution of income to a PE. This means that, for a debt claim (and consequently the interest payable on the debt claim) to be allocated to a Danish PE, the debt claim would have to be regarded as held by the PE from a non-tax law perspective.

VI. Legislative Changes

Since Danish tax law is believed to be both EU[6] and OECD BEPS compliant, no significant legislative proposals in this respect are expected.

NOTES

[1] The term "decisive influence" is defined in Tax Assessment Act, Sec. 2(2).

[2] As defined in IAS 17.

[3] *Tonnageskatteloven*.

[4] 2003/49/EEC.

[5] See *Cadbury Schweppes* (case C-196/04) and *Halifax* (case C-255/02).

[6] The Anti-Tax Avoidance Directive (ATAD) and the (pending) Proposal for a Council Directive amending the ATAD with regard to hybrid mismatches with third countries (the "ATAD 2 Proposal").

FRANCE

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I. Possibility of French Tax Authorities Recharacterizing Advance of Funds by FCo to FrenchCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

1. General Comments on the Characterization of Hybrids

Whether the transfer of funds to a French entity subject to corporate income tax (CIT) represents debt or equity for French tax purposes has obvious and significant consequences for the tax treatment of the income and expense flows related to the financing instrument by each party.

The main aspect on which this paper will focus is that, while a French borrower is allowed to deduct the interest payable under a debt instrument, even though the deduction may be subject to various limitations, no deduction is allowed with respect to a dividend payment. One area in which debt/equity issues are particularly relevant is in the treatment of hybrid instruments, i.e. instruments that are treated as debt under the tax rules of one country but as equity under those of another country. As a result of this difference in treatment, the use of a hybrid instrument may, intentionally or unintentionally, achieve a position in which a deduction for an interest payment is obtained in one country without a corresponding income inclusion in the other country.

There are other important aspects particular to each method of financing (i.e. debt or equity), notably the treatment of the related income flows with respect to withholding taxes — no withholding tax normally applies to interest paid by a French borrower, while a 30% withholding tax potentially applies to dividends, subject to the effect of France's tax treaties and the exemption granted under France's domestic law implementation of the EU Parent-Subsidiary Directive (Article 119 *ter* of the French Tax Code (CGI) provides a total exemption from withholding tax for dividends paid to an EU resident company holding more than 10% of the French distributing company).

In the reverse situation, where the financing is granted by a French entity to a foreign entity, classification of the relevant instrument as equity rather than debt may allow the related income flows to benefit from the participation exemption under France's holding regime. This latter situation is, however, not covered in this paper, which focuses instead on the treatment of a French entity (FrenchCo) subject to CIT in France and financed by a foreign entity (FCo).

As a general principle and as provided by Article 38 *quater* of Appendix III to the CGI, the legal classification and accounting treatment of a transaction under French GAAP (*Plan Comptable Général* or PCG) determines its tax treatment,[1] except where the tax law provides for a different treatment. In the absence of a specific definition of debt or equity in French tax law, the legal classification and accounting treatment will prevail for purposes of determining the relevant tax treatment.

From a French statutory accounting standpoint, the issuance of bonds convertible into equity is treated in a similar way to the issuance of conventional bonds, i.e. they are booked as debts and interest paid by the issuer is considered a financial expense. The same treatment applies to bonds issued with a warrant (OBSA) and subordinated debt. The accounting treatment of bonds redeemable in shares (ORAs) is more ambiguous since, in some circumstances, such instruments are recorded under French GAAP as "other equity funds." ORAs have consequently historically been the subject of more debate than other such instruments (see below), but normally remain subject to treatment as debt.

Although the French tax authorities must normally rely on the legal and accounting classification of a transaction, they may challenge such classification by reference to the legal and economic characteristics of the transaction if they have sufficient elements to establish that the contractual or accounting treatment is erroneous, based on either the misclassification of the transaction with respect to its legal analysis, or because the transaction is abusive or fraudulent.

Except in situations where the accounting and legal classification of an instrument as debt would be obviously incorrect, the recharacterization of debt as equity would be subject to the abuse of law (or *fraus legis*) procedure rules contained in Article L 64 of the French Tax Procedure Code (LPF), which is quite demanding for the tax authorities to implement.[2] In all cases, the burden of proof would, in principle, lie with the tax authorities but the French entity would be required to provide clear information on the features and purposes other than tax of the transaction concerned (in that sense, the burden of proof is in fact shared between the taxpayer and the tax authorities).

The purpose of the discussion that follows is not to deliver a precise analytical grid (which anyway does

ISSN 0143-7941

not exist), but to comment on how this issue has been approached by the tax authorities and to provide illustrations by reference to the few existing cases that address the matter. In any event, the question of how an instrument is to be classified has lost much of its relevance and materiality from a tax perspective as a result of recent changes to the law, which automatically limit the effect of hybrid instruments (see II., below).

2. Comments of the French Tax Authorities

As indicated above, the French tax authorities have not provided any precise analytical grid for classifying an instrument as either debt or equity and have stated that a case-by-case analysis should be conducted, based on the characteristics of the particular instrument concerned. No single element is decisive in determining how an instrument is to be classified and only a comprehensive analysis of a transaction can lead to its potential reclassification. It is, however, worth referring to some of the past comments of the tax authorities on this subject, though only by way of illustration and not as representing a rule.

The French tax authorities' guidance (in the form of a statement of practice) on the thin capitalization rules,[3] for example, acknowledges the existence of hybrid instruments that share features of both debt and equity. The tax authorities indicate that equity features would, in particular, be the absence of a predefined reimbursement date and the ability of the issuer to suspend the remuneration in the case of insufficient profit, and that debt features would be the existence of predefined fixed or variable remuneration, the absence of voting rights and the right to liquidation surplus. The authorities conclude their statement of practice by noting that once the analysis of an instrument is made that results in its classification as debt, then the interest paid on the instrument is subject to the thin capitalization rules commented on in the guidance.

The French tax authorities also had to comment on these questions in their guidance[4] on the tax treatment of Islamic Finance and Sharia-compliant instruments (Shariah law forbids the payment of any form of interest). The tax authorities indicated that such instruments should be treated in a manner similar to debts, to the extent certain requirements are met. In particular, the tax authorities indicated that "Sukuk" Sharia transactions should be equated with debt instruments, provided:

- The Sukuk holders have priority over shareholders whatever the nature of the equity stakes of the latter.
- The Sukuk holders do not have rights that are specific to shareholders, namely voting rights and rights to share liquidation surplus (unless the Sukuks have been converted into shares).
- Remuneration on the Sukuks is based on the performance of the collateralized assets, but must include an expected rate of return that must be capped at an accepted market rate (EURIBOR, LIBOR) increased by a margin consistent with market practice in relation to debt instruments. The remuneration could be zero in the case of an issuer in a loss-making position. The Sukuks can be reimbursed at below par value (because of the index-linking mentioned in the Sukuk agreement).

It is worth noting that the author has provided comparable analysis with respect to the tax treatment of convertible contingent bonds (CoCos) issued by banks to enhance their Tier 1 equity funds,[5] since hybrid instruments are of great interest to banks from a regulatory perspective, quite apart from any tax advantage that they may confer.

3. Case Law

There is so far little case law on the recharacterization of debt into equity, or the reverse (equity into debt, where a hybrid instrument is used to finance a foreign investment and the French investor claims the benefit of the participation exemption).

The Abuse of Law Committee (which is an administrative committee, not a Court, and does not create "case law" *per se* since the advice of the Committee is not binding on the Courts, even if a positive answer of the Committee shifts the burden of proof to the taxpayer[6]) had to comment on the treatment of exceptional distributions made by a French entity by way of the issuance of ORAs and confirmed the authorities' view that the transactions concerned could be regarded as constituting *fraus legis* under the general anti avoidance rules contained in Article L 64 of the LPF (which is also referred to as being designed to combat "abuse of law" or "fraud to the law").[7] In a decision handed down on the same day, the same Committee concluded that the implementation of a participating loan, concomitant with a reduction of capital through a share repurchase, was not abusive.[8]

In the opposite situation (where the issue was the equity financing of a foreign corporation held by a French holding entity and the benefit of the exemption for dividends received by the French entity), the Committee concluded [9] that a transaction involving the use of preferred shares and a number of other specific elements, was a sham that allowed a bank to benefit improperly from the participation exemption.

As regards actual court cases, the most significant decision on the subject under discussion is the recent decision of the High Court in *SAS Ingram Micro*,[10] even though this concerned the payment of an exceptional dividend distribution by the way of the allocation of ORAs, rather than a pure hybrid situation. The High Court confirmed that the overall transaction, which, in practice, allowed equity reserves to be replaced by debt, without any cash movement, was a fraud. The fact that the reimbursement took the form of ORAs played a part in the analysis (because the refinancing was considered circular since it did not involve any cash movement and used an instrument designed to revert to equity on redemption), but certainly does not allow the conclusion to be reached that ORAs are not debt instruments.

The case created some doubt as to whether the High Court intended to challenge the old principle according to which taxpayers are totally free to decide how they finance themselves, whether by debt or equity (which is a different issue from the treatment of hybrids). Some comments on the case seem to indicate that the intention of the High Court was not to challenge this principle and that the case should remain

an isolated instance — one can but hope that the tax authorities will share a similar conviction.

Another interesting case in this respect was heard by a local court of appeal,[11] which held that the creation of debt resulting from a share buy-back financed by debt did not run counter to the interests of a French entity, which remained free to decide how it should be financed, irrespective of the existence of an advantage for the foreign investor concerned. The Court noted that the fact that a transaction affords advantages to a shareholder in a French entity is not of itself sufficient for the transaction to be regarded as abnormal if the transaction also affords advantages to the entity.

Hence, a challenge to the effect that debt has been artificially created can be made on the grounds of *fraus legis* and Article L 64 of the LPF (but only in limited situations if decades of case law confirming free choice as to financing are to be believed) and other specific debt creation rules provided for by French law (see II.C., below), not on abnormal management or transfer pricing grounds. But again, this concerns debt creation more than it does the use of hybrids as such.

4. Tentative Conclusion

Situations in which a financial instrument that is classified as debt for French commercial law and accounting purposes is recharacterized by the tax authorities as equity for tax purposes remain rare and it is impossible to draw a clear line between the two types of financing. A multi-criteria approach is required, with no particular criterion predominating.

The terms of remuneration, participation in profits and losses and the modalities of redemption are, of course, important factors in the analysis of a financial instrument, but it is not easy for a loan to be recharacterized as equity: convertible bonds and ORAs are, in principle, treated for tax purposes as debt, at least until they are converted into or redeemed with shares. As discussed above, the use of ORAs to replace equity reserves by debt was held by the High Court in *SAS Ingram Micro* to constitute an artificial arrangement and treated as an instance of *fraus legis*, but this decision was essentially driven by the specific fact pattern at issue.

Nor does the fact that a security does not have a predetermined duration disqualify it from being a bond. For example, subordinated bonds (*titres subordonnés à durée indeterminée* or TSDIs) do not have a stated maturity and are reimbursable on the judicial liquidation of the issuer, but this does not allow them to be reclassified as equity (the same is true of perpetual bonds — CoCos). From an accounting standpoint,[12] TSDIs are classified as debt instruments and the French tax authorities also equate TDSIs with debt for tax purposes.[13]

Nor is the fact that the remuneration for a loan is contingent on, and partly or wholly determined with respect to, the profits of the issuer a decisive factor pointing to the conclusion that the loan should be classified as equity. Participating loans, for example, are, in principle, treated as debt, as are indexed bonds and Sukuks.

Where an instrument ranks on the liquidation of the borrower is an important factor in determining its character as either debt or equity (see the discussion of Sukuk at I.A.2., above, in this regard). For example, in the case of a company that has been granted a participating subordinated loan, the lender is reimbursed before the company's shareholders. However, like the other criteria weighed in making the debt/equity distinction, such ranking cannot be taken into account in isolation: for example, on liquidation a preferred share can be refunded before the rest of the equity, but this does not make it a debt.

As suggested above, these complex discussions have lost some of their significance now that France has enacted the measures recommended in the OECD's guidelines allowing a deduction to be denied to the payor where the payment concerned is not recognized as income by the recipient. The relevant rules are discussed in II.A., below.

In light of the above remarks, it can be seen that the assumption in the case under discussion that the financing transaction between FCo and FrenchCo is not supported by any legal documentation would not be fatal to the argument that the financing should be regarded as debt.

Even in the event that FrenchCo and FCo failed to draw up legal documentation (which would be both unwise and, in practice, highly unlikely), the accounting treatment (which would normally be based on a legal analysis under French GAAP) would be a crucial element in the analysis of the arrangement, since the accounting treatment is binding on the taxpayer and is deemed to reflect its management decisions, even if those decisions can be challenged by the tax authorities. This can be illustrated by the conclusion reached by the High Court in a recent case[14] in which a branch recorded a transfer of funds to its head office as a receivable rather than as repatriation of equity: the High Court held that interest should have been charged to the head office on the recorded receivable.

As regards the consequences of FCo's treating the instrument as debt (as assumed for purposes of this section), the approach of the French courts in determining the character of a cross-border transaction is always to rely exclusively on French criteria. The classification of the transaction under foreign rules is ignored. For example, the High Court has held[15] that the character of a foreign partnership (in the case concerned, a U.S. general partnership) should be determined by comparing it with similar French entities with comparable legal features, not by reference to its classification or tax treatment in the foreign country concerned. The same reasoning was used in a case concerning a U.S. LLC.[16] More recently, the High Court[17] held that a debt waiver granted by a French company to its U.K. subsidiary should not necessarily be treated as a (non-deductible) capital contribution, even though it was so treated for U.K. accounting purposes: The High Court reversed the decision of the Court of Appeal, because the lower court should have classified the debt waiver by reference to French legal and accounting standards, irrespective of its foreign law treatment.

The fact that the issuer treats an instrument as debt does not, of itself, prevent the tax authorities reclassi-

fying the instrument as equity if this is the correct analysis under French corporate law and accounting rules.

However, even though the characterization of the instrument as debt by FCo is irrelevant for the legal analysis, it is an element that would be considered in the overall factual analysis. The foreign treatment and whether or not the parties are related in practice (even if not in theory) will clearly have an impact on the conclusion reached by both the tax authorities and the Courts, since establishing *fraus legis* requires an analysis of the intention of the parties to the transaction concerned. In the author's opinion, it is unlikely that the abuse of law procedure could apply or even be invoked by the tax authorities where the hybridity between unrelated parties is merely the result of a difference in treatment of one single instrument and not the result of a contorted attempt to achieve different treatment in each of the countries concerned (for example, the use of listed CoCos by banks to enhance their Tier 1 ratios).

The fact that interest on a debt is taxed in the hands of the recipient will, however, have direct consequences in the context of new limitations on the deduction of interest (see II.A., below).

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The fact that FCo and FrenchCo are related does not of itself point towards either debt or equity treatment, but it does invite an analysis of how the instrument is treated by the financing entity in the foreign country (FC).

As noted above, the treatment of the instrument by FCo, i.e., its classification as equity, is, in theory, not taken into account for purposes of determining its treatment under French tax law in the hands of FrenchCo. However, even though the position under this second scenario should consequently be the same as under the first scenario (see I.A., above) the treatment of the instrument as equity by FCo and the consequent exemption of the payments made to it by French Co are, in practice, likely to affect the analysis for French tax purposes.

In *SAS Ingram Micro*, the High Court regarded the absence of taxation of the foreign company concerned in its country of residence as a relevant factor. The wording of the decision indicates that this was not a crucial element in the Court's analysis (the Court refers to it incidentally — "*au demeurant*"), but it seems likely that the existence of a hybrid mismatch (deduction/non-inclusion) was regarded as important in this particular case. *Fraus legis* requires the identification of an element of intention to avoid tax and it seems unlikely that the recharacterization would have succeeded had the judges felt that the hybrid mismatch was merely the result of differences in tax treatment between the two countries.

Finally, as already noted, the absence of documentation suggested in the case study would not necessarily be fatal to the analysis of an instrument as debt. In the hypothetical absence of documentation, the accounting treatment by FrenchCo would be a clear indication of how the instrument should be characterized (see above), but the tax authorities would be able to mount a challenge using the approach described above. The absence of any documentation would be a poor platform for a French borrower wishing to argue for the existence of a debt for French tax purposes if the instrument concerned were treated as equity in the lender's country of residence.

C. Difference if a Loan Agreement of Some Sort Exists

Where a loan agreement exists, the loan agreement is, in principle, treated as such, but the tax authorities can recharacterize it, based on the approach discussed above. In any event, new rules would apply to limit the deduction of interest if the counterparty was not taxed or was only taxed at a low rate (see II.A., below).

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender (Assuming the Transaction Is Accepted as a Loan)

A. Effect on General Rules if It Is Known That the Lender Does Not Include the Interest Income in Taxable Income

Assuming the instrument is treated as debt, interest paid by a French taxable entity is, in principle, deductible on an accrual basis (including capitalized interest). Unlike in a number of countries, interest is deductible in France even if the debt on which it is payable is related to the acquisition of shares in a controlled entity (whether in France or abroad), which is an important element in the computation of the French taxable base. Even though, as is widely known, France has a high nominal corporate tax rate (though this may change under a new presidency), this interest deduction can significantly reduce the effective rate of taxation (at least it *could* when corporate rates were higher than they are currently).

Interest payable by FrenchCo may, however, be subject to various rules limiting its deduction. Most — but not all — of the limitations concerned apply to interest paid to related parties. The residence of the lender is in principle irrelevant for purposes of determining whether a deduction is available — any rule to the contrary could be denounced as discriminatory (see V., below).

The new rules on hybrids and payments to low-tax countries are summarized in this section. Other rules on debt-to-equity ratios and thin capitalization will be described in II.B., below, and other limits on interest rates and the debt creation rules will be described in II.C., below.

Hybrid instruments are a major focus of attention in the current initiatives of the OECD and EU authorities — not only in the context of efforts to combat tax avoidance and prevent the OECD member countries/EU Member States suffering tax leakage, but also because hybrid mismatches are regarded as generating unjustified competitive advantages for the multinational groups that can implement them. Neither the OECD nor the EU proposals will be addressed here since they are not purely a question of French domestic law and have anyway been extensively discussed elsewhere.

France has implemented most of the recommendations made by the OECD as well as EU recommendations and Directives (see further at VI., below). Whether interest is to be included in the lender's taxable income and how it is to be taxed have become relevant issues since the introduction by the 2014 Finance Bill of what is now Article 212, I-b of the CGI, which establishes a new condition for the deduction of interest by reference to a minimum level of taxation in the hands of the beneficiary, where the beneficiary is a related party of the payor. The law applies for financial years closed after September 25, 2013.

In summary, to obtain relief for interest it pays, a French borrowing entity must now be able to establish, when requested to do so by the tax authorities, that the lender (where the lender is a French or foreign related party) is subject to income tax on the interest received from the French borrower at a rate of at least 25% of the standard French CIT rate (i.e., 33.33% x 25% = 8.33%) or, according to the tax authorities, at a slightly higher rate of 9.5% in situations where additional contributions assessed on CIT would be due. The purpose of this new rule is, therefore, not only to combat hybrid instrument mismatches and situations of double non-taxation, but also to target payments of interest to low-tax countries.

The rule applies only to interest paid to related parties, not to interest paid to other lenders. If the lender is a transparent entity: (1) the rule only applies if the French borrower and the members of the transparent entity are related parties; and (2) whether the minimum taxation threshold is met is tested at the level of the entity's members (subject to certain conditions).

If the lender is a foreign tax resident, the characterization of the instrument in the lender' country of residence is irrelevant — the only relevant question concerns the level of foreign tax applicable to the income received by the lender. The comparison between the minimum 25% threshold and the rate of foreign tax is made with respect to the gross interest income, computed in accordance with French tax rules (for example, the interest is computed on an accrual basis and no account is taken of any basis rebate or deduction for expenses that may apply for foreign tax purposes). The foreign tax rate is computed based on the theoretical foreign tax payable at the nominal rate, not on the effective tax paid. Thus for example, the fact that the lender is in a loss position or does not pay tax because of local tax consolidation or group relief rules is not taken into account. Nor, in principle, is the fact that the lender may itself pay interest to another party.

Because of its general objective of combatting tax optimization (a broader concept than tax avoidance), this rule works mechanically to determine the taxable basis, quite independently of any tax avoidance considerations. There is no safe harbor allowing the taxpayer to avoid the application of the rule by establishing that there is no tax avoidance motive (unlike under other anti-avoidance measures, such as the controlled foreign company (CFC) rules).

Nonetheless, the tax authorities explained in comments issued in December 2015 concerning schemes that can be regarded as fraudulent, that *fraus legis* can be invoked in the following situation: A corporation in State A creates a subsidiary in State B financed by equity; the subsidiary in turn establishes a branch in State C (a low-tax country) that on-lends to a French borrower and the interest is not "effectively" taxed in B and C (although the computation should in principle only take into account the theoretical tax paid in State B). Taxpayers in this position are invited by the guidance to disclose themselves to the tax authorities — and, one might say, *frauslegis* gets back in through the back door.

Should the income received by the foreign lender be taxed in France under the French CFC regime,[18] the interest would be regarded as being sufficiently taxed (so that there would be no cumulative application of the two sets of measures).

B. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The relevant rules will not be discussed in any great depth here, but may be summarized as follows:

- Thin capitalization rules (related party loans): Article 212 of the CGI provides that a borrowing entity is deemed to be thinly capitalized if the total amount of interest incurred on related party loans that is deductible under the interest rate test fails all three tests below (i.e., the tests are cumulative tests):

  (1) Debt-to-equity ratio test: the average of amounts made available to the borrowing company in the form of debt by related entities (including non-interest bearing loans and loans obtained from third parties but guaranteed by a related entity) may not exceed 1.5 times the amount of the borrowing company's net equity or share capital. For each financial year, the taxpayer is free to use either the total equity at the beginning of the year or the total equity at the close of the year. If it is higher than its net equity, the borrower can use the share capital at the end of the financial year. The interest on the excess portion of debt may be non-deductible, depending on whether two other conditions are fulfilled.

  (2) Interest coverage ratio test: interest payable may not exceed 25% of the borrowing entity's operating profit before tax, increased by: (a) interest payable to related parties; (b) depreciation allowances taken into account in determining the entity's pre-tax operating profit; and (c) the portion of finance lease payments taken into account in determining the sale price of leased assets at the end of the lease.

  (3) Interest received test: the above limitations only apply if interest paid to related parties exceeds interest received by the borrowing entity on loans it has itself made to related parties. The existence of this test can increase the level of deduction allowed compared to what would be allowed if only the first two tests applied, especially in the case of a pool leader located in France.

- The deductibility of the excess portion of the interest paid (the excess portion being computed by applying that of the three tests above that produces the most taxpayer-favorable result) is deferred, if it exceeds 150,000 euros (the deferred deduction may be taken in a subsequent year to the extent allowed after applying the above limitations in that subse-

quent year). However, the application of these rules can be avoided if the company can establish that its debt-to-equity ratio is lower than the overall debt-to-equity ratio of the group of which it is a member.

- General limitation on interest relief (this applies to all debt, i.e., it is not restricted to related-party debt): in addition to the above rules limiting deductions for interest paid to related parties, a 75% general limitation applies to the deduction of net financial expenses, i.e., the net difference between all financial income and all financial expenses, when this difference exceeds 3 million euros. Once this threshold is reached, the 75% limit applies to the whole amount of the net expense, from the first euro (and not only to the amount of net expense in excess of 3 million euros). In the case of a tax consolidated group, this threshold is not increased in proportion to the number of companies in the group. The limitation applies to all interest and financial expenses, even those incurred in transactions with unrelated parties.

C. Limits on Interest Deductions Based on Other Factors

The following limitations on interest deductions may also apply:

- Limitation on the maximum interest rate (related party loans): this limitation, which applies only to loans granted by related parties when the borrowing entity is subject to CIT, is computed by reference to floating-rate loans with terms of over two years granted by French banks (2.15% in 2015, 2.03% in 2016). It is however possible to avoid the limitation by establishing that the rate that could have been obtained in a similar situation from an independent credit institution would have been higher.
- Rules preventing artificial debt push-downs and earnings stripping:
  - Under Article 223 B of the CGI (the "Charasse" amendment), a specific limitation applies to interest on debt related, or deemed related, to the acquisition from a related party of shares in a company that becomes part of the tax consolidated group.
  - Under Article 209 IX of the CGI, a similar limitation (the "Carrez" amendment) applies to interest on debt (including third party debt) related to the acquisition of shares in a French or foreign company, when the acquiring entity cannot demonstrate a sufficient level of involvement in the target company's management.
- Interest paid to beneficiaries located in non-cooperative countries and tax havens: under Article 238 A of the CGI, interest paid to beneficiaries in such countries is deemed non-deductible, unless the borrower can demonstrate that the expense corresponds to a genuine loan (interest paid to beneficiaries located in listed "non-cooperative" countries[19] may be subject to a high rate of withholding tax — up to 75%).

D. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Recharacterization of debt as equity (and *vice versa*) is not made in accordance with the provisions of a particular law but with the broad concept of *fraus legis*, which relies entirely on a case-by-case analysis. No bifurcation in characterization would seem to be possible, assuming the instrument concerned is a single instrument. Other rules limiting interest deductions may give rise to bifurcated treatment, especially those that apply only with respect to loans from shareholders or related parties.

E. Effect of an Income Tax Treaty Between France and FC

France's tax treaties generally do not include provisions that would directly allow the recharacterization of debt as equity (or *vice versa*).

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Compared to those of most countries, France's rules on the treatment of partnerships are quite specific.[20] In principle, unlike in most countries, which apply a pure look-through approach for tax purposes, in France a partnership is regarded as an entity/person distinct from its partners and tax liability is computed at the level of the partnership. Despite the fact that a partnership is recognized as a separate entity for tax (and legal) purposes, in principle, the persons liable for the tax on (their shares of) the partnership income are the partners, even though the income will not necessarily have been distributed to them.

Whether it would make any difference to the position set out in II., above if FCo were an entity that is treated as transparent for FC tax purposes would depend on the status of the foreign partnership further to the analysis described immediately above. In essence, the position would probably not be much affected.

IV. Withholding Tax Issues

As noted in I.A., above, the characterization of an instrument has a direct impact on the treatment of the income flows attached to it for withholding tax purposes, since payments of interest are, in principle, not subject to withholding tax (except where the payments are made to beneficiaries in non-cooperative States), while dividends may be subject to withholding tax. The rate of withholding tax on dividends will depend on whether there is a tax treaty between France and the country of residence of the beneficiary and, if there is an applicable treaty, what rate(s) is/are provided for in that treaty.

V. Difference if FCo Has a Permanent Establishment in France

Both French constitutional rules (the principle of equality enshrined in Article 13 of the 1789 Declaration of Human and Citizens Rights) and EU rules (the principles of freedom) proscribe the discriminatory treatment of investments made by foreign investors, not only in an EU context but also in a non-EU context (although this aspect will not be elaborated on in this paper). The non-discrimination rules contained in most of France's tax treaties also have the same implications.

For this reason, most rules enacted in French law are now (in principle) designed in such a way as to ensure that a foreign investor is not treated less advantageously than a French investor. The new anti-hybrid rules therefore apply in a purely domestic context (i.e., where a French borrower and the French branch of a foreign financing entity are involved) as well as in a cross-border context. That being said, this is largely an academic matter because situations in which there is a mismatch in the French tax treatment of two French taxpayers (including where one is a branch) are unlikely to occur.

VI. Legislative Changes

To say that the French Administration has been very active in promoting the OECD and EU initiatives referred to above is perhaps to put it mildly — most of the relevant measures had been incorporated into positive law even before the final OECD BEPS reports were published or the EU Directives issued.

Further to Directive n° 2014/86/EU of July 8, 2014, a "linking rule" was introduced by the amending Bill for 2014. As of January 1, 2015, dividends that can be deducted from the taxable income of the distributing company are excluded from the benefit of the participation exemption.[21]

In addition, further to Directive n° 2015/121/EU of January 25, 2015, the Amending Bill for 2015 introduced new restrictions on the exemptions deriving from the EU Parent-Subsidiary Directive (i.e., exemption from CIT for dividends paid by EU subsidiaries in the hands of their French parent companies and exemption from French withholding tax for dividends paid by French parent companies to their EU subsidiaries).[22] The restrictions apply to schemes designed to obtain artificially the benefit of these exemptions. These restrictions will not be discussed any further here because they do not directly concern the situation discussed in this paper.

Turning to the subject matter of this paper, no specific rules have yet been implemented regarding the treatment of hybrid entities, even though the Draft Bill for 2014 required the Administration to prepare a report on such hybrid structures. Article 9 of the Anti-Tax Avoidance Directive (ATAD),[23] however, does provide further rules on hybrids. Article 9 provides as follows:

1. To the extent that a hybrid mismatch results in a double deduction, the deduction shall be given only in the Member State where such payment has its source.
2. To the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment.

These rules must be implemented by the EU Member States by December 31, 2018, at the latest.

This proliferation of measures seems certain to give rise to a host of questions as to how the measures will apply in practice — not only from a purely French point of view (what is the scope of the measures? what is the order of priority among the various rules?), but also from the point of view of the interaction between the rules of the various countries concerned (potential differences in scope, timing and the order of priority among the various rules in each country) since, under the ATAD, implementation of the measures is mandatory (high-tax countries will be concerned that the failure of some countries to implement these rules in a sufficiently rigorous manner may create new "unfair" competitive advantages).

The profusion of rules will also doubtless generate a deal of uncertainty and multiply the number of instances of double taxation that it will require arbitration to resolve. One of the objectives of the BEPS initiative was to create economic efficiency by eliminating the artificial tax advantages enjoyed by some multinationals. Unfortunately, it seems that the initiative is going to give rise to considerable complexity and economic inefficiency affecting a large number of stakeholders.

The French tax authorities have for many years had adequate tools to challenge transactions that could be regarded as purely tax-driven (in France, the abuse of law procedure has been part of statutory law since 1925 with respect to registration duties and since 1941 with respect to direct taxes) and all the talk surrounding BEPS has put taxpayers on such notice that few would deliberately (or lightly) engage in these kinds of transaction, with the attendant risk of facing double taxation rather than achieving double deduction.

The effect of the BEPS rules is to enlarge significantly the scope of transactions that are potentially within the ambit of anti-avoidance provisions. This is the result of a shift away from the subjective approach of general anti-avoidance rules (such as the French abuse of law rules), in which the intentions of the taxpayer are scrutinized, to specific measures that apply mechanically and catch not only tax-avoidance but also mere tax optimization arrangements, in which no fraud can be detected, and even situations in which there are mismatches of a purely mechanical nature. In this respect, these rules represent not only a means of combatting tax evasion and optimization, but a way for high-tax countries to reduce the attraction of lower-tax countries. The absence of safe harbor rules in most of these new measures will no doubt increase the number of instances of double taxation. In this new environment, tax optimization is not so much a matter of identifying opportunities to achieve double deductions as a matter of steering clear of the risk of double taxation, just as it is in the transfer pricing arena.

NOTES

[1] French Tax Code (*Code Général des Impôts* or CGI), Art. 38 *quater* of Appendix III.

[2] *See* Thierry Pons, *The Economic Substance Doctrine*, France response, Tax Mgmt. Int'l. Forum (June 2010).

[3] Tax instruction 4 H-8-07, December 31, 2007.

[4] Tax instruction 4 FE/S2/10, July 23, BOI-DJC-FIN-20.

[5] *See* Thierry Pons, *Tax Implications Of Contingent Convertible Securities*, France response, Tax Mgmt. Int'l. Forum (June 2012).

[6] For further explanation, *see* Thierry Pons, *The Economic Substance Doctrine*, France response, Tax Mgmt. Int'l. Forum (June 2010).

[7] Committee of December 7, 2010 *Affaire n° 2010-12 concernant la société X France Holding*.

[8] Committee of December 7, 2010 *Affaire n° 2010-13 concernant la SAS Z France Holdings*.

[9] Committee of December 5, 2014 *Affaire n° 2014-30 "SA X."*

[10] CE 13-1-2017 no 391196.

[11] CAA Versailles n° 10VE03601 January 24, 2012.

[12] *Mémento comptable* 2012 n° 2130-4.

[13] *See in this context*: Tax instruction 4 C-3-95 n° 3, April 25, 1995, and administrative doctrine 4 C-2342 n° 3, October 30, 1997, BOI-BIC-CHG-50-30-20-10 n° 60, September 12, 2012. For relevant case law, *see* CAA Versailles July 5, 2016 no 14VE02647, *SA Carrefour*.

[14] CE November 9, 2015 no 370974, *Sté Sodirep Textiles SA-NV*.

[15] CE 24-11-2014 no 363556 *Sté Artemis*.

[16] CE 27-6-2016 no 386842 *Sté Emerald Shores LLC*.

[17] CE 31-3-2017 no 383129 *SAS Senoble Holding*.

[18] CGI, Art. 209 B. *See* Thierry Pons, *CFC rules*, France response, Tax Mgmt. Int'l. Forum (March 2011).

[19] "Non-cooperative" countries are specified in a list published every year by the tax administration. A non-cooperative country is a non-EU Member State that :

- Has been subject to OECD review;
- Has not concluded a tax treaty with France allowing for the full exchange of information for purposes of applying the Contracting States' tax legislation; and
- Has not concluded such treaties with at least 12 other countries.

The last list published by the Administration includes Botswana, Brunei, Guatemala, the Marshall Islands, Nauru, Niue and Panama.

[20] *See* Thierry Pons, *Taxation of Inbound Investment by a Foreign Partnership*, France response, Tax Mgmt. Int'l. Forum (March 2016).

[21] CGI, Art. 145, 6, b.

[22] CGI, Arts. 145, 6, k and 119 *ter*, 3.

[23] EU Directive 2016/1164 of July 12, 2016, laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

GERMANY

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I. Possibility of German Tax Authorities Recharacterizing Advance of Funds by FCo to GermanCo

The liability of a nonresident corporation to German tax depends on whether the income it derives qualifies as "domestic income" within the meaning of § 49(1) EStG.[1] Income derived by a corporation generally qualifies as business income, which is domestic income only if it is derived by a foreign corporation through a German permanent establishment (PE).[2] Since it is envisaged that FCo has no German PE, it would seem that the payments made to it by GermanCo would not qualify as domestic income. In such circumstances, the foreign elements of the case are ignored.[3] If only the domestic facts are taken into account, the payments made by GermanCo to FCo clearly qualify as income from capital, which may be either debt or equity. Income from these sources (i.e., interest or dividends) is dealt with in § 49(1) No.5 EStG.

The distinction between income from debt and income from equity is extremely important. Remuneration with respect to debt owed to a nonresident creditor is treated quite differently from remuneration with respect to equity. Unless the debt on which it is paid is secured by German real estate, loan interest paid to a nonresident is not taxable in Germany because it does not qualify as domestic income.[4] However, dividends paid by a German company to a nonresident taxpayer are taxable, because they qualify as domestic income.[5] Moreover, while interest is a deductible expense, dividends may not be deducted,[6] with the result that foreign shareholders tend to finance their German corporations by way of loans, thus syphoning off domestic business profits and avoiding German corporation tax and trade tax, The distinction between debt and equity and between interest and dividends has thus been a persistent problem for the German tax administration, and finding a way to combat the debt financing of German corporations by their foreign shareholders has been a constant challenge for the German legislator over the past 30 or 40 years. This unfortunate story is too long to rehearse here — suffice it to say that ultimately the legislator drafted an interest barrier rule, which has been in force since 2008 and has been subject to a number of modifications since it was introduced.

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Since there is no provision in German law governing the form of loan agreements, the agreement between FCo and GermanCo would be recognized as a loan, even if there were no written document. Of course, the parties would have to agree on the elements of a loan, i.e., the lender must transfer funds to the borrower, who must agree to pay interest as remuneration for the funds received and eventually to pay back the funds received. If FCo and GermanCo are unrelated parties, the loan will normally be secured. If no security were provided, it would be necessary to establish whether, in reality, some sort of participation by FCo in GermanCo were intended (for example, by way of an atypical silent partnership arrangement). In any event, FCo and GermanCo would have to disclose the kind of agreement they intended to enter into. How that relationship would be treated for tax purposes would depend on how it was classified, not on any kind of recharacterization. Even under the German thin capitalization rules in force before 2008,[7] a loan agreement between a shareholder and a corporation was not recharacterized, although interest was recharacterized when the permissible debt-equity ratio was exceeded, the interest being treated as a hidden profit distribution. As of 2008, the thin capitalization rules were replaced by the interest barrier rule in § 4h EStG.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

It would seem almost impossible to conceive of the agreement between FCo and GermanCo not being a loan agreement, unless FCo were or were to become a shareholder of GermanCo. If FCo were a shareholder of German, the funds transferred by FCo to GermanCo might represent equity, and the remuneration for the equity would then constitute dividends. The assumption that FCo created equity by transferring funds to GermanCo is not based on a recharacterization of the funds, but on the classification of the transfer as a capital contribution by which equity is created. If the transfer were so classified, GermanCo's payments to FCo would be dividends rather than interest. As noted above, dividends are not a deductible business expense.[8]

If FCo were GermanCo's parent and were to grant GermanCo a loan, the debt claim might be converted into equity by virtue of its being waived. In these cir-

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cumstances, the remuneration paid by GermanCo to FCo would no longer qualify as interest but would be classified as a hidden profit distribution.

C. Difference if a Loan Agreement of Some Sort Exists

As noted above, the form of the loan agreement is of no significance. Loan agreements may exist in various forms — for example, in the form of convertible debentures, profit debentures or bonds and benefit bonds or rights — and typical silent partnerships are also treated like loan arrangements.[9] Payments made by the holders of such rights and instruments qualify as interest payments.[10] Atypical silent partnerships qualify as equity as, in exceptional circumstances do benefit bonds and benefit rights, if they entitle the holder to a right to share in liquidation profits.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

The deductibility of interest for German tax purposes is limited by the interest barrier rule ("*Zinsschranke*" — sometimes referred to as the "earnings stripping rule") in § 4h EStG. The application of the interest barrier rule does not depend on the treatment of the loan by the lender. Under the interest barrier rule the extent to which interest is deductible is determined in four steps:

- Interest expense is fully deductible to the extent it corresponds to interest income of the debtor;
- Interest expense in excess of interest income (i.e., "net interest") may be deducted to the extent of 30% of earnings before interest, tax, depreciation and amortization (EBITDA);
- Surplus (i.e., unutilized) EBITDA may be carried forward; and
- Nondeductible interest may be carried forward.

The interest barrier rule does not apply if:[11]

(1) The net interest is less than 3 million euros;

(2) The borrower does not belong to a group of enterprises; or

(3) The borrower does belong to a group, but the equity ratio of the borrower is not less than 2% lower than the equity ratio of the group (the "equity escape").

Exception (2) does not apply if the borrower is a corporation (as is envisaged in the present case) and more than 10% of the net interest is paid to a person that holds more than 25% of the borrower's share capital ("tainted debt financing by a shareholder").[12]

Exception (3) (i.e., the equity-escape) does not apply if the borrower belongs to a group and there is tainted financing by a shareholder.[13]

The application of the general interest barrier rule may be illustrated by a simple example:

Example: GermanCo derives relevant income of 500,000 euros. FCo lends GermanCo 40 million euros at an acceptable interest rate of 10%. GermanCo's interest income is 1 million euros. Depreciation is 500,000 euros.

	Euros		Euros
(1) Interest payable	4,000,000		
Less interest income	1,000,000		
Net interest payable	3,000,000	Deductible interest	1,000,000
(2) Relevant income	500,000		
Plus depreciation	500,000		
Plus net interest	3,000,000		
EBITDA	4,000,000	Deductible 30%	1,200,000
Total deductible interest			2,200,000
Nondeductible interest			1,800,000
(3) EBITDA carryforward	0		
(4) Interest carryforward	1,800,000		
GermanCo's taxable income:			
Relevant income:	500,000		
Plus nondeductible interest	1,800,000		
GermanCo's taxable income:	2,300,000		

For trade tax purposes one fourth of the remuneration for debt (i.e., essentially the deductible interest) is added to the tax base.[14] The trade tax is a municipal tax. The trade tax base is established by the state tax administration, but trade tax assessments are made by the relevant municipality.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The application of the interest barrier rule does not depend on the debt-equity ratio of the borrower. A close relation between the lender (FCo) and the borrower (GermanCo) would be significant if the interest paid by GermanCo to FCo were higher than an arm's-length-interest charge. If GermanCo were a subsidiary of FCo, the interest would be recharacterized as a hidden profit distribution insofar as it exceeds the arm's-length-interest. If FCo were a subsidiary of GermanCo, GermanCo's income would also adjusted, but the legal basis for that adjustment would be § 1(1) AStG.[15]

B. Limits on Interest Deductions Based on Other Factors

Interest deductions are limited by the interest barrier rule and by the arm's-length test as explained above.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

As noted above, under the arm's-length test, the portion of interest expense that exceeds the amount of interest that would have been agreed upon between unrelated parties is non-deductible and, in the case at hand, if GermanCo were a subsidiary of FCo, would qualify as a hidden profit distribution. The portion of the interest expense not in excess of an arm's length amount is, of course, deductible to the extent deduction is not prevented by the interest barrier rule.

D. Effect of an Income Tax Treaty Between Germany and FC

The Interest Article in Germany's tax treaties[16] roughly corresponds to the statutory provision § 49(1) No.5c) EStG, under which interest paid to a nonresident lender is not domestic income and is, therefore, not taxable. The Interest Article gives sole taxing rights to the country of residence of the lender. Some of Germany's treaties even extend source country non-taxability to interest that is domestic and taxable under § 49(1) No.5 c) EStG because the debt with respect to which it is paid is secured by German real estate (see I., above).[17]

The Associated Enterprises Article in Germany's tax treaties[18] confirms the right of the Contracting States to adjust income to the extent that the underlying transaction does not meet the arm's-length test.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The classification of FCo as a partnership by FC is of no significance for German tax purposes. Germany applies its own classification standards with the result that Germany may classify FCo as a corporation even if FC treats it as a partnership. However, if Germany classifies FCo as a partnership under its own standards, the legal consequences do not differ from those that follow where FCo is classified as a corporation.

IV. Withholding Tax Issues

Interest paid to a nonresident is generally not taxable and, therefore, not subject to withholding tax. Where the debt with respect to which the interest is paid is secured by German real estate, the interest is taxable in the hands of the nonresident by way of assessment and is not subject to withholding tax. Dividends are, however, subject to withholding tax at the rate of 25%,[19] reduced to 15% if the recipient of the dividends is a corporation.[20] This withholding tax is also imposed on interest treated as a hidden profit distribution to the extent the interest payment does not meet the arm's-length-test. The rate of withholding tax may also be reduced under an applicable tax treaty or under § 43b EStG, which implements the EU Parent-Subsidiary Directive into German domestic law and also applies to hidden profit distributions. Even where such a reduction applies, the tax must be withheld at the full domestic rate:[21] the excess tax withheld will be subsequently reimbursed on the taxpayer making the appropriate request.

V. Difference if FCo Has a Permanent Establishment in Germany

If FCo has a permanent establishment (PE) in Germany, the question arises as to whether a debt claim with respect to which interest is paid to FCo belongs to that PE. For the debt claim to be attributed to the PE, there must be some plausible reason why it should be so attributed for example, this might be the case where the PE is generally used to perform financing functions. If the relevant debt claim is an asset of the PE, the interest is also attributed to the PE as income of the PE. In these circumstances, the interest qualifies as domestic income of FCo and is, therefore, taxable in FCo's hands as business income under § 49 (1) No.2a) EStG. Germany's right to tax the interest in these circumstances is preserved by Germany's tax treaties.[22]

VI. Legislative Changes

The EU Anti-tax Avoidance Directive[23] provides that the state of residence of the payor of interest is to deny a deduction for the interest when the interest is payable under a hybrid mismatch arrangement.[24] It would seem, however, that since the interest barrier rule in German domestic law essentially corresponds to that provision, no legislative changes will be required in that respect.

NOTES

[1] *Einkommensteuergesetz* — Income Tax Act.

[2] § 49(1) No.2a) EStG.

[3] § 49(2) EStG.

[4] See § 49(1) No 5c EStG.

[5] See § 49(1) No.5a EStG.

[6] § 8(3) KStG (*Körperschaftsteuergesetz* — Corporation Tax Act).

[7] See former § 8a KStG.

[8] § 8(3) KStG.

[9] For more details, see Jörg-Dietrich Kramer, *Tax Management International Forum*, June 1996, Equity Flavoured Debt Instruments, Germany response.

   ISSN 0143-7941

[10] BMF (*Bundesministerium der Finanzen* — Federal Ministry of Finance), letter of July 4, 2008, BStBl.I 2008, 718, note 11.
[11] § 4h(2) EStG.
[12] § 8a(2) KStG.
[13] § 8a (3) KStG.
[14] § 8 Nr.1 GewStG (*Gewerbesteuergesetz* — Trade Tax Act).
[15] *Auszensteuergesetz* — Foreign Relations Tax Act.
[16] Cf. OECD Model Convention, Art.11.
[17] *See, e.g.,* Germany-France tax treaty, Art.10(1).
[18] *Cf.* OECD Model Convention, Art. 9.
[19] §§ 43, 43a EStG.
[20] § 44a(9) EStG.
[21] § 50d(1) EStG.
[22] *See, e.g.*, Germany-United States tax treaty, Art.11 (3).
[23] RL(EU) 2016/1164 (ABl of July 12, 2016 L 193,1.
[24] EU Anti-tax Avoidance Directive, Art. 9.

INDIA

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I. Possibility of Indian Tax Authorities Recharacterizing Advance of Funds by FCo to IndiaCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

There are various ways in which funds can be deployed to an Indian company by a foreign company. Such funds can be obtained via the issue of either equity capital or debt, some of the available forms being equity shares, preference shares, Compulsory Convertible Preference Shares (CCPSs), Optionally Convertible Preference Shares (OCPSs), Compulsory Convertible Debentures (CCDs), Optionally Convertible Debentures (OCDs), bonds and External Commercial Borrowings (ECBs). It should be noted that certain regulatory requirements need to be met when borrowing from foreign entities and, since debt and equity instruments are subject to different tax treatment, the tax consequences following from the choice of instrument will also need to be considered.

The Indian Income-tax Act, 1961 (the "Act") introduced a General Anti-Avoidance Rule (GAAR) in sections 95 to 102 with effect from April 1, 2017. Under section 95, an arrangement entered into by a taxpayer may be declared an "impermissible avoidance arrangement" by the tax authorities and its tax consequences will be determined accordingly. The phrase "impermissible avoidance arrangement" is defined in section 96(1) of the Act. An impermissible avoidance arrangement means an arrangement that fulfills the following two conditions:

- The main purpose of the arrangement is to obtain a tax benefit; and
- The arrangement has "tainted" elements.[1]

Under section 98(1), the consequences of an arrangement being declared an impermissible avoidance arrangement may include denial of a tax benefit arising under Indian domestic law or under one of India's tax treaties. The consequences are to be determined in such manner as is deemed appropriate, depending on the circumstances of the particular case. One of the consequences expressly provided for is that equity may be treated as debt or debt as equity.

There are only a few judicial precedents addressing the recharacterization of loans in the pre-GAAR era.

In *ZaheerMauritius v. DIT*,[2] an Indian company (I Co.) had a 100%-owned Indian subsidiary company (JV Co). I Co. was in the business of developing and dealing in real estate and was the owner of a contiguous tract of land. I Co. and JV Co. executed a development rights agreement under which I Co. transferred an interest in the land to JV Co. with a view to the development of the land. The taxpayer, a Mauritius company, entered into a Securities Subscription Agreement (SSA) and a Shareholder's Agreement (SHA) with I Co. and JV Co., under which the taxpayer subscribed for equity shares and CCDs in JV Co. The SHA provided for a call option to be granted to I Co. by the taxpayer to acquire the securities held by the taxpayer. I Co. exercised the call option and purchased the equity shares and CCDs. The taxpayer filed an application before the Authority for Advance Rulings (AAR), which held that the transaction was a sham transaction and treated it purely as loan.

The AAR further held that the corporate veil should be lifted and that JV Co. and I Co. were essentially one and the same entity. Thus, the capital gains arising to the taxpayer from the disposal of the CCDs that, as such, would have been exempt from Indian tax under the India-Mauritius treaty, were treated as interest income, which was taxable in India under the treaty. On the filing of a writ petition, the Delhi High Court reversed the sham transaction finding, holding that the terms of the arrangement revealed that JV Co. was a genuine commercial venture in which both partners had management rights. There was, therefore, no reason to ignore the legal nature of the CCD instruments or to lift the corporate veil and treat JV Co. and I Co. as a single entity.

In *Mahindra Telecommunications Investment Pvt. Ltd. v. ITO*,[3] the Mumbai Bench of the Tribunal addressed the taxability of contractually agreed fixed returns on an equity investment. The Tribunal held that the fixed consideration payable on exit was determined on a time proportion basis, which generally is akin to interest accruing on a fixed deposit. Thus, in substance, the arrangement at issue was a financial arrangement that yielded returns over time. Considering the substance of the arrangement, the Tribunal held that the income stream was in the nature of interest and recharacterized it accordingly.

In the case of a related-party transaction, it has been observed by the courts[4] that even if the transaction is priced at arm's length, it can be recharacterized if its economic substance differs from its form. Thus, while there are no statutory provisions authorizing a transfer pricing officer to make such a recharacterization, under judicial law, such a recharacterization

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may be made by the tax authorities when the substance of a transaction is found to be at variance with its stated form.

To summarize, apart from the tainted elements test in the GAAR, the judicial precedents indicate that substance-over-form is one of the principles that enable the tax authorities' to recharacterize a transaction. Thus, in the case at hand, since FCo's treatment of the transaction as a loan for FC accounting and income tax purposes is a matter of legal form, the Indian tax authorities might have grounds for recharacterizing the transaction if its substance differed from that legal form.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Under Indian tax law, the treatment of a transaction as a loan by the issuer of funds (here FCo) generally does not impact the taxation of the funds in the hands of the recipient. Although its treatment as a loan indicates the legal form of the transaction, as discussed above, the Indian tax authorities may look to the substance of the transaction and recharacterize the loan as an equity contribution. The rules for such recharacterization are the same whether or not IndiaCo and FCo are related parties.

C. Difference If a Loan Agreement of Some Sort Exists

Generally, the existence of a formal loan agreement between the parties will help to confirm the substance of the transaction as a loan. Nonetheless, even where a formal loan agreement exits, if the Indian tax authorities are able to establish that the substantial purpose of the transaction is to avoid or evade tax, the loan may be recharacterized. In the absence of a formal agreement, the tax authorities will generally look at various other factors in determining the substance of a transaction. In these circumstances, the taxpayer will need to be able to demonstrate the nature of the transaction and its consequences for the parties.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

The general rules regarding the deduction of interest in computing income under the head "Profits and Gains from Business or Profession," whether the interest is paid to a resident or a nonresident, are contained in section 36(1)(iii) of the Act. Section 36(1)(iii) provides that the following three conditions must be fulfilled for an interest deduction to be allowed:

- There must be a borrowing;
- Money must have been borrowed for business purposes; and
- Interest must be paid or payable with respect to the transaction.

By way of exception, section 36(1)(iii) of the Act further provides that interest paid on borrowing used for the acquisition of a capital asset during the period before the asset is first put to use is capitalized and included in the cost of the asset.

Section 36(1)(iii) of the Act provides a 100% deduction for interest that meets the requirements set out above, subject to section 94B of the Act, which applies in the case of borrowing from a nonresident associated enterprise. The provisions of section 94B are discussed below.

Section 94B of the Act, which took effect from April 1, 2017, limits the deduction of interest payments made by an Indian corporate borrower or an Indian permanent establishment (PE) of a non-resident company where the debt on which the interest is payable is issued by a nonresident lender that is an associated enterprise of the Indian borrower. Specifically, if an Indian Company or a PE of a foreign company pays interest to a nonresident lender that is an associated enterprise of the borrower with respect to any form of debt, the interest will be deductible only to the extent of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA).

There are also general rules that disallow an interest deduction where the payer of the interest does not fulfil its withholding obligations. Under section 195(1) of the Act, any person responsible for paying interest to a nonresident must deduct income tax on the interest at the rates then in force. Where an interest payment is made to a nonresident without the tax being withheld, the amount of the interest will be disallowed as a deduction under section 40(a)(i) of the Act. However, the interest would be allowed in the year in which the tax that has been deducted by the payer of the interest is deposited.

The provisions described above apply even if it is known that the lender (FCo) does not have to include the interest income in its taxable income. If the lender and borrower are related parties, the transaction must be priced at arm's length, in accordance with section 92 of the Act, and the deduction of any interest in excess of an arm's length amount is disallowed.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

There are no specific limits on interest deductions based on the ratio of the borrower's debt to its equity. In a recent case,[5] the taxpayer company was granted a loan by its shareholders (which were also companies). As a result of the loan, the taxpayer's debt-to-equity ratio was 248:1. The tax authorities rejected a claim to deduct the interest on the loan on the grounds that the company was so thinly capitalized that its debt was effectively equity. On appeal, the Bombay High Court held that since there are no thin capitalization rules in force in India, the interest payment on the loan could not be disallowed. However, now that section 94B of the Act has become law, in such circumstances there could be a statutory disallowance of the interest paid. On the other hand, the revenue authorities could invoke the GAAR in order to recharacterize the loan.

B. Limits on Interest Deductions Based on Other Factors

As noted above, section 94B of the Act provides that the deduction for interest paid to nonresident associated enterprises is capped at 30% of EBITDA. Taxpayers that have insufficient profits or are in a loss position will not be able to claim a deduction for interest payments made to their nonresident associated enterprises.

Also as noted above, another factor that could limit interest deductions is the requirement that pricing between related parties must be at arm's length, in compliance with India's transfer pricing provisions. Thus where interest charged by a related party exceeds an arm's length price, the excess amount is disallowed as a deduction

Further, section 14A of the Act provides that no deduction is to be allowed with respect to expenditure incurred by a taxpayer to earn income that is exempt. Thus, where an interest expense is incurred to earn income that is exempt under the Act, the expense would be disallowed as a deduction.

C. Possibility of a Transaction Being Bifurcated into a Portion that Permits Deductible Interest and a Portion That Does Not

The authors are not aware of any express provision in the Act or any judicial precedent that could provide for the bifurcation of a transaction into some portion that permits deductible interest and some portion that does not. Under the general rules in section 36(1)(iii) of the Act, if part of the funds obtained via a debt are shown not to be used for business purposes, then a deduction for the interest expense corresponding to that portion of the debt can be disallowed by the Indian tax authorities.

Similarly, as noted above, if part of the funds obtained via a debt is used to acquire a capital asset, interest proportionate to that part before the asset is first put to use must be capitalized and included in the cost of the asset.

D. Effect of An Income Tax Treaty Between India and FC

India's tax treaties generally do not include provisions that expressly limit the deductibility of interest. Nor do the treaties contain provisions relating to the recharacterization or bifurcation of income. However, many of India's treaties do include a provision that denies treaty benefits with respect to that portion of an interest payment made between related parties that exceeds the amount of interest payable at an arm's-length rate.

With effect from April 1, 2017, section 92CE of the Act provides that where a primary adjustment is made on the basis that the rate at which interest is payable is in excess of an arm's-length rate, a secondary adjustment is to be made to the accounts of the taxpayer and the associated enterprise concerned to ensure that the actual allocation of profits between the parties is consistent with the transfer price determined under the primary adjustment. If excess funds made available to the associated enterprise are not repatriated to India within the time prescribed, they will be deemed to be an advance made by the taxpayer to the associated enterprise, and interest will be computed on the deemed advance and included in the income of the taxpayer.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Currently, the recharacterization principle and the rules for deductibility would not differ if FCo were treated as transparent for FC tax purposes. The Indian tax authorities would still be able to examine the legal form and substance of a transaction in deciding whether to allow an interest deduction. Also, since section 94B of the Act applies to all nonresident lenders that are associated enterprises of the taxpayer, IndiaCo's interest deduction would still be limited to 30% of EBITDA as discussed in II., above.

IV. Withholding Tax Issues

There is no express provision dealing with the withholding consequences of the recharacterization of a loan as an equity contribution by the Indian tax authorities. In the event such a recharacterization is made, logically the rules relating to the payment of dividend distribution tax (DDT) on dividends distributed would apply. However, practical challenges could arise in attempting to levy the DDT, as the payments under the recharacterized instrument would already have been remitted in the form of interest by the time the DDT fell due.

Where a loan is not recharacterized as an equity contribution, under section 195(1) of the Act, any person responsible for paying interest to a nonresident must deduct income tax thereon at the rates in force, at the time the interest is credited to the account of the payee or is paid in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier. Where an interest payment is made to a nonresident without the deduction of tax at source, the amount of the payment is disallowed as a deduction under section 40(a)(i) of the Act. However, the interest would be allowed to be deducted in the year in which the tax that has been deducted by the payer of the interest is deposited.

V. Difference if FCo Has a Permanent Establishment in India

Generally, India's tax treaties provide that if a beneficial owner of interest that is a resident of the other Contracting State carries on business in India through a PE in India and the debt-claim with respect to which the interest is payable is effectively connected with the PE, the provisions of Article 7 apply. Article 7 generally provides that the business income of a foreign enterprise is taxable in a Contracting State only if it is attributable to a PE of the enterprise in that State.

VI. Legislative Changes

As noted in II., above, section 94B of the Act was introduced into Indian tax law in the 2017 Finance Act. Similarly, the GAAR provisions, which were introduced in the 2012 Finance Act, entered into effect on April 1, 2017.

NOTES

[1] 96. (1) An impermissible avoidance arrangement means an arrangement [that] . . .

(a) creates rights, or obligations, which are not ordinarily created between persons dealing at arm's length;

(b) results, directly or indirectly, in the misuse, or abuse, of the provisions of the Act;

(c) lacks commercial substance or is deemed to lack commercial substance under section 97 of the Act, in whole or in part; or

(d) is entered into, or carried out, by means, or in a manner, which are not ordinarily employed for *bona fide* purposes.

[2] [2014] 47 taxmann.com (Delhi).

[3] [2016] TS-296-ITAT-2016 (Mum.).

[4] *Bharti Airtel Ltd. v. Addl. CIT*=[2014] 43 taxmann.com 150 (Delhi Trib.); *ITO v. Sterling Oil Resources (P.) Ltd.* [2016] 67 taxmann.com 2 (Mum Trib.).

[5] *Topsgrup Electronic Systems Ltd. v. ITO* [2016] 67 taxmann.com 310 (Mum. Trib.).

IRELAND

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I. Possibility of Irish Tax Authorities Recharacterizing Advance of Funds by FCo to IrishCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

The classification of the legal arrangement between the parties regarding the advance of funds to IrishCo by FCo is of relevance to the Irish tax treatment of IrishCo. A corporation tax deduction may be available to IrishCo with respect to an interest expense but not with respect to a dividend or other distribution. In addition, different withholding tax regimes apply to interest payments and distributions.

Irish tax legislation does not define debt or equity. Therefore, the Irish corporate law analysis of the arrangement should generally be respected for Irish tax purposes. Assuming the Irish general anti-avoidance provision[1] is not applicable and the arrangement is not a sham, the nature of the advance of funds to IrishCo should be determined by its legal form for Irish corporate law purposes. The classification should not be affected by the proper accounting treatment (either by IrishCo or FCo) of the arrangement or by the underlying economic characteristics of the arrangement, given that Irish courts consistently uphold the doctrine of form over substance. Subject to the comments below in relation to a section 110 qualifying company, if a company meets the requirements laid down by a provision of the Irish tax legislation that facilitates securitization and structured finance, the accounting treatment and income tax treatment of the arrangement in FC should not have any bearing on the arrangement's characterization in Ireland.

Determining the legal form of an arrangement involves an analysis of the legal rights and obligations of the parties created by the arrangement. The description given to the arrangement by the parties to the arrangement should generally be respected for Irish tax purposes, subject to the possibility of an Irish court, where it sees fit, looking beyond the label given by the parties to determine the true legal nature of the arrangement. A fundamental criterion for the existence of a loan is a promise by the borrower to repay the principal amount advanced by the lender at a future time or when lawfully demanded to do so by the lender, and the absence of documentation with respect to the arrangement could be expected to give rise to difficulties for IrishCo in substantiating its treatment of the arrangement, should that treatment be challenged by the Irish tax authorities. In the absence of a written agreement providing for the arrangement, there may be other documentation that may evidence the particular intention of the parties concerning the arrangement, for example, board minutes, and the accounting treatment of the arrangement may possibly also support IrishCo's contention as to the parties' intention concerning the arrangement.

An exception to the general rule that the Irish corporate law analysis is respected for tax purposes applies in relation to certain types of securities issued by IrishCo where the interest payable on the securities is recharacterized by the tax legislation as a distribution.[2] In these circumstances, the recharacterized interest (since it is deemed to be a distribution) is not tax deductible and dividend withholding tax is required to be addressed, although there is a wide range of exemptions from Irish dividend withholding tax.

One of the instances in which interest on a security might be recharacterized as a distribution for Irish tax purposes is where IrishCo is a 75% subsidiary of the lender (here FCo), or both IrishCo and the lender both are 75% subsidiaries of a third company.[3] The recharacterization does not apply where the lender (i.e., FCo) is: (1) tax resident in an EU Member State; or (2), where the borrower (i.e., IrishCo) is making the payment on the security in the ordinary course of its trade and makes the necessary election for the recharacterization not to apply, is tax resident either in an EU Member State or in a country with which Ireland has a tax treaty. In addition, the recharacterization does not apply — regardless of the tax residence of the lender — in the case of "yearly" interest (that is, generally, interest on a loan where the term of the loan is, or is capable of being, one year or longer) where the borrower is making the payment on the security in the ordinary course of its trade and makes the necessary election for the recharacterization not to apply.[4] Depending on the tax residence of the lender, the terms of an applicable Irish tax treaty, for example, the non-discrimination clause in the Ireland-United States tax treaty, may also override the Irish domestic recharacterization.

The Irish tax authorities have published their practice with respect to the tax treatment of interest paid by an Irish company to a 75% parent or group company that is tax resident in a country with which Ireland has a tax treaty.[5] Where the applicable treaty was signed before 1976, interest that is recharacterized as a distribution because of the relevant 75% relation-

ISSN 0143-7941

ship between the parties[6] will continue to be regarded as interest for tax deductibility purposes. Where the applicable treaty was signed after 1976 and the treaty includes a Nondiscrimination Article based on Article 24(4) of the OECD Model Convention, interest that is recharacterized as a distribution because of the relevant 75% relationship between the parties[7] will continue to be regarded as interest for tax deductibility purposes unless the applicable treaty expressly permits the application of the Irish domestic recharacterization provision.[8]

The relationship between IrishCo and FCo may also be of relevance in the context of the Irish transfer pricing rules. Interest that is deductible as a trading expense (see II.C., below) may come within the scope of the Irish transfer pricing provisions,[9] which apply the arm's-length principle to trading transactions between associated persons. The arm's length principle is construed in accordance with the OECD Transfer Pricing Guidelines.[10]

There is a restriction on the deduction of interest on a loan from a connected company obtained to acquire assets from a connected company typically within the charge to Irish corporation tax,[11] but that restriction takes the form of an express denial of deduction rather than a recharacterization of the interest.

A further example of circumstances in which interest on a security might be recharacterized as a distribution for Irish tax purposes is afforded by profit-dependent interest, i.e., interest that is dependent on the results of a company's business or part of a company's business, which is generally recharacterized as a non-deductible distribution.[12] It should be noted, however, that, in order to facilitate securitization and structured finance transactions involving the use of an Irish company, section 110 of the Taxes Consolidation Act 1997 generally disapplies such recharacterization in the case of profit-dependent interest payable by a section 110 qualifying company. Changes were made by the Finance Act 2011 to restrict the deductibility of profit-dependent interest payable by a section 110 qualifying company in certain instances in order to address the concern of the Irish authorities over the double non-taxation of such interest where a nonresident lender was not taxable with respect to such interest as a result of the different classification or particular tax treatment of such interest in the lender's country of residence. In the case of a payment of profit-dependent interest made to a nonresident by a section 110 qualifying company that is not paid on a quoted Eurobond (debt that meets certain conditions including listing on a recognized stock exchange) or a wholesale debt instrument (debt that meets certain conditions including that it should have a term of not more than two years), generally, in order for such interest to be deductible, the interest must, under the laws of an EU Member State or a country with which Ireland has a tax treaty, be subject to tax, without reduction computed by reference to the amount of such interest, that generally applies to profits, income or gains received by persons in that country from foreign sources. For example, in such circumstances, a deduction would not be available if the relevant nonresident lender was not taxed on the interest in its country of residence because of a participation exemption.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The Irish tax treatment in these circumstances should follow that discussed in I.A., above, and the nature of the advance of funds to IrishCo in this instance should be determined by reference to its legal form rather than by its proper accounting treatment (either by IrishCo or FCo) or by FCo's income tax treatment of the arrangement (other than where IrishCo is a section 110 qualifying company paying profit-dependent interest in which case FCo's tax treatment of the interest may be relevant). Depending on the reason for the particular accounting and income tax treatment by FCo of the arrangement, that treatment could potentially present further difficulties for IrishCo in substantiating its tax treatment, given the absence of documentation regarding the arrangement.

C. Difference if a Loan Agreement of Some Sort Exists

The classification of the arrangement for Irish tax purposes should be determined by the Irish corporate law analysis of the arrangement as provided for by the loan agreement between the parties, absent the arrangement being a sham or the Irish general anti-avoidance rule (GAAR) or legislative provisions that recharacterize the payment of certain interest being applied.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Generally, the deduction of interest paid by an Irish borrower is not affected by the lender being a nonresident. As noted above, there are exceptions to this in the case of interest paid by an Irish resident borrower to a nonresident lender where the borrower is a 75% subsidiary of the lender, or where the borrower and lender are both 75% subsidiaries of a third company, and in the case of profit-dependent interest payable by a section 110 qualifying company.

In the case of a company that carries on a trade in Ireland that includes the lending of money, where the interest payable on money it lends is taken into account in computing its trading income, the recharacterization of interest the company pays to a 75% group company may be disapplied if the interest is "short" interest (i.e., interest on a loan where the term of the loan is less than one year) and FC, FCo's country of residence, taxes foreign interest at a rate equal to or higher than the Irish corporation tax rate of 12.5%.[13] If FC taxes foreign interest at a rate lower than 12.5%, then relief in Ireland should only be given at that effective rate. If FC exempts foreign interest, then no deduction is available in Ireland.

A provision that defers deductions for trading interest payable to a connected company until such time as the recipient is taxable on the corresponding income[14] does not apply where the lender is a nonresident and is not controlled by Irish residents.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The deductibility of interest by an Irish resident borrower is not limited or affected by the ratio of debt to

equity of the borrower, and the OECD's proposed worldwide ratio test has not been implemented into Irish law or otherwise adopted in Ireland. The matter of the implementation into Irish domestic law of the EU Anti-Tax Avoidance Directive (ATAD), which requires the implementation of rules to restrict interest deductions, is discussed at VI., below.

B. Limits on Interest Deductions Based on Other Factors

Broadly, interest is allowed as a deduction for tax purposes where it is a trading expense, a rental expense or a charge on income. Where interest is incurred wholly and exclusively for purposes of IrishCo's trade, in order to be deductible, the expense must be a revenue expense and not a capital expense. Generally, interest on money borrowed to purchase, improve or repair rented property is allowed as a deduction against the related rental income in arriving at the taxable income,[15] but the deduction is restricted to 75% of the interest where the property concerned is residential property. Where interest is incurred by a company on funds borrowed to acquire shares in, or loan money to, certain other companies, it may be deductible as a charge on income.[16] The relevant provision allowing for deduction as a charge is relatively involved and requires various conditions to be fulfilled, including that the funds are used for particular qualifying purposes, that there is a common director of both the lender and borrower, and that there is no recovery of capital.

In addition to the restrictions on deductibility noted above, there are certain other statutory restrictions on the deduction of interest. Interest will not qualify as a deduction if a scheme has been put into place, the sole or main benefit of which is to obtain a reduction in a tax liability.[17] Interest on any loan that is convertible, directly or indirectly, into shares of a company, where the shares are not quoted on a recognized stock exchange, is treated as a nondeductible distribution.[18] Interest that represents more than a reasonable commercial rate of return for the use of money is treated as a nondeductible distribution.[19]

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Generally speaking, Irish tax law does not provide for the possibility of a transaction being bifurcated into a portion that permits deductible interest and a portion that does not. However, while interest that represents more than a commercial rate of rate of return for the use of money is recharacterized as a nondeductible distribution, the element of interest that represents a commercial rate of return is not.[20] The relevant provision addresses this bifurcation on an objective basis by reference to a commercial rate of return rather than by allowing the Irish tax authorities to determine the matter on a subjective basis.

D. Effect of an Income Tax Treaty Between Ireland and FC

While Ireland's tax treaties generally do not include provisions that directly limit the deductibility of interest, many of Ireland's treaties provide that where there is a special relationship between the payer and the recipient of interest, the application of the relevant Interest Article may be restricted. Generally, Ireland's tax treaties provide that any interest that is in excess of fair and reasonable consideration for the use of money is not entitled to benefit from the treaty concerned.

As noted in I.A., above, the terms of an applicable Irish tax treaty, for example the Nondiscrimination Article in the Ireland-United States tax treaty, may override the Irish domestic recharacterization of interest paid to a nonresident 75% parent or other group company.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

In general, the answers given above will be the same if FCo is an entity that is treated as transparent for FC tax purposes.

IV. Withholding Tax Issues

As noted in I.A., above, different withholding tax regimes apply to interest payments and distributions. IrishCo is required to withhold Collect? Pay? Or rephrase to say the payment is subject to withholding tax?

Irish withholding tax, currently at the rate of 20%, on a payment of Irish-source "yearly" interest, absent an exemption. Where the payment is recharacterized by Irish domestic law as a distribution, dividend withholding tax, rather than interest withholding tax, is required to be withheld Collected? Withheld?

on the payment, absent an exemption.

Such treatment is subject to the application of a relevant Irish tax treaty. The matter of withholding tax in the case of recharacterization as a result of the relevant 75% relationship between the parties is also addressed in the published practice of the Irish tax authorities, referred to in I.A., above. In the case of a pre-1976 treaty, interest that is recharacterized as a distribution will be treated as interest for purposes of the Interest Article in the relevant treaty unless it is treated under the treaty as a dividend. Thus Irish dividend withholding tax[21] (subject to an exemption) will normally be limited by the rate of source taxation applicable to interest under the relevant treaty. In the case of post-1976 tax treaties, dividend withholding tax treatment will depend on the definition of the term "dividends" in the applicable treaty. Where the definition of "dividends" would include interest treated as a distribution as a result of the Irish domestic law recharacterization, dividend withholding tax (subject to an exemption) will apply up to the limit prescribed in the Dividend Article in the applicable treaty. Where the treaty does not contain a broad definition of dividends that would include a recharacterized interest payment, the position outlined in relation to pre-1976 treaties will apply — that is, dividend withholding tax will be limited by reference to the provisions of the Interest Article.

If IrishCo elects, where applicable, that interest not be characterized as a distribution under Irish domestic law as a result of the relevant 75% relationship with FCo, a payment of interest will not be so recharacterized and will be treated as interest for Irish tax

purposes. Dividend withholding tax will not be applicable since the payment will not be regarded as a distribution, but the payment, where it is "yearly" interest, will be subject to interest withholding tax, absent an exemption.

Regarding the deductibility of profit-dependent interest paid by a section 110 qualifying company (see I.A., above) where such interest is not paid on a quoted Eurobond or wholesale debt instrument, deductibility is allowed where the interest has been subject to Irish interest withholding tax.

V. Difference if FCo Has a Permanent Establishment in Ireland

In general, the answers given above will be the same if FCo is an entity that has a PE in Ireland. As to the taxability of the PE in Ireland, broadly speaking, the critical issue will be the extent to which the interest arises from a trade carried on in Ireland. Factors such as FCo's physical presence in Ireland, the extent of the Irish-located employee involvement in the lending transaction, and whether the loan was concluded in Ireland (as opposed to in FC) would be relevant in determining whether the interest was taxable in Ireland as income of the Irish PE.

VI. Legislative Changes

The ATAD was formally adopted by the Economic and Financial Affairs Council of the European Union (ECOFIN), on July 12, 2016. Article 4 of the ATAD provides for fixed-ratio interest limitation rules that would, subject to a 3 million euro *de minimis* threshold, deny a deduction with respect to net interest expense (i.e., gross interest expense less interest income) that exceeds 30% of the taxpayer's EBITDA. Article 9 of the ATAD provides for the introduction of anti-hybrid rules. Specifically, Article 9 provides that in the event of a double deduction for the same payment in two EU Member States, the deduction will only be given in the source state. Additionally, Article 9 provides that in situations where a deduction is given for tax purposes in the payer's Member State, but the income is not included in the taxable income of the recipient in another Member State, a deduction is to be denied in the Member State of the payer.

The ATAD does not have direct effect in Ireland, but Ireland is required to implement the ATAD into Irish domestic law. While the ATAD is required generally to be implemented by January 1, 2019, the Irish Department of Finance has indicated that Ireland will seek a derogation under the Directive with respect to the interest limitation rules. If the derogation applies, the interest limitation rules will have to be implemented into Irish law by January 1, 2024. The anti-hybrid rules provided for by Article 9 of the ATAD must be implemented by January 1, 2019.

On February 21, 2017, ECOFIN reached agreement on the adoption of a proposal for a new directive, known as "ATAD 2," which would effectively increase the scope of ATAD to address hybrid mismatches with third countries. EU Member States would generally be required to implement the new rules by January 1, 2020.

NOTES

[1] Taxes Consolidation Act 1997 (TCA 1997), sec. 811C.
[2] TCA 1997, sec. 130.
[3] TCA 1997, sec. 130(2)(d)(iv).
[4] TCA 1997, sec. 452.
[5] Tax Briefing 45, published in October 2001.
[6] TCA 1997, sec. 130(2)(d)(iv).
[7] TCA 1997, sec. 130(2)(d)(iv).
[8] As for example, do the Ireland-Israel, -Poland, -Sweden and -Switzerland tax treaties.
[9] TCA 1997, Part 35A.
[10] The guidelines approved on July 13, 1995, by the Council of the OECD as its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.
[11] TCA 1997, sec. 840A (the provision does not apply to interest payable by a sec. 110 qualifying company).
[12] TCA 1997, sec. 130(2)(d)(iii)(I).
[13] TCA 1997, sec. 452A.
[14] TCA 1997, sec. 817C.
[15] TCA 1997, sec. 97.
[16] TCA 1997, sec. 247.
[17] TCA 1997, sec. 817C.
[18] TCA 1997, sec. 130(2)(d)(iii).
[19] TCA 1997, sec. 130(2)(d)(iii)(II).
[20] TCA 1997, sec.130(2)(d)(iii)(II).
[21] As the payment is deemed by Irish domestic law to be a distribution, Irish dividend withholding tax rules would apply, rather than Irish interest withholding tax rules.

ITALY

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I. Possibility of Italian Tax Authorities Recharacterizing Advance of Funds by FCo To ItalianCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Since January 1, 2004, the Italian tax legislation has provided definitions of financial instruments "similar to shares" and financial instruments "similar to bonds." The introduction of these tax definitions derives from the reform of Italian corporate law, which was also enacted in 2004. The 2004 law introduced new forms of corporate financing[1] that do not fit into the traditional categories of "debt" and "equity" that had hitherto characterized the corporate law system and, consequently, the statutory tax provisions.[2]

Under Article 44, Paragraph 2, letter c) of the Income Tax Code (ITC), financial instruments that directly or indirectly entitle the investor to participate in the economic results of the issuer, of other group companies, or of specific business initiatives are classified as being similar to shares and are subject to the same tax regime as applies to shares.[3] As a consequence, under Article 109, Paragraph 9, ITC, the related profit — participating remuneration is not deductible for the issuer. Conversely, instruments that entail a refund obligation for the issuer and that do not confer on the investor any authority with respect to the issuer, are classified as being similar to bonds.

This distinction, which has been referred to as an "imperfect dichotomy,"[4] leaves room for an intermediate, undefined category of "atypical" instruments. In the hands of the investor, the tax regime applicable to such an instrument is analogous to the tax regime applicable to bonds, ensuring the deductibility for the issuer of that portion of the remuneration on the instrument that is not related to the economic results of the issuer, of other group companies or of specific business initiatives.

The rule described above applies irrespective of the residence status of the investor, of any relationship between the parties and of the tax treatment in the hands of the investor of the remuneration received.

While the remuneration on instruments classified as similar to shares is not deductible for the issuer,[5] the remuneration on instruments classified as similar to bonds is deductible, subject to the general limitations imposed by the Italian interest deduction rules (see below).

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

As described in I.A., above, the classification of the transaction for Italian income tax purposes depends entirely on whether the financial instrument directly or indirectly entitles the investor (here FCo) to participate in the economic results of ItalianCo, of other group companies or of specific business initiatives. The classification of the transaction from the perspective of the investor has no relevance to its classification for Italian income tax purposes.

Also, as noted in I.A., above, this classification rule applies irrespective of the status or country of residence of the investor or of any relationship between the parties.

C. Difference If a Loan Agreement of Some Sort Exists

The existence of a loan agreement would have no influence on the tax classification of the instrument as debt or equity since, under current Italian tax legislation, such classification depends only on the features of the remuneration payable under instrument. Of course, determining the classification of a financial instrument will be made simpler if all the terms and conditions of the instrument have been agreed in writing. This will also be true as regards determining the deductibility of that part of the remuneration that qualifies as interest, especially where the arrangement is between related parties.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

If the financial arrangement qualifies as debt, the related remuneration will qualify as interest and be deductible for corporate income tax purposes subject to the limits imposed by Italy's "interest barrier" rule.

The deduction of interest expenses from corporate income is governed by Article 96 of the ITC, which was introduced by the Budget Law for 2008 for the purpose of replacing the prior thin capitalization rule, which was based on a debt-to-equity ratio and an arm's-length test.

Under Article 96 of the ITC, interest expenses are fully deductible up to the amount of interest income, while any excess of interest expenses over interest income is deductible to the extent it does not exceed 30% of the enterprise's EBITDA (i.e., gross operating margin, before interest, tax, depreciation and amortization)[6] and dividends on shareholdings in nonresi-

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dent companies. Interest exceeding this statutory limitation is not deductible for purposes of the corporate income taxation of the borrower, but is not classified as a hidden profit distribution. Excess interest can be carried forward indefinitely or transferred to other group companies within the group taxation regime.

The application of this rule, like the interest classification rule, does not depend on whether the lender includes the interest income in its taxable income in its country of residence. The interest barrier rule applies to interest payable to any person, whether domestic or foreign, and whether related or unrelated to the borrower.[7]

The deduction of interest payable to a related party lender, even when the amount of interest payable is within the limits laid down by Article 96 of the ITC, is also subject to the transfer pricing rules in Article 110, Paragraph 7 and Article 9 of the ITC.

Under Article 110, Paragraph 7 of the ITC, transactions with nonresident related parties are assessed based on their respective market value, defined as the "conditions and prices that would be agreed between independent parties in comparable circumstances in a free market."[8]

Interest payable at a rate exceeding market value is not deductible for an Italian borrower but is not recharacterized as a hidden profit distribution.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The interest barrier rule in Article 96 of the ITC is based not on a debt-to-equity ratio but on an interest-over-earnings percentage (currently 30% — see above).

The statutory definition of interest, as complemented by administrative guidance, encompasses interest embedded in a finance lease agreement and interest arising under any agreement with a loan function. On the other hand, interest arising from trade payables is not subject to the interest barrier rule.[9]

Although the rule in Article 96 of the ITC has now been in force for almost ten years (having been introduced by the Finance Act for 2008), no consideration has been given to the adoption of a group ratio rule. There is a chance that the regime may be changed in the future so as to implement, at least in part, the recommendations of Action 4 of the BEPS project, but no proposal has yet been made with respect to this issue.

B. Limits on Interest Deductions Based on Other Factors

Another factor that may limit deductions for interest payable between related parties is that the rate of interest must reflect an arm's-length rate. Under Article 110 of the ITC, interest arising from a related party relationship is deductible to the extent the rate at which it is paid does not exceed an arm's-length rate.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

The bifurcation of the remuneration with respect to a financial instrument into debt and equity remuneration is expressly provided for by Article 109, Paragraph 9 of the ITC. Specifically, the provision classifies as equity remuneration only that part of the remuneration that is related to the economic results of the issuer, of other group companies or of specific business initiatives. The remaining part of the remuneration (whether it is fixed or determined based on other parameters) qualifies as debt remuneration.

D. Effect of an Income Tax Treaty Between Italy and FC

Some provisions in Italy's tax treaties may, in principle, have an effect on Italy's domestic interest deduction rules. More specifically, treaty provisions equivalent to Article 9(1) of the OECD Model Convention may not accommodate the effects of domestic rules that limit the deduction of related-party interest based on the arm's length principle. Furthermore, provisions corresponding to Article 24(4) of the OECD Model impose a requirement that (except where treaty-based arm's length rules apply) cross-border interest payments should be deductible subject to the same conditions as apply to domestic interest payments.

The practical effect of these provisions is, however, negligible in the case of Italy, since the domestic interest classification rule in Article 109, Paragraph 9 of the ITC (see I.A., above) and the interest barrier rule in Article 96 of the ITC (see II., above) are not based on the arm's length principle (or, more precisely, do not distinguish between related-party relationships and unrelated-party relationships) and apply identically to domestic and cross-border situations.

Interest that is not deductible because it exceeds the specified threshold still qualifies as interest under Italy's domestic rules (the Italian legislation does not provide for the recharacterization of excess interest as a hidden profit distribution).

Interest re-characterized as equity remuneration for purposes of the Italian income taxation of the borrower would still qualify as interest income in the hands of the lender for tax treaty purposes. Italy's treaties adopt the definitions of dividends and interest provided by, respectively, Article 10 and Article 11 of the OECD Model Convention. Under Article 11(3) of the OECD Model, interest is defined as "income from debt claims of every kind (. . .) whether or not carrying a right to participate in the debtor's profits" and is thus neutral with respect to the "result participation" criterion provided by the Italian domestic legislation. Also, under Article 10 of the OECD Model, dividends are defined as income from shares or from "corporate rights," a category that does not include debt instruments, even where the remuneration payable on such instruments is results–related.

Most of Italy's tax treaties include the equivalent of Article 11(6) of the OECD Model Convention.[10] Should the rate of debt remuneration exceed an arm's-length rate, the excess portion will be fully subject to Italian domestic withholding tax (at a 26% rate) and will not qualify for the lower source-country taxation rate provided by the applicable treaty. Also, the excess interest will not be deductible for the borrower under Italy's transfer pricing rules to the extent those rules are consistent with the treaty-based arm's length principle.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The current Italian tax considerations described above generally apply regardless of whether the lender is a pass-through or a body corporate.

It is worth noting that, under Article 87, Paragraph 1, letter d) of the ITC, all foreign subjects other than individuals qualify as non-flow-through entities for Italian tax purposes. As a result, any non-resident entity (with the sole exception of an individual) is treated as a corporation for Italian tax purposes.[11] This classification does not depend on the treatment of the entity in its country of residence, so that even nonresident partnerships and other nonresident transparent entities qualify as taxable persons for Italian purposes.

IV. Withholding Tax Issues

In general, under Italy's withholding tax rules, the financial remuneration with respect to both debt and equity is subject to the same treatment.[12] Specifically, interest and dividends paid to a nonresident recipients (without a permanent establishment (PE) in Italy) are currently both subject to the same withholding tax at the rate of 26%.

A difference in treatment between interest and dividends may arise with respect to the application of withholding tax reductions provided for under Italy's tax treaties or Italy's domestic law implementation of EU Directives. In such circumstances, the recognition of the benefits will depend also on the characterization of the remuneration paid.

Also, special regimes have been introduced in recent years with respect to specific categories of interest (for example, outbound interest on loans made by banks established in the European Union). It could be argued that such regimes do not apply where the remuneration concerned does not constitute interest under Italian rules.

V. Difference if FCo Has a Permanent Establishment in Italy

If the lender (here FCo) has a PE in Italy, the interest it receives may be taxable in the hands of the PE, if — under Article 152 of the ITC — the interest is attributable to the PE. Article 152 was amended in 2015 with the aim of aligning the Italian rules on the attribution of income with the most recent version of Article 7 of the OECD Model Convention and eliminating the previously prevailing "force of attraction" principle. In the absence of any more specific Italian practice or official guidance, the approach of the OECD Commentary (on Article 7(1)) may be adopted in determining the circumstances in which items of income (including interest) can be attributed to an Italian PE.

Should income be attributable to an Italian PE of FCo, the income classification rules of Article 109, Paragraph 9 of the ITC, would be unchanged in their application to the borrower.

The Italian PE of FCo may benefit from Italy's participation exemption regime with respect to any part of the remuneration under the financial arrangement that qualifies as income from shares.[13] Indeed, the tax regime applicable to financial instrument similar to shares was designed by reference to the tax treatment of shareholdings[14] and is, thus, inspired by the same purpose of preventing the double taxation of corporate profits.

Under Article 44, Paragraph 2, letter a) of the ITC, financial instruments are treated as similar to shares to the extent they provide for remuneration linked to the economic results of the issuer, of another company of the same group or of specific business initiatives. According to the Italian tax authorities, financial instruments qualify under Article 44, Paragraph 2, letter a) only if they are represented by securities or certificates. If these conditions are fulfilled, the remuneration concerned qualifies as a dividend and would be 95% exempt in the hands of an Italian PE of FCo.

If the interest was taxable in the hands of an Italian PE of FCo, Italy's transfer pricing rules would in practice not apply: Article 110 of the ITC applies only to transactions with related parties that are nonresidents of Italy and the official instructions of the Italian tax authorities also may be considered implicitly to exclude from the scope of the transfer pricing rules transactions involving the Italian PE of a nonresident.[15]

VI. Legislative Changes

No specific legislative changes affecting the classification or deduction of interest are currently being considered. That being said, Italy is due to implement Council Directive (EU) 2016/1164 of July 12, 2016 laying down rules against tax avoidance practices (ATAD).

Article 9 of the ATAD provides that "to the extent that a hybrid mismatch results in a deduction without inclusion, the Member State of the payer shall deny the deduction of such payment." This provision means that Member States (like Italy), under whose rules the deductibility of interest does not currently depend on the taxation of that same interest in the hands of the lender, are required to amend their domestic interest deduction rules accordingly by December 31, 2018.

* * *

NOTES

[1] Reference is made, in particular, to financial instruments provided for in Civil Code, Art. 2346, Para. 6 (instruments issued in return for contributions in kind or in cash and granting the investor certain administrative rights, but not the right to vote at the shareholders' meeting) and in Civil Code, Art. 2447-*ter* (instruments relating to a specific business initiative).

[2] See M. Leo, *Le imposte sui redditi nel testo unico*, Milano, 2010, p. 727, noting that the earlier tax legislation did not contain any definition of debt or equity but was based on the related corporate law definitions. It is also worth noting that G. B. Calì, *Tax treatment of hybrid financial instruments in cross-border transactions. National Report. Italy*, in *Cahiers de droit fiscal international*, Rotterdam, 2000, p. 403, concluded that, at the time of the survey, "no specific rules govern the classification of hybrid financial instruments for tax purposes."

[3] P. Flora, *Participating financial instruments: Opportunities and risks*, in *Derivatives & Financial Instruments*, 2006, No. 2, p. 77 ff.

   ISSN 0143-7941

[4] See G. Mameli, *The debt-equity conundrum. National Report. Italy*, in *Cahiers de droit fiscal international*, Rotterdam, 2012, p. 381 ff.

[5] P. Flora, *Participating financial instruments: opportunities and risks*, in *Derivatives & Financial Instruments*, 2006, No. 2, p. 77 ff.

[6] For a description of the Italian rule, see P. Flora, *Limitations on deductibility of interest payable: Recent tax law developments*, in *Derivatives & Financial Instruments*, 2008, No. 5, p. 210 f.; T. Marino, M. Russo, *Italian restyling of interest deduction rules: The amendments of the Italian finance bill for 2008*, in *Intertax*, 2008, No. 5, p. 204; G.A. Galeano, A.M. Rhode, *Italy sets the barrier to deduction of financing costs at 30 per cent of EBITDA*, in *Intertax*, 2008, No. 6/7, p. 292; M. E. Palombo, *Financing: A global survey of thin capitalization and transfer pricing rules in 35 selected countries: Italy*, in *International Transfer Pricing Journal*, 2008, No. 6, p. 318. The rule on the computation of deductible interest was amended by Legislative Decree No. 147 of September 14, 2015, Art. 4 to the effect that foreign dividends are to be added to EBITDA for purposes of computing the 30% threshold.

[7] Certain exemptions apply relating to the activity of the borrower, (e.g., the activities of banks, insurance companies and consortium companies, which are subject to industry specific rules). Also entrepreneurs and partnerships are excluded from the scope of application of the rule.

[8] The definition of arm's length conditions has been very recently amended by La Decree No. 50 of April, 24th 2017. Under the prior definition, the market value was the "*the average price charged for the goods and services of the same or a similar quality, in free competition and at the same stage of commercialization, at the time and the place where the goods or services were delivered, and, failing that, the nearest time and place*". The effect of the amendment is the alignment of the Italian definition with the one to be found in the OECD Model Tax Convention and in Italian tax treaties.

[9] An extensive analysis of the objective scope of application of the interest barrier rule can be found in A. Dodero, G. Ferranti, L. Miele, *Interessi passivi*, Milano, 2010, pp. 131 ff.

[10] OECD Model Convention, Art. 11(6) provides as follows:

Where, by reason of a special relationship between the payer and the beneficial owner (. . .), the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

[11] By way of exception, the income of nonresident trusts with identified beneficiaries is attributed to the beneficiaries and taxed accordingly (ITC, Art. 73, Para. 2).

[12] G. Mameli, The debt-equity conundrum. National Report. Italy, in Cahiers de droit fiscal international, Rotterdam, 2012, p. 375 ff.

[13] ITC, Art. 89, and Art. 44, Para. 2, letter a.

[14] As indicated in Circular Letter No. 4/E dated Jan. 18, 2006, the fact that ITC, Art. 44, Para. 2, Letter a) defines a category of financial instruments as being similar to shares implies that a resident corporate recipient of the remuneration on such instruments should benefit from the participation exemption provided by ITC, Art. 89, even though Art. 89 does not expressly provide for such exemption. See also G. Escalar, *Il nuovo regime di tassazione degli utili da partecipazione e dei proventi equiparati nel decreto legislativo di "riforma dell'imposizione sul reddito delle società"*, in *Rassegna Tributaria*, No. 6, 2003, p. 1922.

[15] Circular Letter No. 32 of September 22, 1980.

JAPAN

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I. Possibility of Japanese Tax Authorities Recharacterizing Advance of Funds by FCo to JCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

In principle, the Japanese tax treatment of the advance provided by FCo to a Japanese corporation (JCo) is determined based on the legal form of the arrangement, rather than on an analysis of multiple factors. More specifically, if JCo takes the necessary corporate actions to issue equity (shares of stock) to FCo and receives the advance as consideration for such equity, J Co would be treated as issuing shares of stock to FCo, not only for purposes of private law but also for purposes of Japanese corporation tax law, and the consideration received by JCo would be required to be accounted for by JCo as capital and capital reserves. If JCo does not take any of the corporate actions required for it to issue shares of stock under the Japanese Companies Act, but receives the advance from FCo pursuant to an agreement with FCo under which JCo agrees to repay to FCo the same amount as the advance,[1] the advance would generally be treated as a loan, not only for purposes of private law, but also for corporation tax law purposes. However, it should be noted that the deductibility of the interest paid by JCo to FCo on the loan might be denied or limited for tax purposes under Japan's thin capitalization rules, earnings stripping rules and/or transfer pricing rules, as discussed below.

Under Japanese private law, a loan agreement may be valid even if it is entered into without a deed or other written documentation: in other words, the agreement between the parties may be verbal (although it is advisable to document such an agreement). Thus, the absence of a documented loan agreement would not, in and of itself, make it impossible for JCo to treat the advance as a loan from FCo. However, as a matter of fact-finding, if the funds advanced are found to have been provided by FCo to JCo and that JCo has neither: (1) taken the necessary corporate actions to issue shares of stock to FCo pursuant to the Companies Act; nor (2) agreed to repay the funds to FCo, it is possible (perhaps even likely) that the advance could be treated (depending on other relevant facts and circumstances) as a donation made by FCo to JCo,[2] which would be treated as taxable income in the hands of JCo for Japanese corporation tax purposes.

B. Fco Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Where JCo treats the transaction as a loan from FCo to JCo, but FCo treats the transaction as something other than a loan (possibly, JCo's issuance of its shares of stock to FCo), Japanese tax law does not generally provide for the recharacterization of the loan as equity by reference to various factors (the "recharacterization approach"). However, the recharacterization approach may be available to the Japanese tax authorities if they are able to invoke a specific anti-avoidance rule that applies with respect to family (i.e., closely held) corporations.[3] This anti-avoidance rule could be invoked where: (1) treating the advance as a loan (which is the private law characterization of the advance) is found to enable JCo to unjustly reduce its corporation tax liability; and (2) JCo is a family corporation. That FCo does not treat the transaction as a loan for FC accounting and income tax purposes, in and of itself, would not be conclusive evidence that JCo has unjustly reduced its corporate tax liability. However, this fact and the fact that FCo is related to JCo might make the tax authorities suspect that JCo and FCo may have abused the FC accounting and income tax treatment of the loan to unjustly reduce JCo's corporate tax liability.

C. Difference if a Loan Agreement of Some Sort Exists

As noted in I.A. above, in principle, the legal form of an advance is respected for determining its tax treatment under Japanese tax law. Thus, if JCo and FCo execute a loan agreement that comports with the definition of a loan agreement under the relevant private law (i.e., the Civil Code of Japan) and the parties to the agreement perform their respective obligations in accordance with the terms of the agreement (for example, interest is paid on a regular basis and repayment is properly made in accordance with the amortization schedule provided for in the loan agreement), this will determine that the arrangement is a loan for Japanese tax purposes.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

For Japanese corporation tax purposes, the general rule regarding the deduction of interest paid by a Japanese corporate borrower such as JCo to a nonresident lender is that such interest is tax deductible unless specific rules in the tax law (discussed in I.B.,

ISSN 0143-7941

above and II.B. and C., below) apply to limit such deduction. The residence of the lender is generally irrelevant for purposes of determining whether a deduction is available. Whether the interest is included in the nonresident lender's taxable income may become relevant under some of the exception rules.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

Japan's thin capitalization rules,[4] which were introduced in 1992, apply to a Japanese corporation such as JCo as well as to a Japanese branch of a foreign corporation (for simplicity's sake, any entity falling into either category will be referred to below as a "Japanese corporate borrower"). The limitation on the deductibility of interest under these rules is triggered if: (1) the ratio of the average amount of interest-bearing debt (subject to certain exceptions) owed by a Japanese corporate borrower to a lender that is either (a) a "foreign controlling shareholder" (as more fully defined in the rules[5]) of the borrower, or (b) an intermediary financier of a specified kind (as more fully defined in the rules[6]), to the amount of the foreign controlling shareholders' share in the net assets of the Japanese corporate borrower is greater than three to one; *and* (2) the ratio of the average amount of all interest-bearing debt owed by the Japanese corporate borrower to its net assets is greater than three to one. If both conditions (1) and (2) are fulfilled, the deductibility of any excess interest incurred by the Japanese corporate borrower would be denied under the thin capitalization rules. A Japanese corporate borrower is, however, allowed to demonstrate that it should be able to use a more favorable debt-to-equity ratio than the three to one ratio (in computing both (1) and (2) above) by reference to another Japanese corporation engaging in the same category of business, where the size of that corporation's business and other conditions are similar to those of the Japanese corporate borrower.[7] In other words, if the Japanese corporate borrower is able to find a Japanese corporation engaging in the same category of business, the size of whose business and other particulars are similar to the Japanese corporate borrower's business conducted in Japan, and if that Japanese corporation's debt-to-equity ratio is, for example, ten-to-one, then the calculation in items (1) and (2) above would be made using a ten-to-one ratio rather than the three-to-one ratio provided for in the thin capitalization rules.

B. Limits on Interest Deductions Based on Other Factors

Japan's transfer pricing rules[8] limit the deductibility of interest where a Japanese corporate borrower receives a loan from any of its "foreign related persons" (as more fully defined in the rules[9]) if the interest is charged at a rate in excess of an arm's-length rate. Whether the interest is charged at an arm's-length rate would have to be determined by reference to the arm's-length test provided for in the transfer pricing rules. To the extent the interest exceeds the arm's-length amount determined under the transfer pricing rules, the excess amount would, under those rules, be denied as a deduction for the Japanese corporate borrower's corporate income taxation purposes.

In addition to the thin capitalization rules, in 2012, Japan introduced "earnings stripping rules,"[10] which apply to any corporate taxpayer subject to Japanese corporation tax (such as JCo). The earnings stripping rules disallow the deductibility of interest payments that are excessive compared to the borrower's income. Specifically, where a Japanese corporate borrower's "net interest payments" (as more fully defined in the rules[11]) to "related persons" (as more fully defined in the rules[12] to include, without being limited to, a person having a direct or indirect 50% or more shareholding relationship with the borrower) exceeds 50% of its "adjusted taxable income" (as more fully defined in the rules[13]) in any tax year, the Japanese corporate borrower is not allowed to deduct the excess interest. Disallowed interest expense may be carried forward and deducted against the profits of the seven following years.[14] It is worth noting that, in calculating the net interest payments, interest payments made by JCo that are subject to Japanese income taxation, are excluded from the calculation, even if those interest payments are made to related persons of JCo.[15] In other words, if FCo is a related person of JCo and interest received by FCo from JCo is not included in FCo's Japanese corporation tax base (which would be the case if the advance is provided by FCo through its office outside Japan), then the interest would be included in the "net interest payments" to "related persons," but if interest received by FCo from JCo is subject to Japanese corporation tax (which would be the case if the interest is attributable to FCo's permanent establishment (PE) in Japan, as noted in V., below), then the interest would be excluded in calculating the "net interest payments" to "related persons," even if FCo is a related person of JCo.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

There is no provision in Japan's corporation tax law that specifically authorizes the tax authorities to recharacterize only a portion of a debt as equity. It should be noted that generally Japanese tax law has not adopted the recharacterization approach (except possibly in the context of the specific anti-avoidance rule for family (closely held) corporations referred to in I.B., above). However, a deduction may be disallowed with respect to only part of the interest paid on a loan under the thin capitalization rules, the earnings stripping rules or the transfer pricing rules.

D. Effect of an Income Tax Treaty Between Japan and FC

Japan's tax treaties generally do not include any explicit provisions that directly limit the deductibility of interest. Some of Japan's treaties include a provision similar to Article 11(6) of the OECD Model Convention, which limits the application of treaty benefits with respect to such portion of an interest payment between related parties as exceeds interest payable at an arm's-length rate and allows each Contracting State to tax the excess portion of such interest in accordance with its domestic tax law.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Generally, the position set out above would not be affected purely by the fact that FCo is an entity that is treated as transparent for FC tax purposes. This is because, as noted above, the Japanese tax treatment, in principle, follows the legal form of the transaction in question and the lender's entity classification under the laws of FC generally should not affect the legal form of the transaction entered into by JCo, as borrower. Further, if FCo is treated as transparent for FC tax purposes, that does not necessarily mean that FCo would be treated as transparent for Japanese tax purposes. Even if FCo is characterized as a transparent entity for Japanese tax purposes, generally the position set out above would not be affected, except that a question may arise as to whether and how the Japanese transfer pricing rules could apply to a transaction between JCo and a foreign transparent entity.

IV. Withholding Tax Issues

Interest paid by JCo to a nonresident lender such as FCo is generally subject to Japanese withholding tax under Japanese domestic tax law[16] unless the interest received by FCo is eligible for exemption from Japanese source basis taxation under an applicable tax treaty. In principle, whether JCo is required to withhold Japanese withholding tax with respect to the interest paid by JCo to a nonresident lender under the withholding tax rules is not dependent on whether the interest is treated as deductible by JCo for corporation tax purposes. Accordingly, assuming that FCo's advance to JCo is legally characterized as a loan and JCo's payment to FCo is legally characterized as interest on that loan, any excess interest the deductibility of which is denied for JCo's corporation tax purposes would continue to be characterized as "interest" for purposes of the Japanese withholding tax rules, and JCo would nevertheless be required to withhold the applicable withholding tax, if any, with respect to the entirety of the interest paid by JCo to a nonresident lender such as FCo.

V. Difference if FCo Has a Permanent Establishment in Japan

If FCo has a PE in Japan, under Japanese corporation tax law, FCo would be subject to Japanese corporation tax with respect to its business income (which may include interest income) only to the extent such income is attributable to the PE.[17] If the advance provided to JCo is funded and booked by FCo's head office or other offshore branch, rather than FCo's PE in Japan, the interest received by FCo from JCo would not constitute income attributable to FCo's PE in Japan. Accordingly, in such circumstances, the position set out above should not be affected.

VI. Legislative Changes

Reportedly, in order to deal with the interest deduction issues raised in the Final Report of BEPS Action 4, the Japanese Government is in the process of considering whether amendments to the current Japanese tax rules are necessary, and, if so, how the current rules should be amended. However, there are, at present, no specific proposals in the legislative process that would change the position set out above.

NOTES

[1] See Civil Code (Law No. 89 of 1896, as amended), Art. 587 for the definition of a "loan agreement."

[2] Corporation Tax Act (Law No. 34 of 1965, as amended — CTA), Art. 37, para. 7.

[3] CTA, Art. 132, para. 1.

[4] Special Taxation Measures Law (Law No. 26 of 1957, as amended — STML), Art. 66-5.

[5] See STML, Art. 66-5, para. 5, item (i) and Special Taxation Measures Law Enforcement Order (Cabinet Order No. 43 of 1957, as amended — STMLEO), Art. 39-13, para. 12.

[6] See STML, Art. 66-5, para. 5, item (ii) and STMLEO, Art. 39-13, para. 14.

[7] See STML, Art. 66-5, para. 3.

[8] STML, Arts. 66-4 and 66-4-2.

[9] The exact meaning of "foreign related person" is provided in STMLEO, Art. 39-12, paras. 1 through 4.

[10] STML, Arts. 66-5-2 and 66-5-3.

[11] See STML, Art. 66-5-2, para. 2.

[12] See STML, Art. 66-5-2, para. 2.

[13] See STML, Art. 66-5-2, para. 1 and STMLEO, Art. 39-13-2, para. 1.

[14] See STML, Art. 66-5-3.

[15] See STML, Art. 66-5-2, para. 2.

[16] Income Tax Act (Law No. 33 of 1965, as amended), Art. 161, para. 1, item (x) and Art. 212, para. 1.

[17] See CTA, Art. 138, para. 1, item (i) and Art. 141, item (i)(a).

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MEXICO

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I. Possibility of Mexican Tax Authorities Recharacterizing Advance of Funds by FCo to MexCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

While it does not contain any debt recharacterization rules, Mexican tax law does contain rules that, as described below, may recharacterize interest payments as non-deductible dividends. In fact, the definition of debt in the income tax law is provided in the context of the liabilities to be included in calculating inflation adjustments with respect to monetary assets and liabilities (explained in further detail below).

Whether funds transferred by a foreign entity to a taxpayer in Mexico are deemed to be debt or equity is paramount in determining the Mexican tax treatment applicable to both the foreign entity (i.e., in terms of whether and how income derived from such debt or equity is taxed in Mexico) and the Mexican taxpayer (i.e., in terms of whether and to what extent the taxpayer is entitled to deduct payments made to the foreign entity and the consequences for withholding and formal filing obligations).

In determining whether an instrument qualifies as debt or equity, Mexican tax law relies on a strictly formalistic approach. From a practical point of view, to be considered an equity contribution, funding must be supported by documentation as a formal contribution of capital approved by the shareholders. Absent such formal documentation, a transfer of funds will generally be treated as debt from a Mexican tax perspective if it is documented under a financing agreement. In this sense, a document in which the parties state their intentions to treat the transfer of funds as debt could be sufficient support for the treatment of the fund transfer as a loan. For purposes of this formalistic analysis, no regard is had to whether the country of residence of the foreign entity transferring the funds considers the corresponding instrument or arrangement to be debt or equity. Where both parties to a financing arrangement are related, this does not create any additional elements to be taken into account in determining whether the arrangement is to be treated as debt or equity for Mexican tax purposes.

If no agreement is in place and the intention of the parties is not otherwise properly documented, the Mexican tax authorities may try to classify the transfer of funds as giving rise to an increase in the wealth of the Mexican taxpayer. In practice, in recent years, the Mexican tax authorities have been taking this approach on audit and asserting that amounts transferred without proper documentation should be treated as taxable income, even if the transfer is registered in the accounting records as a loan. In such circumstances, the Mexican taxpayer would be required to recognize amounts transferred to it by a foreign entity as income.[1]

Moreover, if the indebtedness is not properly documented, a Mexican taxpayer may not be allowed to deduct payments made with respect to it.[2] Though disallowing the deduction of interest payments in these cases, Mexican tax law does not go so far as to recharacterize the relevant debt as equity. Thus, at the level of the Mexican taxpayer, the liability will still be treated as debt for income tax purposes (regardless of whether the taxpayer is permitted the corresponding interest deduction).

One adverse effect of this feature of Mexican tax law (as compared to the position under a recharacterization regime) is that the Mexican taxpayer will nonetheless be obliged to include the liability (i.e., regardless of whether the liability gives rise to interest deductions or not) in the annual inflation adjustment, which results in taxable inflationary gains in the case of a net liability position. In broad terms, Mexican companies must recognize the impact of a change in the purchasing power of the Mexican peso on their monetary assets and liabilities.The inflation adjustment is calculated each year by applying the change in the consumer price index for the year to the net balance of the taxpayer's monetary liabilities and assets (i.e., the difference between the taxpayer's total monetary liabilities and its total monetary assets). If the taxpayer reports a net liability balance, whether peso or foreign currency denominated, a gain must be recognized as a result of a decrease in the value of the liability caused by a loss in the purchasing power of the peso. Likewise, a deductible adjustment is allowed against taxable income for the inflationary component attributable to a net monetary asset position to take into account a loss in the purchasing power of the peso.[3]

For purposes of calculating the inflationary adjustment, almost all liabilities are taken into account, including derivatives, hedges, accounts payable related to finance leases and subscriptions for future capitalization. Certain specific liabilities are, however, excluded from the calculation, such as liabilities related to nondeductible taxes, some reserves, contributions

and liabilities related to nondeductible interest expenses as determined under the thin capitalization rules.[4]

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

As noted above, Mexican tax law relies on a strictly formalistic approach for purposes of determining whether an instrument qualifies as debt or equity. In this sense, the accounting or tax treatment given to the transfer of funds in a foreign country has no special importance for determining whether the transfer is to be considered debt or equity for Mexican tax purposes. Nor does the fact that the parties to the arrangement are related parties change the analysis. The most important factor in the determination is whether or not the transfer is recognized as a formal contribution of capital by the shareholders from a corporate perspective. As noted above, even contributions for future capital increases are considered debt for purposes of the inflationary adjustment calculation.

C. Difference if a Loan Agreement of Some Sort Exists

The existence of some sort of loan agreement will allow both parties to demonstrate more effectively that the relevant funds have been advanced under a debt instrument and that the recipient Mexican taxpayer is not receiving funds that should be considered to constitute an increase of wealth (income) for Mexican tax purposes. If this assumption prevails, the Mexican taxpayer will not have to recognize as income the amounts transferred to it by the foreign entity concerned.

However, absent a proper written loan agreement, a document stating the intention of the foreign party to transfer the funds as part of a financing arrangement and the obligation of the Mexican taxpayer to repay the funds would support the treatment of the transaction as debt. That being said, a proper loan agreement would be preferable, since the existence of such an agreement would alleviate the Mexican taxpayer's burden of proof before the tax authorities and would also support the requirement to pay interest on the obligation.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Mexican tax law lays down both general requirements for the deductibility of expenses and specific requirements for the deductibility of interest expenses.

In general terms, a corporate taxpayer is allowed to deduct expenses relating to its business activity, provided the following requirements, among others, are met:[5]

- The expenses must be strictly indispensable to achieving the purpose of the taxpayer's business activity. While the MITL does not define what constitutes a "strictly indispensable" expense, the standard is generally interpreted to mean that the expense must relate to the business activity carried on by the taxpayer and must either relate to the income generating activity or be expenses such that, if the entity did not incur them, it would be prevented from continuing its operations.
- The expenses must be properly reflected in the taxpayer's accounting records.
- The expenses must be properly documented by way of a digital invoice (*comprobante fiscal digital por Internet* or CFDI) that meets the requirements under the Federal Fiscal Code (FFC).
- The expenses must have been incurred in the tax year in which the deduction is claimed and the documentation supporting the deduction must be dated accordingly.
- In the case of payments to third parties from which the taxpayer must withhold taxes, the taxpayer must fulfill the withholding obligations laid down by the law or, if applicable, the taxpayer must obtain a copy from the third party of the documentation that evidences the payment of such taxes. Furthermore, should a nonresident recipient of a payment qualify for a reduced or zero rate of withholding under one of Mexico's tax treaties, the Mexican payer may have to prove to the tax authorities that the recipient does in fact qualify for treaty benefits.
- Payments to a nonresident are deductible only if the taxpayer complies with the requirements of Article 76 of the MITL, which covers reporting requirements for payments made to nonresident related parties.
- If applicable, value added tax (VAT) must be accounted for. With respect to interest paid to a nonresident, the transaction concerned would likely qualify as an importation of a service, which might require VAT to be self-assessed by the Mexican taxpayer.
- An invoice must be obtained from the nonresident lender that meets the requirements under Mexican tax laws.

It is worth emphasizing that because Mexican law is so formalistic, it is important not to underestimate the documentation requirements for claiming deductions in Mexico.

Mexican tax law contains specific "general interest deductibility" rules and limitations, as well as anti-hybrid rules, for the deduction of interest expenses. Among others, the following general interest deductibility rules must be observed by taxpayers claiming deductions for interest payments:[6]

- The thin capitalization rules deny a deduction for interest expenses with respect to loans from foreign related parties when the borrowing company's debt-to-equity ratio exceeds 3:1 (see II.A., below).
- The borrowed funds must be used to finance the taxpayer's business operations.
- If the taxpayer borrows funds and lends them to third parties, the interest on the borrowed funds is deductible only to the extent of the interest charged to the third parties. Thus, a company that borrows to make a loan to a related company must charge a mark-up on the second loan. Specific rules exist for purposes of comparing the interest on borrowed funds with the interest earned on loans receivable.
- For a corporate taxpayer, interest is generally deductible on an accrual basis, regardless of whether payment has been made.

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- If debt is used to finance an investment or a cost that is either nondeductible or partly nondeductible, the deductibility of the interest expense relating to that debt will be limited to the extent to which the investment or cost is deductible. This rule has a significant impact on the manner in which certain investments and costs are financed.
- Generally, "moratory" interest (for example, interest resulting from late payments) is deductible, while prepayment penalties are not.

In addition, interest paid with respect to a related-party loan is treated as a non-deductible dividend if any of the following features is present:

- The loan agreement provides that the debtor unconditionally promises to repay the loan at any time determined by the creditor.
- In the event of default, the creditor has the right to intervene in the administration of the debtor's business.
- The payment of the interest is conditional on the availability of the borrower's profits or the amount of the interest is determined based on such profits.
- The interest is not deductible because it is not stated at a fair market rate.
- The interest is payable on a back-to-back loan, including a back-to-back loan entered into with a financial institution.

For this purpose, a "back-to-back loan" is defined as:

> . . .an operation in which one party provides, directly or indirectly, cash, goods or services to an intermediary that goes on to provide cash, goods or services to a related party or the original party. In addition, a back-to-back loan includes a loan that is provided by a party where the loan is guaranteed by cash or cash deposits, shares or debt instruments of any type of a party related to the borrower or by the borrower, to the extent the loan is guaranteed in this manner. In this respect, it is considered that the loan is guaranteed in terms of this provision when the granting of the loan is conditioned on the execution of one or more contracts that provide an option right in favor of the lender or a party related to the lender, the exercise of which depends on partial or complete compliance with the payment of the loan or its accessories by the borrower.

A back-to-back loan is also deemed to exist where a group of debt derivatives or derivative transactions are entered into by two or more related parties with the same financial intermediary, when the transactions of one of the parties give rise to the other transactions, with the primary purpose of transferring a given amount of resources from one related party to the other.

It should be noted that the treatment of the return as dividends in these cases does not mean that the debt is recharacterized as equity for tax purposes. Based on the foregoing, a Mexican taxpayer to which this interest-treated-as-dividend rule applies is in a less favorable position than a taxpayer to which a debt recharacterization regime applies since:

- Payments made by the Mexican taxpayer to a foreign lender cannot be taken as deductions for income tax purposes.
- The Mexican taxpayer is nonetheless obliged to withhold the corresponding dividend withholding tax at a rate of 10%.
- Tax may be imposed on the "distributing" Mexican taxpayer, if the "interest" is in excess of the balance on the previously taxed earnings account (CUFIN). Dividends in excess of the CUFIN balance are subject to tax at the distributing company level at an effective rate of 42.86%.
- The Mexican taxpayer will also be required to include the liability in the calculation of the inflationary adjustment, which may give rise to taxable income as described in I.A., above.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

As indicated above, Mexico has thin capitalization rules that deny a deduction for interest expenses with respect to loans from foreign related parties when the borrower's debt-to-equity ratio exceeds 3:1. Specifically, the nondeductible interest is interest payable on debt granted to the taxpayer by one or more persons that are considered related parties of the taxpayer, to the extent the amount of the debt is higher than three times the amount of the shareholders' equity shown on the taxpayer's balance sheet. Furthermore, to the extent the debt is denominated in a foreign currency, the exchange loss attributable to the excess debt will also be considered non-deductible interest.

The amount of excess debt for this purpose is calculated by subtracting from the average annual balance of all interest-bearing debt the amount that results from multiplying by three the average balance of shareholder's equity. If the average balance of the taxpayer's debt owed to foreign related parties is less than the debt in excess of the acceptable 3:1 debt-to-equity ratio, all interest on the related party debt is deemed nondeductible. If the average balance of debt owed to foreign related parties is more than the debt in excess of the 3:1 debt-to-equity ratio, then a part of the interest on the related party debt is deemed nondeductible, based on the proportion of the excess debt to the average balance of the related party debt. Although the debt-to-equity ratio is calculated by including debt owed to both related and unrelated parties, only the interest on related party debt is subject to limitation.

Unlike the rules described in II A., above that reclassify interest as dividends, the thin capitalization rules allow the excess debt to be excluded from the inflationary gain calculation.

B. Limits on Interest Deductions Based on Other Factors

Mexico has been at the forefront in implementing a number of the measures proposed by the OECD/G20 in the context of the BEPS action plan. For example, in 2014, Mexico was quick to implement some of the recommendations on hybrids in Action 2 (Neutralizing the Effects of Hybrid Mismatch Arrangements) of the BEPS project, even before the final report on Action 2 was released.[7]

Mexico's anti-hybrid mismatch rules disallow the deduction of interest payments that are not recognized as income by the lender's country of residence or that generate double-dip deductions in that country, as follows:

- **Payments to related parties:** A Mexican taxpayer is not allowed to deduct interest payments made to

a related party that are also deductible for the related party under domestic or foreign rules. However, the corresponding interest expense will be deductible if the related party also recognizes the income of the Mexican taxpayer in the same fiscal year or the immediately following fiscal year.[8]

- **Payments to controlling or controlled entities:** A Mexican taxpayer is not allowed to deduct interest payments made to a foreign related entity that controls or is controlled by the Mexican taxpayer if:[9]

  - The foreign related entity is a fiscally transparent entity, unless its members are subject to taxation and the payments comply with the arm's length standard;

  - The payments are not recognized as existing for tax purposes in the foreign entity's country of residence; or

  - The foreign entity does not have to recognize the payments as taxable income.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Mexican law generally does not provide rules for the bifurcation of debt into a portion that permits interest to be deducted for tax purposes and a portion that does not. That being said, when the deductibility of interest is limited by the thin capitalization rules, it is possible that part of the interest will not be deductible but the balance will be deductible, based on the 3:1 ratio and the specific methodology established in the relevant computational rules. In addition, the excess debt under the thin capitalization rules is excluded from liabilities for purposes of the inflation adjustment.

D. Effect of an Income Tax Treaty Between Mexico and FC

Mexico has consistently included in its tax treaties saving clauses under which the treaties concerned are not deemed to prevent Mexico or its treaty partners from applying their domestic anti-avoidance rules, including interest deduction limitation rules (such as the thin capitalization rules).

Almost half of Mexico's in force tax treaties include this type of saving clause. For instance, Article 28 of the Mexico-Germany tax treaty provides as follows:

> This Agreement shall not be interpreted to mean that a Contracting State is prevented from applying its domestic legal provisions on the prevention of tax evasion or tax avoidance, including the provisions regarding thin capitalization and preferential tax regimes.
>
> If the foregoing provision results in double taxation, the competent authorities shall consult each other pursuant to paragraph 3 of Article 25 on how to avoid double taxation.

Although the wording may vary from treaty to treaty, these clauses generally grant Mexico the right to apply its domestic law restrictions on interest deductions. For instance, Point 9 of the Protocol accompanying the Mexico-United States tax treaty provides as follows:

> If the law of a Contracting State calls for a payment to be characterized in whole or in part as a dividend or limits the deductibility of such payment because of thin capitalization rules or because the relevant debt instrument includes an equity interest, the Contracting State may treat such payment in accordance with such law.

Other saving clauses in Mexico's tax treaties go even further and, in addition to the thin capitalization rules, take into account other itemized restrictions or limitations. For example, Point 10 of the Protocol accompanying the Mexico-Austria tax treaty provides as follows in connection with back-to-back loan interest restrictions:

> With reference to Article 11.
>
> In the case of abusive transactions, interest paid on back to back loans and thin capitalization will be taxed in accordance with the domestic law of the Contracting State in which the interest arises.

This kind of provision helps to avoid disputes in which the non-discrimination rules in a tax treaty are used by taxpayers to claim exemption from domestic restrictions and limitations on interest deductions.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

As explained in I.A., above, Mexican tax law does not contain a recharacterization regime. For this reason, in determining whether a transfer of funds from a foreign entity is to be regarded as debt or an equity contribution, no attention is paid to the nature of the foreign entity. Whether or not the foreign lender is a transparent entity does not affect the characterization of the instrument or arrangement concerned as debt or equity. In any event, due regard will be given to the formal documentation of the instrument/arrangement (see I.A., above).

That being said, the anti-hybrid mismatch rules are triggered when a foreign lender is a transparent entity that is controlled by or controls a Mexican borrower. Under these rules, a Mexican taxpayer is not allowed to deduct interest payments made to a foreign related party that is controlled by or controls the Mexican taxpayer, if the foreign related party is a fiscally transparent entity (unless its members are themselves subject to taxation and the payment complies with the arm's length standard).

IV. Withholding Tax Issues

In the circumstances in which Mexican tax law provides that interest payments are to be treated as non-deductible, it does not follow that a Mexican payer is not obliged to withhold mandatory withholding tax from the payments (when this is required by law).

Mexican taxpayers are required to deduct withholding taxes from both interest and dividend payments. A withholding tax of 10% must be deducted from all dividends distributed to foreign shareholders. The withholding tax applies to dividends paid out of earnings generated after December 31, 2013.[10] In the case of interest payments, Mexican tax law provides for various withholding tax rates, generally ranging from 4.9% to 35%, the applicable rate depending on the nature of the loan concerned and the parties involved

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in the loan or financial agreement concerned. The general rate is 35%, which is reduced under most of Mexico's tax treaties to 10 or 15%.

Interest paid to a foreign entity (other than a financial institution) that is subject to a preferential income tax regime in its jurisdiction of residence is subject to withholding tax, generally at the rate of 40%, unless the jurisdiction of residence has a broad exchange of information agreement with Mexico.

Interest arising from the following is not subject to income tax and, therefore, is not subject to withholding tax:[11]

- Loans granted to the Federal Government or the Central Bank;
- Loans granted by foreign financial entities engaged in export programs, to the extent such loans have a term equal to or exceeding three years; and
- Loans granted by the above-mentioned entities to authorized non-profit entities.
- If payments made by a Mexican taxpayer qualify as interest, the deduction of the interest expense will only be allowed if the Mexican taxpayer deducts the corresponding withholding tax.

V. Difference if FCo Has a Permanent Establishment in Mexico

The general deductibility requirements described above would apply to MexCo (the borrower) regardless of the existence of a permanent establishment (PE) of FCo (the lender) in Mexico.

While all Mexico's tax treaties generally provide for a reduced withholding rate on interest, they also include a provision modelled on paragraph 4 of Article 11 of the OECD Model Convention, which provides that the reduced withholding tax rate will not apply if the beneficial owner of the interest, being a resident of the other Contracting State, carries on business in Mexico through a PE situated in Mexico and the debt-claim with respect to which the interest is paid is effectively connected with that PE. In such circumstances, the treaties provide that such interest income must be treated as income of the PE and taxed as business profits in accordance with the provisions of Article 7.

Based on the above, interest income that is attributable to a Mexican PE of an enterprise of the treaty partner country must be recognized at the level of the PE and will be subject to corporate taxation in Mexico in the same manner as income of a domestic company. Broadly, this means that the income will be subject to income tax at a rate of 30% (the corporate income tax rate) on a net basis. An important consideration will therefore be whether any cost can be attributed or documented at the level of the PE in connection with the indebtedness. An asset, risk and function analysis should be performed to determine whether and to what extent costs related to the financing activity can be allocated at the level of the PE. Such income recognition will apply regardless of whether or not the corresponding interest expense is allowed as a deduction at the level of the borrower.

There are no specific rules for determining whether interest income is attributable to a Mexican PE of a foreign enterprise. Instead, general rules establish that the income attributable to such a PE includes all income related to the business activity carried on, goods or services sold, or services rendered by the enterprise's home office in Mexico. In addition, income will be attributable to a PE to the extent the PE has participated in the expenditure incurred to generate such income.

VI. Legislative Changes

The Mexican Congress has already introduced a number of measures reflecting the recommendations of the OECD/G20 BEPS project. One of these measures relates to the non-deductibility of interest payments derived from hybrid financial instruments and transactions in the terms defined in Article 28 XXXI of the MITL. Mexico has also adopted the transfer pricing guidelines as amended by the OECD in accordance with BEPS Action 13.

Mexico is expected to implement additional BEPS recommendations, subject to certain limitations. For example, Mexico's main political parties share a political commitment not to raise taxes until 2018 (the "stability pact"). In this context, the authors understand that the Mexican government has been analyzing the possible introduction of an interest deduction limitation rule based on a percentage of EBITDA (Action 4). However, in view of the stability pact it seems this is not likely to occur under the current administration.

* * *

NOTES

[1] Mexico has a very broad concept of gross income, which encompasses any kind of increase in wealth. Thus, the gross income of a resident legal entity includes all income received in the form of cash, property, services, credit or any other form derived during the tax year including income derived by a foreign establishment of the entity (including inflationary gains attributable to monetary liabilities). Since a resident legal entity is subject to tax on a worldwide basis, its foreign-source income is also included in its gross income. Mexican Income Tax Law (MITL), Arts. 44, 45 and 46.

[2] MITL, Art. 27.

[3] MITL, Arts. 44, 45 and 46.

[4] MITL, Art. 46.

[5] MITL, Art. 27.

[6] MITL, Art. 28.

[7] Final reports on the BEPS Actions were released on Oct. 5, 2015.

[8] MITL Art. 28, para. XXIX.

[9] MITL Art. 28, para. XXXI.

[10] The dividend withholding tax was introduced with effect from fiscal year 2014. However, a grandfathering rule exempts dividends distributed out of profits already taxed at the level of the Mexican distributing company before 2014 (to this end, a Mexican company must maintain a special account the previously taxed earnings account or CUFIN).

[11] MITL, Art. 166.

THE NETHERLANDS

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I. Possibility of Dutch Tax Authorities Recharacterizing Advance of Funds by FCo to NLCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Under Dutch tax law, the classification of a funding instrument is relevant for the tax treatment of the remuneration on the funding as well as potential increases (or decreases) in the principal amount. Interest expenses incurred by a Dutch corporate taxpayer on an instrument that is regarded as a loan for Dutch income tax purposes are generally tax-deductible (subject to the limitations imposed by specific interest restrictions and transfer pricing regulations), in contrast to dividend payments made by a Dutch corporate taxpayer, which are non-deductible. Also, dividend payments made by a Dutch company are, in principle, subject to Dutch withholding tax, whereas no withholding tax is levied on interest payments made by a Dutch company on loans that qualify as such for Dutch income tax purposes. Moreover, in the case of cross-border payments, the Netherlands's tax treaties generally provide lower source country taxation rates (in some cases even a 0% rate) for interest payments than for dividend payments.

The general rule developed in Dutch case law is that a funding instrument that qualifies as a loan under Dutch civil law should, in principle, also be considered a loan for Dutch income tax purposes.[1] Under Dutch civil law, the main characteristic attributed to a debt instrument is the obligation of the borrower to repay the amount that is borrowed from the lender.[2] In addition, other relevant characteristics of a debt instrument under civil law are: the right to receive interest, a preferred ranking *vis-à-vis* shareholders in the case of the insolvency of the debtor company; and the absence of voting rights.

According to the Dutch Supreme Court, there are three exceptions to the above general rule, where:

- The loan is a "sham loan:" the borrower and the lender represent the instrument as a loan, but the actual intention of both parties is to make a capital contribution;[3]
- The loan is a "bottomless pit loan:" the lender grants a loan to a company based on its status as a shareholder in that company in such circumstances that it should have been obvious to the lender, when it granted the loan, that the loan could not be repaid (in full);[4] or
- The loan is granted on terms that, to a certain extent, give the lender, by way of the money lent, a participation in the borrower's business, i.e. the loan is a "participating loan." A loan is considered a participating loan if it meets the following cumulative requirements:[5]
  - The loan has no maturity date or the maturity date is more than 50 years after the date on which the loan was granted;
  - Repayment of the loan can only be demanded by the lender in the event of the liquidation, bankruptcy or insolvency of the borrower;
  - The loan is subordinated to all other debts and obligations of the borrower; and
  - The remuneration on the loan is completely (or almost completely) dependent on the profits of the borrower.

Both the civil law and the income tax classification of a funding transaction depend on the conditions agreed between the parties. Although the existence of a loan agreement is not a condition *sine qua non* for the existence of a loan, without proper loan documentation it may be difficult to demonstrate the existence of a loan. In particular, the presence of a repayment obligation for the recipient of the funding will be relevant in this respect. The fact that FCo treats the transaction as a loan for FC accounting and income tax purposes, while it may be an indication that it should be regarded as a loan for Dutch civil law and income tax purposes, is not decisive.

The position set out above, in principle, applies irrespective of the relationship between FCo and NLCo, with the exception of the case law concerning "bottomless pit loans," which concerns only related party situations. However, in practice, the Dutch tax authorities might be more inclined to accept the arrangement as a loan for Dutch income tax purposes if FCo and NLCo were unrelated.

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B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The classification of a funding instrument for Dutch income tax purposes, in principle, follows its classification under civil law (see I.A., above).

The fact that FCo does not treat the transaction as a loan for FC accounting and income tax purposes, while it may be an indication that it should not be regarded as a loan for Dutch income tax purposes, is again not decisive.

In practice, the Dutch tax authorities might be more willing to accept the arrangement as a loan for Dutch income tax purposes if FCo and NLCo were unrelated.

C. Difference if a Loan Agreement of Some Sort Exists

The existence of a loan agreement is in itself not a requirement for a funding transaction to be considered a loan under civil law and for income tax purposes. In general terms, a loan agreement could be of considerable help in demonstrating the terms agreed between parties, which will determine the classification of the transaction under civil law and, consequently, be relevant for the classification of the transaction for income tax purposes.

For the factors relevant for purposes of the income tax classification of a funding instrument, see I.A., above.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Under Dutch corporate income tax law, arm's-length interest expense incurred by NLCo would generally be tax deductible. Specific interest restrictions may apply depending on the use to which the borrowed funds are put and/or the relationship between the lender and the borrower (i.e., whether the lender and the borrower are related or non-related). See II.B., below for a discussion of the common restrictions on the deduction of interest.

Dutch corporate income tax law currently does not include a general rule that disallows a tax-deduction for interest paid to a lender — whether resident or nonresident — that is not taxed on the corresponding interest income.[6] In certain circumstances, however, the tax treatment of the interest income in the hands of the lender can have some relevance in determining whether an interest deduction should be allowed to the borrower.

Under Article 10a of the Dutch Corporate Income Tax Act of 1969 (CITA), generally referred to as the "anti-base erosion rules," the deduction of interest paid by a Dutch corporate taxpayer with respect to debt owed to a related party is, in principle, restricted if the debt has a connection with a "tainted transaction."[7] A "tainted transaction" exists, for example, where the taxpayer uses the funds borrowed to finance the acquisition of, or a capital contribution to, a related company, or to finance a profit distribution or a capital repayment to a related company. If a debt falls within the scope of these rules, the taxpayer can still take a tax deduction for the interest payable on the debt if it can demonstrate that either: (1) both the "tainted transaction" and the debt financing are based on business reasons; or (2) that the corresponding interest income is sufficiently taxed in the hands of the lender.[8]

In addition to this "safe harbor" provision in Article 10a of the CITA, it seems fair to suggest that, in general, the Dutch tax authorities are more inclined to accept that there are business reasons for a financing structure and that a tax deduction should be allowed for the interest expense, if the interest income corresponding to the interest expense is subject to effective taxation in the hands of the lender.

Beginning in 2019, the taxability of the interest income could become relevant for the deductibility of the interest expense, following the implementation of the Anti-Tax Avoidance Directive (ATAD)[9] — see further at VI., below.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

As of January 1, 2013, the CITA no longer includes general thin capitalization rules.[10] However, the equity funding of a taxpayer remains relevant in the context of specific interest restrictions, which are discussed in II.B., below.

The Netherlands has not adopted the OECD's proposed worldwide ratio test. The Netherlands will need to implement the earnings-stripping rule in the ATAD before January 1, 2019. The ATAD allows EU Member States to include an escape clause for corporate taxpayers that are part of a corporate group. It is not yet clear how the Netherlands will implement the earnings-stripping rule in its domestic tax law.

B. Limits on Interest Deductions Based on Other Factors

Dutch corporate income tax law imposes various interest restrictions, the most common of which are addressed in II.B.1. to 7., below. Generally, the Dutch rules that potentially restrict the deduction of interest expense focus on the relationship between the lender and the borrower and/or the use to which the borrowed funds are put.

1. Non-Business-Motivated Loans

The Dutch Supreme Court has developed the concept of a "non-business-motivated loan," primarily in response to the tax treatment of valuation losses on loans at the level of the lender.[11] This case law also affects the position of the borrower with respect to a non-business motivated loan, as discussed below.

A loan can be either business-motivated or non-business-motivated. If the interest rate agreed between the parties is not at arm's length, but can be substituted by a fixed interest rate that a non-affiliated party would have charged on a loan with similar terms, then the loan is considered to be business-motivated. If that is the case, only the interest has to be adjusted for tax purposes (see also II.B.2., below).

The situation changes if no fixed interest rate can be determined under which an independent third party would have been prepared to grant a similar loan; in this case, the loan is considered to be non-business-motivated. According to the Supreme Court, the interest rate on a non-business-motivated loan should be determined as the interest rate that the borrower

would have to pay for a third-party loan granted under similar conditions, with the borrower's parent company acting as guarantor. If the adjusted interest rate based on the above case law exceeds the interest rate applied by the parties, the excess interest will be treated as consideration for equity and, consequently, will be considered non-deductible.

2. Article 8b of the CITA (Arm's Length Principle)

Article 8b of the CITA codifies the arm's length principle. In essence, Article 8b prescribes that where affiliated entities deal with each other, they should do so on terms similar to those that would apply between unaffiliated entities in a similar transaction, in similar circumstances.[12]

A restriction applies where interest expense on debt owed to an affiliated party is not at arm's length, i.e., where the interest payable is not in line with the interest that would normally have been agreed between unrelated parties in similar circumstances. If a Dutch taxpayer incurs interest expense on a related-party debt at a rate that exceeds an arm's-length interest rate, the excess interest is treated as consideration for equity and, consequently, as non-deductible.[13]

3. Article 10.1.d of the CITA (Participating Loan)

Article 10.1.d of the CITA codifies the Dutch case law on participating loans. See I.A., above.

4. Article 10a of the CITA (Anti-Base-Erosion Rules)

See II., above.

5. Article 10bof the CITA (Interest-Free or Low-Interest Loans)

Under Article 10b of the CITA, a Dutch corporate taxpayer is not allowed to deduct (imputed) interest expense on debt owed to an affiliated party if the debt does not provide for interest remuneration or if the amount of interest agreed is substantially less than an arm's-length interest amount, and the debt either does not have a fixed maturity date or has a maturity date that is more than 10 years after the date of creation of the debt.

6. Article 13lof the CITA (Participation Interest)

Article 13l of the CITA applies to situations in which a Dutch corporate taxpayer holding participations in group companies is excessively financed with debt. Such a taxpayer is generally considered to have financed its participations excessively with debt if, and to the extent, its equity for tax purposes exceeds the acquisition price of the participations. This means that the amount of equity funding of the Dutch company can be relevant for the deductibility of interest (see II.A., above).

Article 13l of the CITA contains detailed rules for determining the excessive debt financing of participations. Interest on excessive participation debt is non-deductible. Article 13l provides for a safe harbor of 750,000 euros of interest expense (i.e., interest expense of 750,000 euros is tax-deductible regardless of the outcome of the excessive interest calculations).

7. Article 15ad of the CITA (Acquisition Interest)

Article 15ad of the CITA provides for an interest restriction in situations in which a Dutch company incurs debt for purposes of funding the acquisition of another Dutch company and both the acquiring and the target company are included in a fiscal unity for corporate income tax purposes. In essence, these rules limit the ability to deduct interest expense on the acquisition debt from the taxable profits of the target company.

The interest on the acquisition debt is deductible to the extent the acquiring company has stand-alone taxable profits. Moreover, regardless of whether the acquiring company has stand-alone taxable profits, the interest on the acquisition debt is deductible to the extent the debt does not exceed a certain percentage of the acquisition price of the shares in the target company.[14] This means that the amount of equity funding of the acquiring company can be relevant for the deductibility of interest (see II.A., above).

Article 15ad of the CITA provides for a safe harbor of 1 million euros of interest expense (i.e., interest expense of 1 million euros is tax-deductible regardless the outcome of the above calculations).

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Dutch tax law provides for limited forms of "bifurcation" with respect to debt funding.

If a lender provides a loan to a Dutch company based on the lender's status as a shareholder in that company on such terms that, when the lender provided the loan, it should have been obvious to it that the loan could not be repaid in full, the loan will be partly "reclassified" as equity for tax purposes (see I.A., above). A loan will be recognized to the extent of the fair value of the loan; the difference between the fair value and the nominal value of the loan (i.e., the "uncollectible" part of the loan) will be regarded as equity. Any interest accrued on the equity part of the loan will be considered a return on equity and consequently treated as non-deductible.

According to the parliamentary history of Article 10a of the CITA, third-party debt of a Dutch corporate taxpayer that is guaranteed by a group company will — for purposes of Article 10a — be considered related-party debt if, and to the extent that, the group guarantee enabled the taxpayer to borrow more than it would have been able to without the group guarantee.[15]Interest accrued on the part of the debt that is classified as related-party debt because of the group guarantee falls within the scope of Article 10a of the CITA and its deductibility is potentially restricted.

If a Dutch corporate taxpayer issues convertible debt, according to Dutch case law, an informal capital contribution is to be recognized at the level of the taxpayer in an amount equal to the fair value of the conversion right.[16] For tax purposes, debt will initially be recognized to the extent of the difference between the nominal amount of the debt and the "equity" part of the debt. The difference between the tax book value of the debt and its nominal value is amortized, i.e., rec-

ognized as (interest) expense over the term of the convertible debt. Such expense is treated as non-deductible for the borrower under Article 10.1.j of the CITA. The "normal interest" is in principle deductible (provided no specific restrictions apply — see above).

In addition to the above, Dutch corporate income tax law allows a transfer pricing adjustment to be made where the interest rate applied by affiliated parties on a loan for income tax purposes exceeds an arm's length rate (based on the case law regarding non-business-motivated loans and Article 8b of the CITA). This effectively results in a disallowance of part of the interest expense on the loan.

D. Effect of an Income Tax Treaty Between the Netherlands and FC

1. General

The Netherlands' tax treaties are generally in line with the OECD Model Convention. As such, in accordance with Article 9 of the OECD Model Convention, a Dutch tax treaty will generally allow the Netherlands to make tax adjustments where excessive interest payments are made by a Dutch corporate taxpayer to an affiliated lender resident in the treaty partner country.

In addition, because the Dutch rules on the classification of funding instruments and interest restrictions do not distinguish between domestic and cross-border situations, the Dutch domestic tax position on the deductibility of interest expense is not affected by the non-discrimination provision in the Netherlands's tax treaties, in line with Article 24(4) of the OECD Model Convention.

2. Effect on Withholding Tax Treatment

Interest payments on a loan that qualifies as equity for Dutch income tax purposes in certain circumstances are treated as dividends and, as such, are subject to Dutch dividend withholding tax at a rate of 15%. The same withholding tax treatment can apply to excessive interest payments on a loan for income tax purposes.[17]

The Netherlands' tax treaties may affect the Dutch withholding tax position with respect to interest payments that are treated as dividends under Dutch domestic tax rules. Generally, the tax treaties provide lower withholding tax rates (in some cases even a 0% rate) for interest payments than for dividend payments.

The Netherlands' tax treaties generally include a provision allowing the Netherlands to tax excessive interest in accordance with Dutch domestic legislation and to treat such interest as a dividend for tax treaty purposes also (in line with Article 11(6) of the OECD Model Convention).

Interest payments on loans that qualify as equity for Dutch income tax purposes will generally be treated as dividends for tax treaty purposes only if, considering all the circumstances, the lender can be regarded as effectively sharing the risks borne by the borrower, i.e., when repayment of the loan depends largely on the success or otherwise of the borrower's business.[18] In other cases, the interest payments are generally treated as interest for treaty purposes.

Some of the Netherlands' tax treaties explicitly include interest on a profit participating loan within the scope of the Dividend Article.[19]

Under some circumstances, a lender may be subject to Dutch income tax on interest received from a Dutch company in which it owns a share interest of 5% or more (a "substantial interest"). These "non-resident taxation rules" apply to both corporate and individual lenders even though the conditions are different. The classification of interest under the Netherlands' tax treaties described above also affects the Netherlands' ability to levy Dutch income tax on the interest income in the hands of the lender.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The circumstances of the lender (for example, whether the lender is taxed or exempt, a corporate body or a partnership, or resident or nonresident) should not impact the classification of a financing instrument for Dutch income tax purposes as debt or equity. The tax classification, in principle, follows the civil law treatment of the instrument (see I.A., above).

In certain specific situations, if a loan is treated as a loan for Dutch income tax purposes and if the lender and the borrower are related, the circumstances of the lender may have an impact on the deductibility of the interest payable on the loan. The circumstances of the lender may also affect its ability to rely on a tax treaty, which can be relevant if the interest payments on a loan are partly (in the case of "excessive" interest) or wholly (in the case of a loan that is treated as equity for income tax purposes) classified as dividend distributions. These situations are addressed, respectively, in III.B. and C., below.

In the case of a lender that is a foreign partnership, it is necessary to determine how the partnership is to be treated for Dutch income tax purposes. If the partnership qualifies as transparent for Dutch income tax purposes, each partner will be considered to hold a part of the loan granted by the partnership, in proportion to its interest in the partnership. In these circumstances, the tax positions of the partners and their ability to rely on a tax treaty may be relevant.

A. FC Partnership — Dutch Partnership Classification Rules

The Dutch rules for classifying foreign partnerships are laid down in a Decree of the Ministry of Finance dated December 1, 2009.[20] Under the Decree, the classification of a foreign partnership is to be determined based on the answers to the following questions:

- Can the partnership hold the legal title to assets?
- What are the liabilities of the partners? (Are the partners wholly or partially liable for the debts of the partnership?)
- Does the partnership have a capital divided into shares?
- Are the interests in the partnership freely transferable? (Can a partner join the partnership or transfer its partnership interest without the consent of all the other partners?)

Generally, a foreign partnership will qualify as transparent if it is comparable to a Dutch limited part-

nership (*commanditaire vennootschap* or CV)[21] and if the partnership interests can only be transferred with the unanimous consent of all the partners.

B. Interest Restrictions — Article 10a of the CITA

The following concerns the specific situation in which an FC partnership ("FC partnership") holds a share interest in NLCo of one-third or more and provides a loan to NLCo that is used by NLCo to fund a "tainted transaction" under Article 10a of the CITA.

If FC partnership is treated as opaque for Dutch income tax purposes, the partnership will be regarded as the lender, and, consequently, the loan will fall within the scope of Article 10a of the CITA. The deductibility of the interest on the loan will be restricted unless NLCo can demonstrate that both the "tainted transaction" and the debt financing are based on business reasons, or that the corresponding interest income is sufficiently taxed in the hands of the lender. NLCo will, in principle, not be able to invoke the second grounds for rebuttal, since FC partnership is not taxed in FC. The position may be different if the partners of FC partnership are taxed on the interest income.[22]

On the other hand, if FC partnership is transparent for Dutch income tax purposes, the partners of the partnership will be regarded as the lenders. It will then be necessary to determine whether the partners qualify as related to the borrower for purposes of Article 10a of the CITA. If the partners do not qualify as so related, the interest deduction restriction under Article 10a will not apply. If the partners do qualify as so related,[23] for purposes of determining whether the sufficient taxation rebuttal rule in Article 10a applies, it will be necessary to consider the tax treatment of the interest at the level of the partners, i.e., the foreign tax position of the partnership will be irrelevant.

C. Dividends — Tax Treaty Access

If all or part of the interest payments on the loan from FC partnership are treated as dividends for Dutch tax purposes (either because the loan is qualified as equity or because the interest is payable at a rate that exceeds an arm's-length rate) in principle, Dutch dividend withholding tax will be imposed at a rate of 15%. A reduced rate or an exemption may apply if FC partnership is able to invoke a tax treaty.

If FC partnership is treated as opaque for Dutch income tax purposes, FC partnership will be treated as the recipient of the dividends. Since FC partnership is not subject to tax in FC, in principle, it will not be able to benefit from reduced withholding tax rates under a tax treaty. However, it may be possible for the partnership to apply for a reduction of withholding tax if and to the extent the partners in the partnership would have been able to benefit from reduced treaty rates had they lent to NLCo directly.[24]

If FC partnership is treated as transparent for Dutch income tax purposes, the partners of the partnership will be considered the recipients of the dividends. It will then be necessary to consider the tax treaty position of the partners to determine whether a reduced rate or exemption from Dutch dividend withholding tax can apply.

V. Difference if FCo Has a Permanent Establishment in the Netherlands

A possible allocation of the loan to a Dutch permanent establishment (PE) of FCo, in principle, should not impact the position set out above. In practice, the Dutch tax authorities may be more inclined to accept the deductibility of interest expenses where the corresponding interest income is subject to Dutch corporate income tax.

The Dutch Ministry of Finance has set out its views on profit attribution to PEs in its Decree dated January 15, 2011.[25] These views are broadly in line with the Commentary on Article 7 of the OECD Model Convention and the OECD "Report on the Attribution of Profits to Permanent Establishments."

Based on the Decree, assets and risks must generally be attributed to the place where the "significant people functions" are performed. The "significant people functions" are linked to the people who take on and manage the risks and involve the "day-to-day" activities that are crucial to business operations. Where these activities are performed is decisive for the attribution of the economic ownership of the assets, and the risks borne by the business.

The economic ownership of financial assets, such as liquid funds and receivables, must be attributed to a PE if the "significant people functions" with respect to taking on and managing the risks associated with these assets are performed by the PE.

VI. Legislative Changes

No legislative proposals are currently pending that would introduce additional restrictions on the deduction of interest expenses. It is expected, however, that further interest deduction restrictions will be proposed and introduced over the next few years consequent on ATAD 1 and ATAD 2.[26]

ATAD 1 provides for interest limitation rules in the form of an earnings stripping rule, under which, in principle, no deduction would be given for interest expense exceeding 30% of EBITDA. The ATAD also contains rules designed to combat hybrid mismatches (situations involving hybrid entities and hybrid instruments): to the extent a hybrid mismatch results in a double deduction, a deduction is only to be allowed in the state in which the payment is sourced. If a hybrid mismatch results in a deduction without inclusion, the deduction is to be denied.

The earnings stripping rule will need to be implemented in Dutch tax law before January 1, 2019. The same applies to the rules combatting hybrid mismatches in intra-EU situations. Ultimately with effect from January 1, 2020, the latter rules should also cover hybrid mismatches with non-EU countries. This follows from ATAD 2, on which the EU Member States reached agreement on February 21, 2017.

NOTES

[1] *See, e.g.,* Dutch Supreme Court, January 27, 1988, BNB 1988/217.

[2] *See, e.g.,* Dutch Supreme Court, September 8, 2006, BNB 2007/104.

[3] *See, e.g.,* Dutch Supreme Court, January 27, 1988, BNB 1988/217. A "sham loan" does not, in fact, represent a real

exception, since it would not qualify as a loan under civil law, because under civil law, the intentions of the parties, and not the form, take precedence.

[4] See, e.g., Dutch Supreme Court, January 27, 1988, BNB 1988/217, and Dutch Supreme Court, May 24, 2002, BNB 2002/231.

[5] *See, e.g.*, Dutch Supreme Court, March 11, 1998, BNB 1998/208.

[6] As of 2016, the Dutch Corporate Income Tax Act of 1969 (CITA) contains a specific "mismatch clause" for "interest" income. In accordance with the EU Parent-Subsidiary Directive, a section has been added to the Dutch participation exemption provisions that stipulates that the participation exemption (which results in the tax-free receipt of income from qualifying shareholdings) does not apply if the payment concerned has been deducted at the level of the subsidiary (the "debtor").

[7] An entity and a taxpayer would generally be considered related if: the entity holds a direct or indirect share interest of one-third or more in the taxpayer; the taxpayer holds a direct or indirect share interest of one-third or more in the entity; or a third party holds a direct or indirect share interest of one-third or more in both the entity and the taxpayer.

[8] Even if the interest is sufficiently taxed in the hands of the lender, the interest expense deduction is still restricted if the Dutch tax authorities can make a *prima facie* case that the "tainted transaction" and the debt financing are not based on business reasons.

[9] Council Directive (EU) 2016/1164 of July 12, 2016 (ATAD, also sometimes referred to as "ATAD 1")

[10] Under former CITA, Art. 10d (which applied from January 1, 2004, until December 31, 2012) generally, the maximum allowable debt-to-equity ratio was 3:1 or a ratio equal to the debt-to-equity ratio of the taxpayer's group, if the latter was more advantageous to the taxpayer. Under Art. 10d, only interest on related party debt was restricted.

[11] *See, e.g.*, Dutch Supreme Court, May 9, 2008, BNB 2008/191, and Dutch Supreme Court, November 25, 2011, NTFR 2011/2722.

[12] Two entities are affiliated within the meaning of CITA, Art. 8b if one entity participates in the management of the other entity (or vice versa), or if a third person participates in the management of both entities.

[13] Conversely, if the interest rate applied is lower than an arm's-length rate, an imputation of interest expense for tax purposes is generally allowed.

[14] 60% at the end of the financial year in which the target company was acquired, 55% at the end of the following financial year, 50% at the end of the second following financial year, etc. until a final percentage of 25% is reached.

[15] Explanatory Memorandum, Parliamentary Papers II 1995/96, 24.696, nr. 3, pp. 16-17.

[16] See, e.g., Dutch Supreme Court, October 12, 2007, BNB 2008/6.

[17] A dividend will be considered to have been paid where the interest payments are made to a direct or indirect shareholder or sister company of the taxpayer.

[18] See Sec. 25 of the Commentary on Art. 10(3) of the OECD Model Convention.

[19] E.g., the Netherlands-Luxembourg tax treaty.

[20] Nr. CPP 2009/519M.

[21] A Dutch CV does not have legal personality. The general partner of a CV is fully liable for the debts of the CV; the limited partners are liable only to the extent of the equity they contribute to the CV.

[22] According to the Decree of the Ministry of Finance dated March 25, 2013, nr. BLKB 2013/110M, BNB 2013/136, where the lender is a company, the "taxation test" may be met if the interest income is taxed not in the hands of the lender, but in the hands of a shareholder of the lending company Agreed under local controlled foreign company (CFC) rules. It could be argued that this approach should also apply in the case of a hybrid foreign partnership where the partners are taxed on the interest income of the partnership.

[23] The partners will qualify as related parties if they constitute a "collaborative group" and together own one-third or more of NLCo, which may be the case considering they are "joined" in the partnership.

[24] This treatment is based on the Decree of the Dutch Ministry of Finance dated March 19, 1997, nr. IFZ97/204, regarding the application of tax treaties in situations involving foreign hybrid entities.

[25] Decree dated January 15, 2011, nr. IFZ2010/457M.

[26] ECOFIN Council meeting agreement on a general approach to the Council Directive amending Directive (EU) 2016/1164 regarding hybrid mismatches with third countries.

SPAIN

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I. Possibility of Spanish Tax Authorities Recharacterizing Advance of Funds by FCo to SpanishCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

The principal tax advantage of debt over equity is the potential tax deductibility of the interest payable with respect to debt (subject to the limitations described below), whereas the payment of a dividend with respect to equity does not give rise to a deduction.

Spain's thin capitalization rules (which applied until 2012) restricted the deductibility of interest paid to related entities of the borrowing company, broadly speaking, where the total net debt exceeded a debt-to-equity ratio of 3:1. Although the thin capitalization rules were abolished (and replaced by rules that limit the tax deductibility of financial expenses, as explained below), there are a number of situations in which a tax deduction for interest payments can be denied under increasingly complex anti-avoidance legislation, and the corresponding debt instrument recharacterized as equity:[1]

- Most importantly, Spain's transfer pricing legislation, which applies to both interest expenses and principal amounts, can restrict interest deductibility where the level of funding exceeds that which the company concerned could have obtained from an unrelated third party or the interest rate charged is higher than an arm's-length rate.
- The tax authorities can also reject the tax deductibility of interest expenses under the anti-avoidance provisions of the General Tax Law (i.e., on the recharacterization of debt as equity).
- With effect for tax periods starting on or after January 1, 2015, the Spanish Corporate Income Tax (CIT) Act applies the following restriction/recharacterization rules with respect to hybrid financial instruments ("anti-hybrid provisions"):
  - The return accrued on hybrid financial instruments representing share capital or equity of the issuer (for example, non-voting shares or redeemable shares) is to be characterized as a dividend for CIT purposes regardless of its characterization for accounting purposes.
  - Interest accrued on profit participating loans (granted after June 20, 2014) when the lender and the borrower form part of the same accounting group is characterized as a dividend for CIT purposes (and is therefore non-tax deductible), regardless of the tax residence of the lender.
  - Interest accruing on a financial arrangement entered into by a Spanish borrower with a related party is not tax deductible for the borrower if such interest is characterized as a dividend in the lender's jurisdiction and as a consequence of this tax characterization the income is tax exempt in the lender's jurisdiction or subject to a nominal tax rate lower than 10%.

In order to justify additional debt in the form of a shareholder loan, the authors strongly recommend that the level of additional debt (and its remuneration) should be established in advance by means of a transfer pricing study. In the authors' experience, the preparation of a prospective study in the form of a "Defense File" is to be highly recommended. Companies that are to be involved in certain financial controlled transactions should be analyzed in the Defense File with a view to achieving compliance with the arm's length principle as described in the OECD Transfer Pricing Guidelines.[2] Generally speaking, the objective of the Defense File should be:

- First, to determine an arm's-length indebtedness level for companies engaged in comparable activities to those engaged in by the subject company. A debt capacity analysis should be undertaken with respect to a number of borrowers in order to assess the overall leverage achievable by comparable borrowers to the subject company. This would entail, among other things, reviewing financial covenants embedded in potential comparable loan transactions.[3]
- Second, to determine the arm's-length interest rate applicable to intercompany loans through a comparability analysis.

The arm's length principle is the international standard that mandates that transactions between related-parties take place under terms and conditions that are comparable to those that would be made between uncontrolled parties engaged in comparable transactions.

In the case of FCo and SpanishCo, the courts would look primarily to the terms of the arrangement to determine whether the instrument represents debt or equity. The fact that FCo and SpanishCo are related does not in itself incline towards either debt or equity treatment; instead it invites comparison with debt between unrelated parties.

It is envisaged that FCo has not produced any documentation of the advance. If FCo and SpanishCo are

ISSN 0143-7941

not related, the lack of documentation would incline towards equity treatment, but would be considered in combination with the other relevant factors. If FCo and SpanishCo are related, however, the lack of a properly documented analysis would be more problematic, since it is unlikely that an unrelated lender would lend a significant amount of funds to a borrower without previous risk analysis. The existence of a hypothetical true debt instrument standard puts pressure on FCo and SpanishCo as related parties.

The Spanish tax authorities' approved guidelines regarding the General Tax Control Plan focus specifically on transactions between related parties whose sole purpose is to transfer, through intragroup transactions, income that should be taxed in Spain to other group entities resident in jurisdictions with lower tax rates.

Tax audits are usually initiated at the discretion of the tax authorities under the General Tax Control Plan guidelines (as approved each year) or if specific information comes to light that indicates that a particular taxpayer has not complied with its tax obligations. Highly relevant in this context are the new sources of information available to tax authorities in the current post-BEPS environment, such as country-by-country reporting, which may lead to an increase in the number and sophistication of tax audits carried out in Spain.

It should also be noted that, in the course of any tax audit, the tax authorities may recharacterize facts, activities, operations and businesses, overriding the previous characterizations made by the taxpayer in these respects.

In the authors' view, it is much more likely that a transaction will be recharacterized or disregarded when it is a controlled transaction, because of the relative ease with which this may be done under Spain's new transfer pricing rules as compared with what is required in the case of a transaction between unrelated parties.

A Spanish company prepares transfer pricing documentation for two key purposes:

- To demonstrate compliance with the arm's length principle.
- To provide the company with penalty protection.

Regarding penalties, it is worth noting that Spain's special transfer pricing penalty regime is very closely linked to adequate compliance with the documentation requirements. Where a taxpayer fails to comply with these requirements, the tax administration is authorized to impose penalties of up to 1,000 euros for each non-documented "single relevant data item" or 10,000 euros for each non-documented "group of relevant data items" if the lack of documentation does not result in any correction of the valuation of the related party transaction(s) concerned. However, the amount of the penalty is capped at the lower of the two following amounts:

- 10% of the amount of the controlled transactions carried out by the company in a given year; or
- 1% of the net sales of the company.

If the lack of documentation does result in a transfer pricing adjustment with respect to the transaction(s) concerned, the penalty will amount to 15% of the adjustment.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The position would be the same as that set out at I.A., above.

C. Difference if a Loan Agreement of Some Sort Exists

See the position set out in I.A., above.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

The CIT Act provides for the following limitations on tax deductions for financial expenses:

- Interest on debt incurred within a corporate group in order to acquire a participation in the capital or equity of any entity from another group entity or to make a capital or equity contribution to another group entity is not tax-deductible. The restriction does not apply if the taxpayer can provide evidence to the effect that there are valid economic reasons for the underlying transactions.
- Net financing expenses are deductible only up to the higher of 1 million euros or 30% of operating profit.
- There is an additional limit on the deduction of financial expenses relating to debt incurred in order to purchase an interest in any kind of company (the "LBO provision"). Under the LBO provision, in computing the operating profit for purposes of applying the 30% limit on the deduction of interest payable by the acquiring company on the debt borrowed to acquire the target entity, the operating income of a target entity that: (1) in the following four tax periods joins the acquiring company's tax group; or (2) in the following four tax periods, merges with the acquiring company, is excluded. The restriction does not apply if the debt does not exceed 70% of the purchase price of the shares and is reduced, from the time of acquisition, at a minimum by the proportion of the debt relating to each of the following eight years until the debt is reduced to 30% of the purchase price. The restriction does not apply to entities included in a tax group or restructuring transactions carried out before June 20, 2014.
- The anti-hybrid provisions discussed in I.A., above may also apply.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

See the comments in I.A. and II., above. Spain has not adopted the OECD's worldwide ratio test, and is not expected to do so.

B. Limits on Interest Deductions Based on Other Factors

See the comments in I.A. and II., above.

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Spain's transfer pricing rules enable the tax authorities to make adjustments that may have the effect that a part of a borrowing company's interest expenses are not tax-deductible, as discussed above. Specifically

the tax authorities can challenge the arm's length nature of the interest rate and/or the company's level of indebtedness. If, based on a challenge to the indebtedness level of the company, the tax authorities conclude that the company's debt is not in compliance with the arm's length standard, they may recharacterize/disregard the transaction(s) at issue.

D. Effect of an Income Tax Treaty Between Spain and FC

Spain's tax treaties generally do not include provisions that directly limit the deductibility of interest. Many of Spain's treaties do, however, include a provision that denies treaty benefits with respect to that portion of an interest payment between related parties that exceeds the interest that would be payable at an arm's-length rate, as well as including beneficial ownership clauses.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

The Spanish tax considerations described above are generally applicable where the lender is a pass-through as well as where the lender is a corporate body (the proportionate share of the items of income derived by a partnership is allocated to its partners as taxable income).

If FCo is treated as transparent for FC tax purposes, but as a taxable entity for Spanish tax purposes, then FCo will be considered a "reverse hybrid" within the meaning of ATAD 2.[4]

IV. Withholding Tax

The recharacterization of SpanishCo's debt as equity could have significant consequences with respect to the Spanish withholding tax applicable to SpanishCo's payments to FCo.

Generally, Spain imposes withholding tax at the rate of 19% on payments of Spanish-source income to a foreign person, subject to the effect of tax treaty provisions and EU legislation. The Spanish Non-Resident Income Tax Act provides exemptions for the following kinds of income derived by a nonresident other than through a Spanish permanent establishment (PE): (1) interest on Spanish public debt; (2) interest on a non-resident account; (3) interest on bonds issued by Spanish securitization funds; (4) income from preferred shares, to the extent certain requirements are met; and (5) interest paid to an entity or individual resident in another EU Member State, provided that State does not qualify as a tax haven.

V. Difference if FCo Has a Permanent Establishment in Spain

If FCo has a PE in Spain, FCo's income will be treated in one of two ways. First, FCo's Spanish-source income that is not attributable to the PE will be taxed in the same way as it would have been if FCo did not have a Spanish PE, i.e. ,as described in IV., above. Second, FCo's interest or dividend income received from SpanishCo that is attributable to FCo's PE in Spain will be taxed at the standard CIT rate of 25% (generally in accordance with the same rules as apply to Spanish subsidiaries).

In addition, the remittance of profits to a foreign head office is taxable in Spain at a rate of 19% ("branch profits tax"). The branch profits tax does not apply if the head office is located in: (1) an EU Member State (unless the country or territory in which it is located is regarded as a tax haven); or (2) a country that has concluded a tax treaty with Spain, unless the treaty concerned expressly permits the branch profits tax to be imposed.

The factors that determine whether income is attributable to a Spanish PE must be analyzed on a case-by-case basis. That being said, it is the authors' experience that the Spanish tax authorities are adopting an increasingly aggressive position on this issue.

Finally it should be noted that hybrid PE mismatches are also addressed in ATAD 2.

VI. Legislative Changes

No specific legislative changes that would affect Spanish-resident corporations and their foreign lenders are currently pending before the Spanish Congress.

NOTES

[1] With a view to neutralizing the advantageous tax effects of hybrid instrument mismatches, the OECD and G20 members have proposed a comprehensive set of coordination rules to be implemented at domestic law level — see Neutralizing the Effects of Hybrid Mismatch Arrangements, BEPS Action 2 (published on October 5, 2015) and Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, BEPS Action 4 (published on December 22, 2016). In essence, the coordination rules require a jurisdiction to examine the tax treatment of the hybrid instrument by the counterparty jurisdiction when deciding the tax treatment to be accorded to that instrument by the first jurisdiction.

Spain's policy is also to seek the inclusion of anti-hybrid provisions in its tax treaties. Spain has introduced unilateral measures to adjust the tax treatment of hybrid entities and instruments (ax explained below).

[2] The current OECD Transfer Pricing Guidelines ("Transfer Pricing Guidelines for Multinational Companies and Tax Administrations") represent a revision of the OECD Report, "Transfer Pricing and Multinational Enterprises," issued in 1979. The OECD Guidelines were approved by the Committee on Fiscal Affairs on June 27, 1995, and by the OECD Council for Publication on July 13, 1995. The current version was approved by the Council on May 23, 2016.

[3] Based on data provided by such sources as the Bloomberg database.

[4] On February 21, 2017, the 28 EU Finance Ministers agreed in an ECOFIN council meeting on a general approach to Council Directive 2016/1164 regarding hybrid mismatches with third countries (ATAD 2) with a view to adopting the approach, subject to receiving the opinion of the European Parliament and to legal-linguistic revision.

SWITZERLAND

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I. Possibility of Swiss Tax Authorities Recharacterizing Advance of Funds by FCo to SwissCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

From a Swiss law perspective, loan agreements can be concluded orally and do not necessarily require written documentation.[1] Based on the general rule regarding the burden of proof, the tax authorities have the burden of proving facts giving rise to (an increase in) taxation, while it lies with the taxpayer to prove facts resulting in a tax deduction/a reduction in taxation.[2] Therefore, the taxpayer generally has the burden of proving that it owes funds under a loan agreement and that it has to pay (tax deductible) interest on the loan concerned. Given that a gratuitous contribution/distribution is not generally assumed unless explicitly agreed to, an amount transferred to another party without any other specific reason will be repayable and therefore qualifies as a debt of the recipient. Against this background, the Swiss tax authorities usually accept loan arrangements without an agreement in written form (in the case of certain other arrangements, in particular escrow arrangements, the Swiss tax authorities generally demand an agreement in writing[3]). Thus, the Swiss tax treatment of a loan as such would not be denied merely because there was no written documentation of the lending arrangement — at least provided there was a proper accounting record and a journal voucher showing evidence of the actual transfer of the loan amount and of the interest payments made under the loan.

That being said, failure to document a lending arrangement in writing, at least if the amount concerned is not insignificant, is unusual and not in keeping with good corporate governance.[4] If the lending arrangement is between related parties and compliance with the arm's length principle is in question, the Swiss tax authorities often adduce the lack of written documentation as an indication that an intra-group lending arrangement is not at arm's length.[5] In this context, if the rate of the interest paid by SwissCo to FCo were to exceed the safe haven interest rate published by the Swiss Federal Tax Administration (see II.C., below), it would become significantly more difficult to prove that the interest actually paid was still at arm's length where the interest rate was not formally agreed in advance as it would have been between unrelated parties.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

In the context of outbound investments, Swiss federal income tax legislation contained provisions preventing hybrid mismatch arrangements long before the issue was addressed by the OECD: In order for the corresponding income item to be classified as a dividend benefitting from participation relief, a payment made by a subsidiary to its Swiss parent may not be tax-deductible at the level of the subsidiary. If the payment is so deductible, the participation reduction (which generally results in virtual tax exemption) does not apply, and the corresponding income item is taxed at the level of the Swiss parent as if it were interest income.[6] For cantonal tax purposes also, income derived under hybrid financing arrangements is generally not classified as dividend income, and the participation reduction (which again generally results in virtual tax exemption) is, therefore, denied.[7] In short, for many years Switzerland has had in place the primary response to a deduction/no income hybrid mismatch resulting from a hybrid loan, as recommended in the final OECD Report on BEPS Action 2.[8]

In the context of an inbound investment, however, such as that at issue here, there are no explicit rules preventing a hybrid mismatch. First, Switzerland neither has controlled foreign corporation (CFC) legislation nor otherwise requires that (interest) income should be taxed at the level of the lender. Before the hybrid mismatch issue was raised by the OECD and the European Union, inbound investments using hybrid loans were regularly used to obtain a tax deductible interest expense in Switzerland, while at the same time the corresponding income was treated as dividend income in the non-Swiss lender's country of residence and, therefore, not taxed at the level of the lender. In particular, such hybrid loan structures were used in arrangements involving lending entities tax resident in Luxembourg.[9]

While hybrid financing arrangements are no longer typically seen in Switzerland, an inbound investment situation resulting in a hybrid mismatch is basically still possible. The mere fact that a financing arrangement qualifying as a loan from a Swiss tax perspective is not treated as a loan for FC tax purposes does not result in its recharacterization for Swiss tax purposes. Moreover, according to Swiss doctrine, loans with special features such as a perpetual term (which may only be possible in the case of a loan that is not governed by Swiss law) or a variable interest rate are generally classified as loans rather than as equity.[10] The

doctrine states that the decisive criterion for determining whether a mezzanine finance instrument generally qualifies as debt for Swiss tax purposes is whether the investor has a claim to repayment of the invested amount before the equity investors are satisfied, even if the claim to repayment is suspended and/or subordinated to the claims of other creditors.[11]

While the fact that the foreign law classification produces a hybrid mismatch generally does not compel the Swiss tax authorities to reclassify a hybrid loan as equity, there are scenarios in which the Swiss tax authorities may reclassify a loan as an equity instrument. If the instrument concerned is treated as a loan for Swiss statutory accounting law purposes, it may only be recharacterized as an equity instrument to the extent there exists a legal basis allowing a deviation from the statutory financial statements (which are generally binding for Swiss income tax classification purposes). In particular, such recharacterization may occur in the following circumstances:

- **Non-compliance with the arm's-length principle:** If the features of a financial arrangement between affiliates deviate from the features that would be agreed on between independent parties, the tax authorities may tax the arrangement as it would have been agreed on between independent third parties. This applies both as regards the characterization of the hybrid loan as either debt or equity and as regards the characterization of the remuneration under the arrangement as either interest or dividends. As regards the recharacterization of the loan, Swiss tax law allows debt between related parties that has the economic function of equity to be treated like equity.[12] For this purpose, the Swiss Federal Tax Administration has published safe haven thin capitalization rules that list the minimum equity percentage for each category of assets.[13] If the actual weighted equity percentage of all assets falls below the threshold, debt owed to related parties is reclassified as equity, unless the borrowing company provides evidence to the effect that an independent third party would have granted the same amount as debt. The limitation on interest tax deductions that applies in these circumstances is outlined in II.B., below.
- **General anti-tax-avoidance scheme:** According to long-standing Swiss practice, tax avoidance is deemed to exist, based on the *bona fide* principle, if: (1) the taxpayer chooses an unusual/peculiar/artificial fact pattern that is not appropriate to the economic situation; (2) the fact pattern is chosen in order to save taxes; and (3) the chosen fact pattern would actually result in substantial tax savings (as compared to an economically appropriate approach) if accepted by the tax authorities.[14] If tax avoidance is assumed to have occurred, the tax authorities levy tax based on a fiction under which an usual and appropriate fact pattern is deemed to have been implemented rather than the artificial fact pattern chosen. Thus, where SwissCo borrowed funds in circumstances in which the lending arrangement chosen would be unusual/peculiar/artificial, the tax authorities and courts might deny the tax deductibility of "interest" payments under the arrangement based on the general anti-tax-avoidance rules, in particular where SwissCo's interest payments are exempt from taxation at the level of FCo and the arrangement appears to have been adopted solely in order to achieve such a hybrid mismatch. If, however, the fact pattern is based on valid economic reasons, there is no tax avoidance for Swiss tax purposes regardless of the principal purpose of the financial arrangement and regardless of its tax outcome.
- **Economic approach:** Under the economic approach, the terms of the tax laws may be interpreted in accordance with the underlying economic situation. It is a matter of controversy in Swiss doctrine whether a formal loan arrangement can be recharacterized as equity for Swiss tax purposes in a situation in which the lender assumes business risks of the borrower.[15] In particular, this would include a situation in which, rather than receiving repayment of the borrowed principal amount upon completion of the term, the lender receives a repayment the amount of which varies based on the business results of the borrower. The presence of features such as subordination, profit participation without any loss participation, a very long term, etc., is, however, as such, generally not regarded as being sufficient for a loan arrangement to be recharacterized as equity for Swiss tax purposes.[16]

While the arm's length principle can only justify the reclassification of formal debt as equity if FCo and SwissCo are related parties, reclassification based on the general anti-tax-avoidance scheme or the economic approach is theoretically also conceivable with respect to an arrangement between unrelated parties. In practice, however, reclassification of a formal loan as equity only occurs based on the thin capitalization rules, which are relevant exclusively in financing arrangements between related parties. In a recent court case, the Swiss Federal Supreme Court decided that the thin capitalization rules may also apply to a lending arrangement between unrelated parties in a situation in which a loan is only granted by an independent third party lender because of a security provided by an affiliate of the borrower.[17]

C. Difference if a Loan Agreement of Some Sort Exists

Since neither Swiss commercial law nor Swiss tax law requires that a loan agreement must be documented in written form (see I.A., above),[18] the actual terms of a loan agreement (as orally agreed and as reflected in the financial statements and in the payments made by the parties) are decisive, rather than whether or not written loan documentation exists. Nonetheless, where the rate of interest paid by SwissCo exceeds the safe haven interest rate published by the Swiss Federal Tax Administration (see II.C., below) and the tax deductibility of the interest based on the arm's length principle is therefore questioned by the tax authorities, the existence of a written loan agreement in a form that would usually be used between independent third parties would support an argument to the effect that the terms agreed in the written loan agreement were at arm's length (see I.A., above).

   ISSN 0143-7941

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Under Swiss income tax law, a company may generally deduct any kind of payment to the extent the payment: (1) was recorded as an expense in its statutory profit and loss statement; and (2) was made for business reasons.[19] Interest payments are, therefore, generally income tax deductible at the level of the borrower regardless of the tax treatment of the interest income at the level of the lender. A tax deduction will only be denied to the extent:

- The interest payment was not made for business reasons (for example, the loan is used to finance the costs of a related party without adequate compensation); or
- The interest is paid to a related party and the relevant conditions are not at arm's length because the debt financing of the borrower is too high (see II.B., below) and/or the interest rate on the debt is excessive (see II.C., below).

A. Specific limits on Interest Deductions Based on the Ratio of Debt to Equity

The Swiss Federal Tax Administration has published safe haven debt-to-equity ratios for every kind of asset (see I.B., above). If a Swiss borrower's debt owed to related parties exceeds the cumulative relevant debt percentage, the excess debt is treated as equity for Swiss tax purposes, unless the actual lending arrangements between the related parties still qualify as being at arm's length. According to Swiss practice, the burden of proving that a lending arrangement is at arm's length lies with the taxpayer in cases where the safe haven debt-to-equity ratios are not respected. To the extent no proof can be provided that the actual lending arrangement is at arm's length, the excess debt is subject to capital tax.

The tax deductibility of interest payments on debt exceeding the safe haven debt-to-equity ratio is calculated as follows:

Actual interest paid to related parties – (safe haven interest rate[20] × maximum acceptable debt based on the thin capitalization rules) = debt not accepted as deductible for Swiss income tax purposes.

The safe haven debt-to-equity ratio takes into account only the (fair value of the) assets of the borrowing entity concerned. A cap on the tax deductibility of interest correlated with any other financial ratio such as EBITDA as recommended in BEPS Action 4 on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments would have no legal basis in Swiss tax law. No such cap is, therefore, applied by the Swiss tax authorities. In particular, a limitation on the tax deductibility of interest linked to the EBITDA of a group as a whole would be an uncomfortable — indeed impossible — fit with current Swiss tax principles because Swiss corporate income tax law does not provide for any income tax consolidation within a group, but rather taxes each legal entity within a group on a separate basis.

B. Limits on Interest Deductions Based on Other Factors

Irrespective of the amount of debt financing, interest payments are not accepted as tax-deductible expenses to the extent the interest rate exceeds an arm's length rate. In this context, the Swiss Federal Tax Administration every year publishes safe haven interest rates. In 2017, the safe haven interest rates from the borrower's perspective for CHF-denominated loans are:[21]

- Mortgage-backed loans:
  - ∘ Residential and rural real estate: 1% on loans of up to 66.6% of fair value, 1.75% on loans in excess of that percentage; and
  - ∘ Industrial and commercial real estate: 1.75% on loans of up to 66.6% of fair value, 2.25% on loans in excess of that percentage.
- Unsecured loans:
  - ∘ Manufacturing and trading: 3% on loans of up to CHF 1 million, 1% on loans in excess of that amount: and
  - ∘ Holdings and asset management: 2.5% on loans of up to CHF 1 million, 0.75% on loans in excess of that amount.

The Swiss Federal Tax Administration also publishes safe haven interest rates for loans denominated in other currencies (currently, for example, 0.75% for euro-denominated loans and 2.5% for US dollar-denominated loans).[22]

The basis for determining these safe haven interest rates is not published. In tax litigation proceedings, the authors have learnt that the assessment of the CHF safe haven interest rates is based on the weighted and rounded average return on 10-year bonds issued by the Swiss Federation and the cantons, as well as return on long-term loans on the Swiss capital market. Based on the general rule allocating the burden of proof, the tax authorities would have to provide evidence in a case in which they were attempting to deny a deduction for an interest payment on the grounds that it was not in compliance with the arm's length principle. However, in practice, if the safe haven interest rates are exceeded, the tax authorities will deny a tax deduction for the excess interest payments, unless the taxpayer provides evidence of compliance with the arm's length principle. In this context, it is generally not regarded as sufficient proof to invoke a reference rate such as LIBOR — instead, evidence must be provided of the arm's length interest rate in the specific case at hand, such as a third party offer to the taxpayer concerned.[23]

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Where the tax deductibility of interest is challenged in the context of interest payments between related parties, the tax authorities can only deny tax deductibility in the amount of the excessive interest. Where an interest rate is excessive, the amount of the non-deductible interest equals the difference between the interest paid and the maximum arm's length interest (i.e., the safe haven rate, unless there is evidence of a higher arm's length rate). For the calculation of the

non-deductible interest amount in the case of excessive debt/violation of the thin capitalization rules, see II.A., above.

D. Effect of an Income Tax Treaty Between Switzerland and FC

Most of Switzerland's tax treaties broadly follow the OECD Model Convention. As far as the authors are aware, no Swiss treaty contains any specific clause regarding limitations on the tax deductibility of interest payments. Under Swiss law, the tax deductibility of interest paid at a rate exceeding an arm's-length interest rate and of interest on loans exceeding an arm's-length debt ratio is denied only to the extent the transaction concerned is entered into between related parties. The denial of interest tax deductibility based on the arm's length principle is generally admissible under treaty provisions corresponding to Article 9(1) of the OECD Model Convention.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Whether FCo is treated as opaque or transparent for FC tax purposes is generally not crucial for Swiss domestic tax purposes. Provided SwissCo is a legal entity with its own legal personality separate from FCo (and not a mere branch of FCo), SwissCo's arm's length interest payments to FCo will generally be tax-deductible.

IV. Withholding Tax Issues

In the scenario envisaged here, the following Swiss withholding taxes might apply:

(1) Withholding on account of FCo's income tax liability on the interest payments made to it by SwissCo, which would apply if the loan with respect to which the interest is paid were secured by Swiss real estate (the withholding tax rate equals the applicable corporate income tax rate, which depends on the canton and municipality concerned);

(2) Federal interest withholding tax on payments to FCo that are classified as interest payments, if the loan is classified as a "bond," a "cash bond" or a "customer credit balance" for Swiss federal withholding tax purposes (the statutory withholding tax rate is 35%, which is grossed up to 53.85% if not passed on to the statutory recipient of the taxable payment); and

(3) Federal dividend withholding tax on the interest paid to a related party at a rate that exceeds an arm's-length interest rate or where the debt is excessive under the debt-to-equity rules: such interest is classified as a constructive dividend for Swiss withholding tax purposes (the statutory withholding tax rate is 35%, which is grossed up to 53.85% if not passed on to the statutory recipient of the taxable payment).

Outside of the above circumstances, no Swiss withholding tax may be imposed in the scenario envisaged here.

Interest withholding tax can only be imposed on an interest payment that is actually classified as an interest payment for Swiss tax purposes and then only in one of the situations described above in (1) and (2). According to the practice of the Swiss Federal Tax Administration, a "bond" is deemed to exist for Swiss withholding tax purposes if a Swiss borrower either: issues a formal bond; or enters into a term loan with written documentation and a principal amount of at least CHF 500,000, where there are more than 10 non-bank lenders. A "cash bond" is deemed to exist for Swiss withholding tax purposes if a Swiss borrower either: issues a formal cash bond; or enters into term loans with written documentation in the aggregate principal amount of at least CHF 500,000, where there are more than 20 non-bank lenders.[24] A "customer credit balance" is deemed to exist for Swiss withholding tax purposes where either: a Swiss borrower receives cash deposits in its capacity as a bank; or a Swiss borrower that is not a licensed bank receives aggregate cash deposits in excess of CHF 5 million and the number of non-bank lenders exceeds 100.[25] For Swiss federal withholding tax purposes, a loan formally owed by a non-Swiss group company may be reclassified as a "bond" or "cash bond" if the above thresholds are met by the non-Swiss group company in a situation in which: (1) the Swiss group company has issued a guarantee for to secure the loan owed by the non-Swiss group company; and (2) that non-Swiss group company forwards funds exceeding its equity to the Swiss company.[26]

While Swiss interest withholding taxes may only be imposed within the limited scope of the scenarios described above, Swiss federal dividend withholding tax applies to any kind of (formal or constructive) dividend.[27] Thus, Swiss dividend withholding tax always applies to an interest payment that is not recognized as an interest payment for Swiss tax purposes and is reclassified as a constructive dividend.

The distinction between withholding tax on interest payments and withholding tax on dividends is also relevant in the context of most of Switzerland's tax treaties. While many of Switzerland's treaties provide for a full exemption from withholding taxes on interest payments, most provide for a residual withholding tax rate on dividends. Based on the practice of the Swiss federal tax administration, the reduced dividend withholding tax rate on dividends paid to qualifying shareholders is only granted if the interest/constructive dividend is directly paid to the shareholder. However, if the interest/constructive dividend is paid to another affiliate, the portfolio rate (i.e., the residual withholding tax rate of usually 15%) applies. The recharacterization of interest payments as constructive dividends will, therefore, generally have a significant impact for Swiss withholding tax purposes.

Deduction of the withholding tax due is not decisive for the deductibility of an interest payment from taxable income at the level of the Swiss borrower.

V. Difference if FCo Has a Permanent Establishment in Switzerland

If FCo has a permanent establishment (PE) in Switzerland, the loan would be allocated to the Swiss PE if it were functionally part of the PE's business activity rather than of the business activity carried on at FCo's non-Swiss headquarters. A Swiss PE of a foreign company must prepare financial statements in accordance

   ISSN 0143-7941

with Swiss statutory accounting law.[28] Such financial statements must reflect all assets, income and expenses relating to the PE's activities. The Swiss tax assessment is made based on these financial statements under the same rules as apply to a Swiss company, as if the Swiss PE were a separate legal entity.[29] The liabilities are generally allocated based on the thin capitalization rules with regard to the PE's assets. Normally, the Swiss tax authorities base their assessment on the financial statements submitted with the tax return. However, if the tax authorities notice that a loan not reflected in the Swiss PE's financial statements functionally belongs to the PE rather than to the non-Swiss headquarters (for example, where the loan agreement was negotiated by the PE's staff), the loan may be reallocated to the PE. While a Swiss PE of FCo would generally not be entitled to tax treaty benefits, it would generally be entitled to a full refund of Swiss federal withholding tax under Swiss domestic tax law with respect to income items functionally allocated to it and taxed in its hands.[30] Entitlement to a refund would, however, lapse if the income subject to federal withholding tax was not duly recorded as an income item in the PE's statutory financial statements.[31]

VI. Legislative Changes

No legislative changes are currently pending that would amend Swiss domestic tax law with respect to the Swiss tax classification or recharacterization of interest payments on hybrid loans. However, Switzerland has been involved in the negotiation of the Multinational Convention to implement tax treaty related measures to prevent base erosion and profit shifting (MLI). The Swiss Federal Council has already expressed its intention to sign the MLI and implement its provisions in the context of Switzerland's tax treaties. While Switzerland's domestic tax law already prevents the use of hybrid loans in the case of outbound investments, future amendments to Switzerland's tax treaties in accordance with the MLI will likely also prevent the use of hybrid structures for inbound investments in the future as well.

NOTES

[1] Swiss Code of Obligations (CO) dated March 30, 1911, arts. 312 *et seqq.* in conjunction with art. 11(1).

[2] Decision of the Swiss Federal Supreme Court 92 I 253 dated October 5, 1966, consideration 2.

[3] Circular S-02.101 of the Swiss Federal Tax Administration regarding Escrow Accounts (*Merkblatt: "Treuhandkonto"*) dated May 31, 1965.

[4] Corporate law explicitly only requires a written agreement if the same individual is acting on behalf of both the lender and the borrower (CO, arts. 718b, 814(4), 899a).

[5] Decision of the Zurich Administrative Court SB.2013.00008 dated June 25, 2014, consideration 2.3.

[6] Swiss Federal Act on the Direct Federal Tax, dated December 14, 1990 (DBG), art. 70(2)(b).

[7] Felix Richner/Walter Frei/Stefan Kaufmann/Hans Ulrich Meuter, *Kommentar zum Zürcher Steuergesetz*, 3rd ed., Zurich 2013, § 72 nos. 9 *et seq*.

[8] OECD/G20 Base Erosion and Profit Shifting Project, Neutralizing the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report, Paris 2015, nos. 27 *et seqq*.

[9] Pierre-Olivier Gehriger, *Konzernfinanzierungsgesellschaften – Quo Vadis Standort Schweiz*, in: *Der Schweizer Treuhänder*, 4/2008, pp. 247 *et seq*.

[10] Peter Hongler, *Hybride Finanzierungsinstrumente im nationalen und internationalen Steuerrecht der Schweiz, Diss. Zurich/Basel/Geneva* 2012, pp. 290 *et seqq*.

[11] Hongler, *op. cit.*, pp. 290 *et seqq*.

[12] DBG, art. 65; Swiss Federal Act on the Harmonization of the direct cantonal and municipal taxes dated December 14, 1990 (StHG), art. 29a.

[13] Circular no. 6 of the Swiss Federal Tax Administration regarding Hidden Equity, dated June 6, 1997.

[14] Markus Reich, *Steuerrecht*, 2nd ed., Zurich 2012, § 6 nos. 18 *et seqq*.

[15] Hongler, *op. cit.*, pp. 264 *et seq*.; 290 *et seqq*.

[16] See note 10 above; for another opinion, see Commentary on OECD Model Convention 2010, Art. 10 no. 25.

[17] Decision of the Swiss Federal Supreme Court 142 II 355 dated June 3, 2016.

[18] See also notes 1 and 3 above.

[19] DBG, art. 58(1); StHG, art. 24(1).

[20] The safe haven interest rates are explained in II.C., below.

[21] Circular of the Swiss Federal Tax Administration regarding interest rates accepted for Swiss tax purposes on advance payments and loans dated February 13, 2017.

[22] Circular of the Swiss Federal Tax Administration regarding interest rates on foreign currencies accepted for Swiss tax purposes on advance payments and loans dated February 14, 2017.

[23] Matthias Erik Vock/Christoph Nef, *Die Problematik der Bestimmungen von Zinssätzen im Konzernverhältnis – national und international*, in: *SteuerRevue* 4-5/2008, p. 7.

[24] Circular of the Swiss Federal Tax Administration regarding bonds, dated April 1999. A part of the doctrine raises doubts as to whether the classification of a lending arrangement as a bond or a cash bond for federal interest withholding tax purposes merely on the basis of counting the non-bank lenders involved is lawful (e.g., Marco Duss/Andreas Helbing/Fabian Duss, in: Martin Zweifel/Michael Beusch/Maja Bauer-Balmelli (ed.), *Bundesgesetz über die Verrechnungssteuer*, 2nd ed., Basel 2012, art. 4 no. 29). While this practice is reflected in almost every credit agreement involving a Swiss borrower or guarantor, as far as the authors are aware, it has never been confirmed by the Swiss Federal Supreme court according to the knowledge of the authors.

[25] Circular no. 34 of the Swiss Federal Tax Administration regarding customer credit balances, dated July 26, 2011.

[26] Federal Withholding Tax Ordinance, dated December 19, 1966 (VStV), art. 14a.

[27] Federal Withholding Tax Act, dated October 13, 1965 (VStG), art. 24(3).

[28] Conradin Cramer, *Zweigniederlassungen in der Schweiz, in: Zeitschrift für schweizerisches Gesellschafts- und Kapitalmarktrecht*, p. 247.

[29] Stefan Oesterhelt/Susanne Schreiber, in: Martin Zweifel/Michael Beusch (ed.), *Kommentar zum Schweizerischen Steuerrecht, Bundesgesetz über die direkte Bundessteuer* (DBG), 3rd ed. Basel 2016, art. 52 no. 2.

[30] VStG, art. 24(3).

[31] VStG, art. 25(1).

UNITED KINGDOM

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I. Possibility of U.K. Tax Authorities Recharacterizing Advance of Funds by FCo to UKCo

The United Kingdom was an early and enthusiastic adopter of rules designed to prevent tax advantages obtained through the use of hybrid instruments or hybrid entities. Indeed, the United Kingdom introduced rules specifically targeting such transactions and entities in 2005 in the form of a code of rules known as the "anti-arbitrage rules." These rules allowed HM Revenue & Customs (HMRC) to issue notices to U.K. companies counteracting advantages obtained from transactions giving rise to a deduction or credit in a range of situations involving hybrid entities or transactions, but only where the main purpose of the scheme or one of its main purposes was to achieve a U.K. tax advantage for the company concerned. These rules sat alongside thin capitalization, transfer pricing and other anti-avoidance rules aiming to deny U.K. tax deductions for payments that fall to be considered as essentially distributions on equity.

The United Kingdom's strong record on attacking hybrid transactions and entities was continued by its early adoption of rules[1] to counter "Hybrid and Other Mismatches," designed to implement the conclusions of Action 2 of the OECD's Base Erosion and Profit Shifting (BEPS) initiative, which is aimed at neutralizing the effects of hybrid mismatch arrangements. These rules were introduced with effect from January 1, 2017, and replace the anti-arbitrage rules, which have ceased to apply. To a great extent, the new anti-hybrid mismatch rules cover the same ground as the previous anti-arbitrage rules, the principal differences being that it is no longer a condition for the rules to apply that there should be a main purpose of achieving a tax advantage for a U.K. company and that some additional situations are covered. Other, less specifically targeted rules focusing on the distinction between debt and equity transactions, continue to apply.

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Under the United Kingdom's loan relationship rules applicable to U.K. companies, a U.K. company is subject to corporation tax on (broadly speaking) profits and losses arising on its loan relationships in accordance with an authorized accounting treatment.[2] As a result, a U.K. company borrower should generally, subject to the rules described below, be entitled to a deduction in calculating its overall profits by reference to debits accrued on its loan relationships, based on interest and other costs associated with those loan relationships.

As noted above, a range of different sets of rules could apply to treat the interest payable by UKCo to FCo, and any other costs incurred by UKCo in connection with the loan relationship, as non-deductible in whole or in part. These are:

- distribution rules,[3]
- transfer pricing rules,[4] and
- anti-hybrid mismatch rules.

1. Distribution Rules

The United Kingdom has for many years treated certain types of payments made by companies as distributions and, therefore, in part or in whole, as non-deductible. The class of distributions includes interest on any security of a company that exceeds a reasonable commercial return for the use of the principal secured,[5] and interest payable on the following types of debt ("special securities") (unless the recipient of the interest is within the charge to U.K. corporation tax):

- Securities that are convertible directly or indirectly into shares of the issuing company or carry a right to receive shares in or securities of the company;
- Securities under which the consideration given by the company for the use of the principal secured is dependent to any extent on the results of the company's business (except where the consideration is reduced if the business results improve or vice-versa);
- Securities that are connected with shares in the company by reason of it being necessary or advantageous for a person who has or disposes of or acquires the securities to also have, dispose of or acquire shares in the company as a result of terms attaching to the securities or shares; and
- Securities that have no set redemption date or have a latest date for redemption that is more than 50 years after the date of issue of the securities.[6]

The factors set out above may be rationalized as being more characteristic of equity than of debt, and, accordingly, an interest deduction is generally denied to payers of interest in the defined circumstances. However, this does not mean that the security with respect to which interest is paid is treated as equity; indeed, in part, the treatment depends on the tax position of the recipient, in that distribution treatment for interest on "special securities" does not apply if the recipient is within the charge to corporation tax.[7]

It should be noted that the lack of a written agreement does not have any effect on the application of the distribution rules, as a matter of principle (although, in the absence of any written documentation, it may be difficult to discern the terms on which the loan is made and accordingly whether any of the described circumstances could apply). Nor does whether a payment is treated as a non-deductible distribution depend on whether UKCo and FCo are related, although, in the absence of a relationship between them, one might speculate that the requisite factors might not arise.

2. Transfer Pricing Rules

The United Kingdom applies transfer pricing rules in accordance with the OECD guidelines. Loan transactions are potentially subject to the United Kingdom's transfer pricing rules, so that interest can be treated as non-deductible in whole or in part to the extent that interest and other payments made by a borrower under a loan differ from the amounts that would be payable on an arm's-length basis between independent enterprises.

The United Kingdom's transfer pricing rules apply only where there is a relevant connection between the parties to the transaction. Such a connection exists where, at the time of entering into the transaction (or, in the case of financing arrangements, within the following six months), one of the parties directly or indirectly participates in the management, control or capital of the other, or a third party directly or indirectly participates in the management, control or capital of each of the parties. Detailed rules govern the application of this test, but a 40% shareholding relationship is sufficient for it to be met.

3. Anti-Hybrid Mismatch Rules

The United Kingdom's new anti-hybrid mismatch rules aim to counteract "cases that it is reasonable to suppose would otherwise give rise to . . . a deduction/non-inclusion mismatch."[8] A deduction/non-inclusion mismatch arises where a deduction would, apart from the effect of the rules, be allowed under U.K. tax law, where a corresponding amount is not treated as taxable income of another person (or where a corresponding amount is "undertaxed"). The rules apply to several different sets of circumstances, including arrangements involving financial instruments, but also where there are transfers of repos and stock loans, and arrangements with hybrid entities, companies with permanent establishments (PEs) and dual resident companies.

For the purposes of the rules, a financial instrument includes anything that is treated as such for purposes of U.K. generally accepted accounting practice. It also includes specifically any loan relationship of a U.K. company.[9] That, in turn, would include any loan received by a U.K. company, irrespective of whether the loan is documented in writing, provided the parties share a contractual intention that the loan should be repaid.

In order for a counteraction to apply under the anti-hybrid mismatch rules with respect to a financial instrument, certain conditions must be fulfilled, including that either:

- The parties must be related; or
- It must be reasonable to suppose that either the financial instrument is designed to secure a hybrid or otherwise impermissible deduction/non-inclusion mismatch, or the terms of the financial instrument share the economic benefit of the mismatch between the parties to the instrument or otherwise reflect the fact that the mismatch is expected to arise.[10]

Therefore, in a situation in which FCo and UKCo are not related parties, no counteraction will be possible under the rules unless it is reasonable to suppose that the terms of the loan are designed to secure a mismatch or the benefit of a mismatch is shared between the parties.

Parties are treated as "related" where they are both within a group of companies that must submit accounts on a consolidated basis, or where either of them holds at least a 25% investment in the other or a third person holds at least a 25% investment in each of them.

Where FCo and UKCo are related, counteraction would be possible. Under the United Kingdom's loan relationship rules, the deduction available to UKCo with respect to its loan from FCo will be calculated by reference to the accrued costs, including interest accruing in the relevant accounting period. That deduction can only be denied to UKCo under the anti-hybrid mismatch rules if there is a relevant mismatch. No mismatch will arise if FCo is treated as receiving income of an amount corresponding to the deduction claimed by UKCo and FCo pays tax in full on that amount at its marginal rate of tax. A grace period of 12 months following the end of the accounting period of the payer in which any payment is made applies in determining whether a mismatch arises.

In general, where FCo treats the transaction as a loan for its accounting and income tax purposes, and provided FCo recognizes any income accruing on the loan in the same period of account as UKCo (or an overlapping period) and is taxed on it in full, no counteraction should apply under the anti-hybrid mismatch rules.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

The fact that FCo does not treat the transaction as a loan should not have any impact on the treatment of UKCo under the United Kingdom's distribution rules and transfer pricing rules (although it may be indicative that the transaction fulfills a condition for denial of a deduction under those rules).

By contrast, if FCo treats the transaction otherwise than as a loan, a mismatch may well arise for purposes of the Anti-Hybrid Mismatch rules. A deduction claimed by UKCo for interest and other costs accrued with respect to the transaction could be disallowed under the rules if UKCo and FCo are related, or if it is reasonable to suppose that the transaction is designed to secure a mismatch or that the benefits of a mismatch are shared between the parties.

C. Difference if a Loan Agreement of Some Sort Exists

The only impact of the loan agreement being in writing would be to provide definitive evidence of the terms governing payment of the amounts due under the loan, which might be relevant for analysis of whether the interest fell to be treated as a distribution.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

Under the rules governing the U.K. tax treatment of loan relationships entered into by U.K. companies, a company is entitled to bring into account for tax purposes the debits and credits that are recognized in determining the company's profit or loss for the period in accordance with generally accepted accounting practice. While the tax treatment of one party to a transaction is intended to mirror the tax treatment of the other party where both parties are companies subject to the charge to U.K. corporation tax, each party's tax treatment is self-standing and does not depend on the tax treatment of the other party. The fact that the lender is outside the United Kingdom does not make any difference to the tax treatment of the borrower.

Where the lender and borrower are connected, an amortized cost basis of accounting must be used for purposes of bringing debits and credits into account for tax purposes. There are also certain rules that prevent impairment losses and releases of debts from being brought into account where the parties to a loan relationship are connected.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The Government has announced that it intends to introduce legislation to restrict the deductibility of interest payable by U.K. companies by reference (broadly) to a cap of 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). Legislation to achieve this was included in draft legislation in March 2017, but this was dropped due to the sudden announcement of a General Election. The legislation is expected to be re-introduced following the General Election, though the timing of that is uncertain. As originally introduced, the legislation would have had effect from April 1, 2017, but the delay in introducing this legislation may mean that this start date is also delayed.

The draft rules impose a limit on the deductibility of interest on a worldwide basis largely in line with the OECD's proposed worldwide ratio test as set out in Action 4 of the BEPS program. There is a threshold of £2 million of interest expense for the application of the rules: groups with less than this level of net interest expense will not be subject to the rules.

Above this level, deductible net interest expense will be limited to 30% of a group's EBITDA. However, a group ratio figure can be substituted for this 30% figure, based on the ratio of net interest expense to EBITDA for the worldwide group based on its consolidated accounts. Interest payable to shareholders and other related parties, and interest on instruments with equity-like features are not reflected in the group ratio.

A carve-out from the main rules applies for the financing of public infrastructure (as contemplated by the BEPS recommendations).

Interest that is treated as non-deductible in a period of account may be carried forward for up to five years.

B. Limits on Interest Deductions Based on Other Factors

The deductibility of interest expense may be affected by the transfer pricing rules and the distributions rules outlined in I.A.1. and 2., above. In the case of interest treated as a distribution, only the amount of interest that exceeds a reasonable commercial return for the use of the principal lent would be treated as non-deductible, and any remaining interest should not be affected. Similarly, under U.K. transfer pricing rules, the deduction available for interest paid on a loan would be limited to the amount payable under a transaction entered into on an arm's-length basis.

In addition, an anti-avoidance rule applies for all purposes of the rules on loan relationships. Where a loan has an unallowable purpose (a tax avoidance purpose that is a main purpose of entering into the transaction concerned is an unallowable purpose), the borrowing company may not bring into account so much of any debit as may, on a just and reasonable basis, be apportioned to that purpose.[11]

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

As noted above, the rules governing the distribution treatment of interest and the transfer pricing rules allow for part or all of an interest expense to be treated as non-deductible in particular circumstances. An adjustment under the transfer pricing rules may trigger denial of a deduction for all or part of an interest expense depending on the circumstances. For example, if the interest rate payable on a loan is determined to be higher than that which would be payable on an arm's-length basis, the excess interest will be treated as non-deductible. By contrast, if it is determined that, in an arm's-length situation, the lender would not have lent at all, all of the interest expense will be treated as non-deductible.

D. Effect of an Income Tax Treaty Between the United Kingdom and FC

The rules set out above are not generally affected by the United Kingdom's tax treaties. The interest article in many of the United Kingdom's treaties allows for interest that is payable as a result of a special relationship between the parties to a loan relationship to be treated as interest only to the extent that it reflects an arm's-length basis, and for any excess interest to be taxed in accordance with the rules of each Contracting State.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

As noted above, the new anti-hybrid mismatch rules apply not just to arrangements involving financial instruments but also to transactions involving hybrid entities.[12] For these purposes, a hybrid entity is any

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entity that is recognized as a person for tax purposes under the tax laws of any territory and that also fulfills one of the two following conditions

Some or all of the entity's income or profits may be recognized as being income or profits of another person under the tax rules of any territory; or

Under the rules of a territory other than that which recognizes the entity as a separate person, the entity is regarded as not distinct from other persons for tax purposes.[13]

Thus, where FCo is a partnership, the tax position of UKCo will depend on whether or not FCo is treated universally as a transparent entity. If it is treated as transparent for tax purposes in all relevant jurisdictions, including the United Kingdom, FC and the jurisdiction of any investor in FCo, then FCo will not fall to be treated as a hybrid entity for purposes of the anti-hybrid mismatch rules. The tax treatment of UKCo will therefore not change from that set out in I. and II., above. It should, however, be noted that where debt is lent through a tax-transparent lender, investors in that lender may be treated as connected with each other for purposes of certain tax rules that are concerned with whether parties are related parties. This means that investors that lend through a tax transparent entity may be taken to be connected parties in certain circumstances even though, if they had each lent separately, they would not have been treated as connected with the borrower.

Where FCo is treated as hybrid entity, interest expense accrued by UKCo may be disallowed to correct any mismatch provided similar conditions to those set out with respect to financial instruments are met, i.e.:

- Either the parties to the arrangement must be in a consolidated group for accounting purposes or there must be at least a 50% control relationship between them, or between each of them and a third party; or
- It must be reasonable to suppose that either the arrangement is designed to secure a hybrid or otherwise impermissible deduction/non-inclusion mismatch, or the terms of the arrangement share the economic benefit of a mismatch between the parties to the arrangement or otherwise reflect the fact that a mismatch is expected to arise.

If a hybrid mismatch was to be disallowed under both the rules for financial instruments and the rules for hybrid entities, the rules for financial instruments would take priority. But in both cases, a similar result would be expected.

IV. Withholding Tax Issues

Payments of interest on debt that is intended to be outstanding for a year or more must be paid subject to withholding of U.K. income tax at the rate of 20%, unless an exemption applies. Exemptions are available for payments to companies that are within the charge to corporation tax as respects the interest[14] and for interest paid on debt securities that are listed on certain stock exchanges.[15] In the case of a payment to an overseas lender resident in a treaty partner country, relief from the requirement to withhold tax may be claimed by the recipient of the interest under a relevant tax treaty.

The requirement to withhold tax from payments of interest is not in principle affected by the question of whether a loan can be recharacterized as equity, especially as the rules that restrict deductibility do not generally operate so as to change the fundamental nature of the payment; they simply restrict the payer's right to a deduction with respect to it. However, HMRC has accepted[16] that, to the extent a payment of interest is treated as a distribution under the distribution rules, no requirement to withhold tax would arise on that part of the interest that is treated as non-deductible. In practice, HMRC may accept that interest that is treated as non-deductible as a result of other anti-avoidance rules would not be subject to withholding tax, although this may change following the introduction of the 30% EBITDA cap on deductibility.

V. Difference if FCo Has a Permanent Establishment in the United Kingdom

Under U.K. law, a company that is resident outside the United Kingdom but carries on a trade through a U.K. PE is subject to corporation tax with respect to the profits of that trade to the extent the trade is carried on through that PE. Therefore, if FCo makes the loan to UKCo as part of its trade and does so through its U.K. PE, FCo will be subject to the U.K. loan relationship rules as respects its profits with respect to that loan relationship, as reflected in its accounts.

The United Kingdom's tax treaties include rules to determine whether a PE exists in the United Kingdom and therefore whether U.K. corporation tax applies to the profits of the overseas company whose PE it is.

For some purposes of the borrower's tax treatment, whether or not a lender is subject to U.K. corporation tax is irrelevant. This includes the United Kingdom's transfer pricing rules, which apply in principle irrespective of whether the parties to the transaction concerned are within or outside the United Kingdom. However, where both parties are within the United Kingdom, it is possible for them to make balancing adjustments between them, the effect of which is to cancel out the effect of a transfer pricing adjustment. Where interest is payable on special securities, but is payable to a lender that is within the charge to U.K. corporation tax as respects the interest, the interest is generally not treated as a distribution.[17] It should be noted, however, that "excess" interest above a reasonable commercial return for the use of the principal lent is treated as non-deductible irrespective of the location or tax treatment of the lender.

Where interest is paid to a lender that is within the charge to U.K. corporation tax as respects the interest, an exemption generally applies from the requirement to withhold tax from the interest.[18]

The anti-hybrid mismatch rules extend to arrangements with "multinational companies," which are companies that are treated as resident for tax purposes in more than one jurisdiction but also companies that carry on business in other jurisdictions through PEs in those jurisdictions.[19] If a mismatch were to arise through FCo having a U.K. PE, UKCo could be subject to a counteraction of that mismatch under the anti-hybrid mismatch rules. Similar conditions would have to be fulfilled for such a counterac-

tion to apply to those that have to be fulfilled in the case of hybrid entities and financial instruments as described above.

VI. Legislative Changes

Rules to implement BEPS Action 2 (Hybrids) are already in effect. Rules recommended by BEPS Action 4 (Interest Expense) to implement the cap on interest deductibility by reference to a group's worldwide EBITDA are expected to be adopted shortly. If enacted as expected, the rules may apply retroactively with effect from April 1, 2017.[20]

NOTES

[1] Taxation (International and Other Provisions) Act (TIOPA) 2010, Part 6A.

[2] Corporation Tax Act (CTA) 2009, Part 5.

[3] CTA 2010, Part 23.

[4] TIOPA 2010, Part 4.

[5] CTA 2010, s 1000(1)E and s. 1005.

[6] CTA 2010, s. 1000(1)F and s. 1015.

[7] CTA 2010, s. 1032.

[8] TIOPA 2010, Part 6A, s. 259A(1)

[9] TIOPA 2010, s. 259N.

[10] TIOPA 2010, s. 259CA(6).

[11] CTA 2009, s. 441.

[12] TIOPA 2010, Part 6A, Chapter 7.

[13] TIOPA 2010, s. 259BE.

[14] Income Tax Act (ITA) 2007, s. 930.

[15] ITA 2007, s. 882.

[16] HMRC Brief 47/08.

[17] CTA 2010, s. 1032.

[18] ITA 2007, s. 930.

[19] TIOPA 2010, Part 6A, Chapter 8.

[20] Finance (No.2) Bill 2017.

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UNITED STATES

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I. Possibility of U.S. Tax Authorities Recharacterizing Advance of Funds by FCO to USCo

A. FCo Treats the Transaction as a Loan for FC Accounting and Income Tax Purposes

Whether a transfer of funds to a corporation (or other entity) represents debt or equity for U.S. federal tax purposes is a fundamental issue in U.S. tax law. Debt and equity instruments are subject to completely different tax regimes, and the tax consequences of a change in classification can be considerable. The difference is especially important when the investor or lender is a foreign person and the issuer of the instrument is a U.S. person.

Differences in the treatment of debt and equity in the cross-border context include the following: an issuer is entitled to a deduction for payments of interest, but not for payments of dividends; the repayment of a debt's principal is not subject to withholding, whereas a return of capital to an equity investor is generally subject to withholding on a gross basis; the Code[1] provides significant exceptions to the requirement to withhold on payments of interest (such as the portfolio interest exception) but not the requirement to withhold on dividends; and tax treaties generally provide lower rates of withholding (often 0%) for interest payments than for dividend payments.

The law determining whether a particular instrument is treated as debt or equity has generally been developed by U.S. courts. Since different jurisdictions have developed slightly different tests, the case law provides more than 20 different factors that must be considered to determine the applicable treatment. As discussed below, courts have generally declined to provide guidance on how to weigh the factors with respect to one another.

Because of the complexity and confusion inherent in the judicial multifactor test, Congress and the Internal Revenue Service have attempted to rationalize the debt/equity rules. In 1969, Congress enacted Section 385 of the Code, which authorizes the Treasury Department to promulgate regulations determining whether an interest in a corporation is stock or indebtedness. The IRS issued multiple versions of regulations under this section in the early 1980s, but ultimately the regulations were withdrawn. Other than the recently issued regulations discussed below, Section 385 has failed to replace case law as the primary source of guidance for corporate debt equity determinations.[2]

One area where debt/equity issues are particularly relevant is the treatment of hybrid instruments, i.e., instruments that are treated as debt under one country's tax rules and equity under another's. Structures that use hybrid instruments can provide a deduction for an interest payment in one country without a corresponding income inclusion in the other country.

Hybrid instruments are a major concern in current efforts to fight tax avoidance in the cross-border context. The OECD's project on base erosion and profit shifting (BEPS), discussed below, includes an action item on hybrid instruments (as well as an action item on interest deductibility in thinly capitalized companies, a related topic). The U.S. Treasury Department has incorporated provisions targeting hybrid instruments in recent amendments to its Model Income Tax Convention.[3] And finally, tax policy concerns with hybrid instruments are certain to inform comprehensive tax reform in the United States, which is generally viewed as likely to occur during the current administration. Any of these efforts could result in measures to limit the deductibility of interest expenses in the cross-border context.

1. Multifactor Test in the United States

As noted above, the determination of whether a particular financial instrument is debt or equity is governed by an extensive body of case law. Debt/equity determinations are a common issue in tax cases, and there are scores (if not hundreds) of published cases that are relevant.

The courts have enumerated more than 20 specific factors that must be considered in making a debt/equity determination. Since case law in the United States is jurisdiction-specific, the actual list of factors used might be slightly different in different jurisdictions. Some of the most significant factors that have been used to distinguish debt and equity for U.S. federal tax purposes are listed in an Appendix to this paper.[4]

Courts developed these factors in an effort to determine the intent of the parties on an objective basis. The multifactor test is focused on the terms of the instrument in question, because in the courtroom, the terms of the instrument are often the best evidence of the parties' intent. Therefore, since the multifactor test focuses on the terms of the instrument, it is especially important for the parties to a funding transaction to adhere to those terms. Moreover, in the context of related-party transactions, where there may not be much pressure to adhere to the written terms of an in-

strument, adherence to the terms is crucial to preserve debt characterization.

While some factors are clearly more important than others, none of the factors is dispositive in itself.[5] Accordingly, in cases where a particular instrument displays characteristics of both debt and equity, it can be difficult to determine the correct classification with a high degree of certainty.

In the case of FCo and USCo, courts will look primarily to the terms of the arrangement to determine whether the instrument represents debt or equity. A relationship between FCo and USCo does not in itself weigh towards debt or equity treatment, but instead invites comparison with debt between unrelated persons.

We know that FCo has not produced any documentation of the advance. If FCo and USCo are not related, the lack of documentation would weigh towards equity treatment, but would be considered in combination with the other relevant factors. If FCo and USCo are related, however, the lack of documentation looks worse, since it is unlikely that an unrelated lender would loan a significant amount to a borrower without proper documentation. The fact that we have a hypothetical standard of a true debt instrument puts pressure on FCo and USCo as related parties.

In any case, a practitioner tasked with writing an opinion on the debt/equity treatment of FCo and USCo's agreement would consider as many factors as possible to determine FCo's and USCo's intent at the time they entered into the transaction. If the terms are otherwise in line with market terms for similar debt transactions, the impact of the lack of documentation could be less — although without documentation, it may be especially difficult to argue that the terms are debt-like because there may not be reliable evidence of those terms. The lack of documentation in itself, however, is not fatal.

If FCo and USCo are related and the instrument in question is treated as debt under the multifactor test, then the instrument may be recharacterized as equity under recently issued regulations under Section 385.

2. Section 385

As noted above, even if an instrument would otherwise be treated as debt under the multifactor test described above, that instrument could nevertheless be recharacterized as equity under new regulations under Section 385.[6] The Section 385 regulations create two main regimes: the first sets out detailed documentation requirements that must be complied with in order for an instrument to be treated as debt, and the second reclassifies certain instruments as equity based on the purpose for which the instrument was issued.

The Section 385 regulations generally apply when a borrower and a lender are both corporate members of an "expanded group." An expanded group generally consists of the members of a group of corporations whose common parent owns directly or indirectly at least 80% of the vote or value of the members' stock. The Section 385 regulations currently do not apply with respect to debt issued by foreign persons.

a. Documentation requirements

The Section 385 documentation requirements apply with respect to debt instruments issued on or after January 1, 2018. Tax practitioners, however, are concerned that IRS examination agents are using the documentation rules as a *de facto* audit standard and are already challenging advances of funds where the documentation does not comply with the Section 385 regulations.

Under the documentation rules, certain issuers must prepare and maintain detailed documentation of intercompany debt, or else the debt will be treated as equity for U.S. federal tax purposes.[7] The regulations are careful to provide that compliance with the documentation requirements, when applicable, does not in itself establish that an instrument is indebtedness and not equity — instead, compliance with the documentation requirements is a prerequisite for an arrangement to be considered debt for U.S. federal tax purposes.[8]

The documentation rules only apply if a member of the relevant expanded group is a publicly traded company, the assets of the expanded group exceed $100 million or the revenue of the expanded group exceeds $50 million. Under these rules, the documentation must establish that the instrument in question is treated as debt for U.S. federal tax purposes. Specifically, the documentation must establish that:

- The issuer has entered into an unconditional obligation to pay a sum certain;
- The holder has the right to enforce the obligation; and
- The issuer's financial position supports a reasonable expectation that the issuer intends to, and would be able to, meet its obligations.[9]

The regulations provide detailed rules on the meaning of these terms and the methods available for documentation to establish the underlying facts. The documentation must generally be prepared by the extended due date of the issuer's U.S. federal tax return for the year in which the debt was issued, taking any applicable extensions into account, for the taxable year in which the debt is issued.[10]

If a particular item of indebtedness fails to meet the documentation requirements, then the instrument is automatically treated as equity for all U.S. federal tax purposes.

Thus, if the expanded group that includes USCo and FCo is subject to the documentation rules — either because that expanded group includes a public company, the assets of the expanded group exceed $100 million or the revenue of the expanded group exceeds $50 million — the advance will have to be documented if it is made after the effective date. Otherwise, the advance will be treated as equity for U.S. federal tax purposes.

b. Recharacterization Rule

The recharacterization rule of the Section 385 regulations is generally effective for tax years ending after January 19, 2017.

Under this rule, debt issued by a domestic corporation to another member of its expanded group is recharacterized as equity if the debt is issued in

connection with: (1) a distribution to shareholders; (2) an exchange for stock of an affiliate; or (3) certain exchanges for property in an asset reorganization (these three groups of transactions are referred to here as "Specified Transactions"). Under a provision known as the "funding rule," debt issued by a corporation can also be recharacterized as equity if the debt is issued with a principal purpose of funding a Specified Transaction.

The Section 385 regulations also include a "*per se* rule" under which certain debt issuances are presumptively treated as subject to the funding rule. Under the *per se* rule, any issuance of debt during the 72-month period beginning 36 months before, and ending 36 months after, the date of a Specified Transaction is treated as having been issued with a principal purpose of funding the Specified Transaction.

The regulations include several exceptions to the rules described above. Among these, the amount of any Specified Transaction is reduced by the earnings and profits of the corporation that issues the applicable debt. In addition, the rules described above do not apply to the first $50 million of debt issued by a corporation or to funding new investments through a controlled subsidiary. Finally, the funding rule does not apply to short-term debt instruments, which generally include short-term funding arrangements (very generally speaking, loans with a term of 270 days or less), ordinary course loans with a term of 120 days or less, interest-free loans, and deposits into the expanded group's cash pool.

The question whether USCo's debt would be recharacterized as equity under the Section 385 regulations depends on the form of the transaction and the purpose for which the debt was issued. For instance, if the debt was issued in exchange for stock of an affiliate, Section 385 would recharacterize the debt as equity. Alternatively, under the *per se* rule, the debt would be recharacterized regardless of the form or purpose of the issuance if the issue date is within the 72-month period described above.

B. FCo Does Not Treat the Transaction as a Loan for FC Accounting and Income Tax Purposes

Under the Code, the issuer's characterization of an instrument is binding on each holder of the instrument, unless the holder makes a special disclosure of the inconsistent treatment on its U.S. federal income tax return.[11]

As described above, FCo's characterization of the transaction is only one factor in the multifactor analysis involved in determining whether the resulting instrument is treated as equity or debt for U.S. federal tax purposes. FCo's treatment of the transaction as other than a loan would increase the likelihood that the resulting instrument would be treated as equity for U.S. federal tax purposes, although FCo's treatment of the transaction would not be dispositive in itself.

The Section 385 regulations described above might also apply with respect to the USCo debt that would otherwise be considered to be debt under the multifactor test.

C. Difference If a Loan Agreement of Some Sort Exists

Generally, the existence of a formal loan agreement is considered as one factor in the multifactor test, as described above. For instance, the fact that unrelated parties would rarely (if ever) make a loan without documentation and the difficulty of proving the terms of such a loan would weigh against treatment of the underlying advance as a debt.

If the issuer's expanded group is subject to the documentation rules in the Section 385 regulations after December 31, 2017, then a loan agreement would be required to preserve debt treatment. As mentioned above, the IRS seems already to be using the Section 385 regulations as an audit standard for acceptable loan documentation, so the risk of an IRS challenge to the instrument based on a lack of documentation may be substantial.

See I.A., above and the Appendix for a list of factors that could affect the characterization of the instrument as debt or equity.

II. General Rules Regarding the Deduction of Interest Paid to a Nonresident Lender

For U.S. federal income tax purposes, interest paid by a U.S. corporate borrower such as USCo is generally deductible, although there are many exceptions to this general rule. The residence of the lender is generally irrelevant for determining whether a deduction is available. Whether the interest is included in the lender's taxable income only becomes relevant in combination with other factors, as described below.

In the cross-border context, a relationship between borrower and lender can affect the timing of interest deductions. Under Section 267(a)(3) and related regulations, a deduction for interest paid to a related foreign person cannot be taken until the interest is actually paid.[12] This provision does not apply, however, to payments of interest that are effectively connected to a U.S. trade or business of the lender (i.e., that are effectively connected income — ECI) and are subject to U.S. federal income tax, or to payments of interest to a controlled foreign corporation or passive foreign investment company.[13] In these cases, the deduction is allowed as of the day on which the interest is includible in the income of the lender.

Measures recommended in the OECD's BEPS Action 2 on Branch Mismatch Structures generally deny a deduction for a payment where that payment is not taken into income by the recipient. The United States has not enacted any provision that specifically denies interest deductions with respect to hybrid instruments. A provision similar to BEPS Action 2 was included in President Obama's budget for Fiscal Year 2017, released on February 9, 2016. This provision would have denied an interest deduction with respect to hybrid arrangements between a domestic borrower and a related foreign lender if either: (1) the interest was not included in the foreign lender's taxable income; or (2) the borrower claimed a deduction for the same interest in more than one jurisdiction.

A. Specific Limits on Interest Deductions Based on the Ratio of Debt to Equity

The earnings stripping limitation of Section 163(j) is based in part on the debt-to-equity ratio of the borrower. This provision limits the deductibility of interest paid to a related lender where the lender does not include that interest in income and where the borrower's debt-to-equity ratio exceeds 1.5 to 1.

The rules for calculating the debt-to-equity ratio for the purposes of Section 163(j) only exist in proposed form.[14] In the absence of finalized regulations, the proposed regulations provide the best guidance of the IRS's position on the issue, so practitioners generally rely on the proposed rules.

These rules provide that the calculation does not take short-term liabilities and commercial financing liabilities into account, and that the liabilities of any partnership in which the corporation is a partner should be attributed to the corporate partner in the amounts and proportions that the partnership's liabilities are allocated under Section 752. Equity for this purpose consists of the sum of the corporation's money and the adjusted basis of all of its assets.[15]

The Section 163(j) limitation disallows a deduction with respect to the portion of the interest payment that exceeds 50% of the borrower's "adjusted taxable income," which is generally defined as the borrower's income calculated without any deduction for interest payments. Deductions that are disallowed in a particular year under Section 163(j) are carried forward until the borrower's net interest expense is less than 50% of its adjusted taxable income.

The 50% limitation under Section 163(j) has been the subject of some attention by tax policymakers. Legislative proposals have been offered that would lower this limitation to 25% for inverted companies[16] and would prescribe different rates for companies operating in different industries.[17] Under BEPS, the suggested limitation is between 10% and 30%, which is well below the current Section 163(j) limitation.

The United States has not adopted the OECD's worldwide ratio test, and is not expected to do so.

B. Limits on Interest Deductions Based on Other Factors

Another factor that limits interest deductions between related parties is whether the rate of interest reflects an arm's-length rate. Under Section 482 of the Code, interest paid between corporations that are under common control must be paid at an arm's-length rate.[18] Payments of interest that exceed an arm's-length rate are subject to reallocation by the IRS, which would effectively deny the borrower a deduction for the amount that exceeds the arm's-length rate.

The regulations under Section 482 include a safe harbor for interest that does not exceed 130% of the applicable federal rate, which is published by the IRS each month.[19]

Other factors include rules that limit the deductibility of interest on applicable high-yield debt instruments (AHYDOs) under Section 163(i) and convertible debt (and other debt if the interest is payable in equity) under Section 163(l), and rules that apply to corporate equity reduction transactions under Sections 172(b)(1)(D) and 172(g).

C. Possibility of a Transaction Being Bifurcated Into a Portion That Permits Deductible Interest and a Portion That Does Not

Generally, bifurcation of an instrument into debt and equity components is not a feature of U.S. federal tax law. The Section 385 regulations, as originally proposed in April 2016, however, included provisions that would have permitted the IRS to recharacterize a portion of a debt instrument as equity. The provision allowing bifurcation was withdrawn when the final Section 385 regulations were released, to allow the IRS to study the issue further. The bifurcation rule may reappear at a later date.

Bifurcation occurs in a handful of contexts outside of Section 385. U.S. courts permitted bifurcation in a case where a mortgage included a shared appreciation right that was separable from a traditional debt instrument.[20] The disqualified portion of interest on an AHYDO, which is comparable to the return on preferred debt, is treated as a stock distribution under Section 163(e)(5), while the rest of the interest maintains its character as interest. Finally, contingent interest is treated as a dividend in some of the United States' tax treaties.[21]

D. Effect of an Income Tax Treaty Between United States and FC

U.S. tax treaties generally do not include provisions that directly limit the deductibility of interest.

Some U.S. tax treaty provisions indirectly address BEPS concerns on hybrid instruments. Many U.S. tax treaties include a provision that denies treaty benefits with respect to that portion of an interest payment between related parties that exceeds the amount of interest that would be payable at an arm's-length rate.[22] Also, new provisions of the U.S. Model Tax Convention allow a treaty partner to "turn off" treaty benefits with respect to payments taxed under a "special tax regime," which generally means a tax rate below the lesser of either: (1) 15%; or (2) 60% of the general statutory rate of company tax in the recipient's country of residence. A special tax regime could include a preferential tax rate on the item of income itself or a reduction of the tax base (i.e. a deduction) for a payment of the income.

As noted above, some of the United States' tax treaties subject contingent interest to the same withholding rates as dividends, which is equivalent to treating the underlying instrument as equity.

III. Difference if FCo Were an Entity That Is Treated as Transparent for FC Tax Purposes

Except for the provisions under Section 482, the current U.S. tax considerations described above are generally applicable to pass-through as well as corporate lenders.

If FCo is treated as a partnership for FC tax purposes, but as a corporation for U.S. tax purposes, then FCo will be considered a "reverse hybrid" for U.S. tax purposes, which could implicate applicable anti-hybrid provisions.

The Code includes one provision, Section 894(c), that denies treaty benefits in the case of hybrids and reverse hybrids. This provision applies with respect to

an item of income of a foreign person derived through an entity treated as "fiscally transparent" if: (1) the item of income is not treated as income of the foreign person under applicable foreign tax law; (2) the applicable tax treaty does not include a provision on items of income derived through a partnership; and (3) the foreign country does not impose tax on a distribution from the entity.

The regulations under Section 894(c) define "fiscally transparent" for purposes of this provision. Under these rules, an entity is treated as fiscally transparent if: (1) the interest holders are required to include the item of income paid to the entity in income in the year of the payment (whether or not the entity actually distributes the income); and (2) the character and source of the item of income in the hands of the interest holders are determined as if the payor had directly paid the item of income to the interest holders.[23]

Accordingly, if the FC tax law treats a payment to FCo as income of FCo's owners, the United States–FC tax treaty does not address partnerships, and FC does not tax distributions from FCo, then the owners of FCo will not be able to benefit from any reduced rate of withholding under the United States–FC tax treaty. This is the case even if FCo's owners are themselves residents of FC.

Certain of the United States' tax treaties also include provisions that apply to hybrid entities. For example, Article IV(6) and IV(7)(b) of the United States–Canada tax treaty provide rules for the applicability of the treaty to hybrid entities.[24]

IV. Withholding Tax Issues

A recharacterization of USCo's debt as equity could have significant consequences with respect to withholding taxes on payments to FCo.

Generally, the United States imposes a 30% withholding tax on payments of U.S.-source income to a foreign person, unless such payments are ECI. Both payments of interest and dividends are sourced by reference to the residence of the issuer,[25] so payments with respect to an instrument between USCo and FCo would generally be subject to the 30% withholding tax, regardless of whether the underlying instrument was treated as debt or equity.

If the instrument is treated as debt, then interest on the debt could be exempt from withholding tax under the Code's portfolio interest exemption.[26] Under this provision, withholding is not required on payments of interest from a U.S. issuer to a foreign lender provided the lender does not own 10% or more of the issuer's equity and certain other requirements are met. The portfolio interest exemption does not apply to contingent interest or interest on loans made in the ordinary course of a banking business. Assuming that FCo does not own 10% or more of USCo and that the interest payments are not contingent interest or interest from bank loans, a recharacterization of USCo's debt as equity could result in the loss of the portfolio interest exemption by FCo. If FCo and USCo are related, however, the portfolio interest exemption would not be available even if the instrument is respected as debt.

Most U.S. tax treaties also provide lower rates of withholding for interest than dividends. Indeed, many current U.S. tax treaties allow a zero rate of withholding on interest. The tax treaty withholding rate on dividends is generally reduced in comparison to the statutory rate (to 15%), with a further reduction (to 5% or sometimes 0%) for dividends paid to a company that holds at least 10% of the payor's stock. If USCo and FCo rely on a tax treaty to reduce the applicable rate of withholding, then the withholding rate could increase if the underlying instrument is reclassified from debt to equity.

Under U.S. tax law, the availability of a deduction to the issuer does not depend on the payment of withholding tax with respect to payments of interest, but the timing of deductions may depend on payment and other factors, as noted above.

V. Difference if FCo Has a Permanent Establishment in United States

Under the Code, a foreign person that has ECI is subject to tax on that ECI at graduated rates, much like a U.S. person. If a tax treaty applies, however, that foreign person will only be taxed on ECI that is attributable to a U.S. permanent establishment (PE) of the foreign person.

Therefore, if FCo has a PE in the United States, FCo's income will be treated in two ways. First, FCo's U.S.-source income that is not attributable to the PE should be taxed in the same way as it would have been if FCo did not have a PE, i.e., as described in IV., above. If FCo's interest or dividend income from USCo is attributable to FCo's U.S. PE, however, then withholding should not be required with respect to such interest or dividend income. Instead, FCo will be liable for U.S. tax on that income directly at graduated rates.

In addition, FCo will be subject to branch profits tax (at 30% under the Code) on an amount that approximates any decrease in the amount of FCo's investment in USCo, determined in accordance with U.S. domestic tax law.[27] Many tax treaties provide a reduced rate for the branch profits tax.

VI. Legislative Changes

No specific legislative changes that would affect U.S.-resident corporations and their foreign lenders are currently pending in the U.S. Congress.

The current expectation, however, is that comprehensive tax reform is likely to take place in the near term. Although the details of tax reform are still unknown, one feature of President Trump's tax plan as published during his campaign is an election to give taxpayers the choice either to retain the interest deduction or to take a new deduction for capital expenditures. If a provision like this were adopted, U.S. tax planning in the international context would have to change.

APPENDIX

Common Law Debt / Equity Factors

The following list describes some of the factors that have been considered significant in case law:[28]

1. *Fixed Maturity Date*. One of the most important factors is a fixed maturity date. An unconditional

promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date is indicative of debt. The further the maturity date is in the future, the more likely it is that the instrument will be treated as equity for U.S. federal tax purposes. The IRS does not recognize perpetual debt.

2. *Interest*. In the eyes of the IRS, a debt entails interest payments. A fixed rate of interest and schedule of interest payments weighs in favor of treatment as debt. Payments that may be reduced depending on the earnings of the borrower, however, weigh in favor of equity treatment.

3. *Creditors' Remedies*. An instrument is more likely to be respected as debt if the holders have traditional creditors' remedies in the case of default, such as the right to sue the issuer, trigger bankruptcy or repossess collateral. Typically, the only action available to holders of an equity instrument in the case of a default by the issuer is a shareholder vote.

4. *Proportionality*. If the same persons hold the instrument in question and the stock of the issuer, and the instrument is held in the same proportions as the stock, then the instrument is more likely to be treated as equity.

5. *Subordination/Preference*. The holders of a debt instrument should enjoy a preference with respect to claims in bankruptcy. The fact that the rights of holders of the instrument are subordinate to the rights of general creditors is indicative of equity.

6. *Participation in Management*. If the holders of the instrument enjoy a right to participate in the management of the issuer, the instrument is more likely to be treated as equity. Holders of an instrument that have no right to participate in management or that have limited voting rights are more likely to be treated as holding debt.

7. *Expectation of Repayment*. If a holder of an instrument has no reasonable expectation of repayment, then that instrument is more likely to be treated as equity.

8. *Label*. The label used by the parties to describe the instrument, either as debt or equity, is indicative of debt or equity, respectively.

9. *Treatment for Non-Tax Purposes*. The intended treatment of the instrument as debt or equity for non-tax purposes, including regulatory, rating agency and financial accounting purposes, weighs in favor of the intended treatment.

10. *Participation in Earnings or Growth*. The fact that the holders participate in the issuer's earnings or growth is indicative of equity. If the amount of an instrument purported to be debt is excessive in comparison with the assets of the issuer, then the court may hold that the only reasonable prospect of repayment is out of the issuer's earnings, and accordingly the instrument is equity.

11. *Source of Interest Payments*. If the interest or principal of the instrument is only payable to the extent of the issuer's net income, then the instrument is more likely to be treated as equity.

12. *Issuer's Losses*. The fact that holders of the instrument are required to absorb the issuer's losses is indicative of equity.

13. *Adequacy of Interest Rate*. The fact that the instrument does not provide for adequate interest reflective of the risk involved in advancing funds to the issuer is indicative of equity.

14. *Acceleration of Interest*. The fact that the instrument includes an acceleration clause is indicative of debt.

15. *Redemption/Prepayment*. The fact that the instrument includes a redemption or prepayment provision is indicative of debt.

16. *Repayment in or Conversion to Stock*. The fact that the instrument, by its terms or in effect, requires the holder to accept repayment of principal in stock of the issuer or is otherwise convertible into such stock is indicative of equity.

17. *Collateral*. The fact that the instrument is secured by the issuer's property is indicative of debt.

18. *Availability of Third-Party Debt*. The fact that the issuer has the ability to obtain funds from outside sources is indicative of debt, particularly if an unrelated party dealing with the issuer at arm's length would have made the same loan on the same terms.

19. *Thin Capitalization*. The fact that the issuer is thinly capitalized is indicative of equity, particularly where either: (1) the parties as of the time of the advance expect the debt-to-equity ratio to increase; or (2) the advances are used to purchase capital assets or commence operations.

20. *Use of Proceeds*. The fact that the advance was used to acquire capital assets is indicative of equity.

21. *Compliance with Terms*. The fact that the behavior of the issuer and holder complies with the terms of the instrument is indicative of debt (whereas postponement of repayment is indicative of equity).

22. *Salvage*. The fact that the holders of the instrument are salvaging a previous stock investment is indicative of equity.

23. *Frequency of Advances*. The fact that there is a pattern of repeated shareholder advances rather than a single outlay is indicative of equity.

24. *Guarantee*. The fact that the debt is guaranteed by the issuer's equity owners can be indicative of equity.[29]

NOTES

[1] For the purposes of this paper, the "Code" refers to the Internal Revenue Code of 1986, as amended, and references to "Sections" refer to sections of the Code.

[2] There are, however, a handful of areas of the tax law where debt or equity characterization is mandated by the Code or the regulations, such as the conduit financing rules (Treas. Reg. § 1.881-3), the regulations on fast-pay arrangements (Treas. Reg. § 1.7701(*l*)-3), and the now-repealed FASIT rules (former § 860H through § 860L). In addition, there are a number of rules that affect the tax consequences of debt instruments by limiting the deductibility of interest or requiring interest to be capitalized. These rules are generally outside the scope of this paper.

[3] See the provisions on special tax regimes and the limitation on benefits provisions.

[4] The IRS has repeatedly published its own lists of factors, e.g., in the withdrawn § 385 regulations and in Notice 94-47. The judicially created factors, however, continue to control.

[5] *See, e.g.*, *John Kelley Co. v. Comm.*, 326 U.S. 521 ("There is no one characteristic . . . which can be said to be decisive in the determination of whether the obligations are risk investments in the corporations or debts.").

[6] The § 385 regulations have been controversial since they were first proposed in April 2016. The final version of the regulations, issued on Oct. 13, 2016, incorporated many changes that responded to taxpayer comments. The regulations continue to be unpopular, however, and there is some speculation that the § 385 regulations may be repealed as a result of the anti-regulatory policies of the new executive administration.

[7] Treas. Reg. § 1.385-2.

[8] Treas. Reg. § 1.385-2(a)(2).

[9] Treas. Reg. § 1.385-2(b)(2).

[10] Treas. Reg. § 1.385-2(c)(4).

[11] § 385(c). If the holder and the issuer take different positions on the proper treatment of the instrument, then the instrument is likely to implicate policy concerns similar to the hybrid instrument provisions of the OECD's BEPS project. Although the United States has not implemented (and is not expected to implement) the OECD's BEPS recommendations, inconsistent treatment could cause a holder to lose the benefits of an applicable tax treaty if the treaty follows the U.S. Model Tax Convention with respect to notional deductions for instruments treated as equity by a holder and debt by an issuer. *See* U.S. Model Tax Convention, Art. XI(2)(e).

[12] Treas. Reg. § 1.267(a)-3.

[13] Treas. Reg. § 1.267(a)-3(c).

[14] Prop. Reg. § 1.163(j)-3.

[15] Special rules apply to affiliated groups of corporations. Prop. Reg. § 1.163(j)-5.

[16] *See, e.g.*, Corporate Inverters Earnings Stripping Reform Act of 2014, S. 2786, 113th Congress (2014).

[17] Proposed in President G.W. Bush's fiscal budget for 2004.

[18] Treas. Reg. § 1.482-2(a)(1).

[19] Treas. Reg. § 1.482-2(a)(2)(iii)(B).

[20] *See Farley Realty Corp. v. Comm'r*, 279 F.2d 701 (2d Cir. 1960).

[21] *See, e.g.*, United States–Canada tax treaty, Art. XI(6)(a).

[22] *See, e.g.*, U.S. Model Treaty, Art. 11(8); United States–Canada tax treaty, Art. XI(5).

[23] Treas. Reg. § 1.894-1(d)(3).

[24] *See also* United States–Japan Tax Treaty Art. 4(6).

[25] § 861(a)(1) and (a)(2).

[26] § 871(h) and Section 881(c).

[27] § 884.

[28] *See* William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971). Plumb notes that one commentator (as of 1971) had isolated 38 factors used by the courts. The IRS listed only eight factors in Notice 94-47. On the factors, *see generallyIn reLane*, 742 F.2d 625 (6th Cir. 1986); *Roth Steel Tube Co. v. Comm.*, ¶ 85,058 P-H Memo TC, *aff'd*, 800 F.2d 625 (6th Cir. 1986); *Estate of Mixon, Jr. v. U.S.*, 464 F.2d 394 (5th Cir. 1972)*; Fin Hay Co. v. U.S.*, 308 F.2d 694 (3d Cir. 1968); *Gilbert v. Comm.*, 248 F.2d 399 (2d Cir. 1957).

[29]*See Plantation Patterns v. Comm.*, 462 F.2d 712 (5th Cir. 1972), *cert. denied*, 409 U.S. 1076 (1972).

APPENDIX Hybrid Mismatches: An EU Perspective

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I. Introduction

Hybrid mismatches, i.e. situations in which a cross-border activity is treated differently for tax purposes by the countries involved, are currently addressed in three instruments at the EU level:

- The Parent-Subsidiary Tax Directive;
- The Anti-Tax Avoidance Directive (ATAD); and
- The (pending) Proposal for a Council Directive amending the ATAD with regard to hybrid mismatches with third countries (the "ATAD 2 Proposal").

II. Parent-Subsidiary Directive

The first EU initiative targeted at hybrid mismatches or, more specifically, at hybrid financial instruments, appears in a July 8, 2014, amendment to the Parent-Subsidiary Tax Directive.[1] Under the amendment, the Member State of residence of the recipient company (i.e., the parent company or a permanent establishment (PE) of the parent company) is to refrain from taxing a profit distribution received from a subsidiary resident in another Member State only to the extent the profit distribution is not deductible in that other Member State — i.e., the Member State of the recipient company is to tax the portion of a profit distribution that is deductible in the source Member State.

The rationale for the amendment is the perceived distortion in competition between cross-border and national groups resulting from the increase in cross-border investments giving cross-border groups the opportunity to use hybrid financial instruments, which is contrary to the intent of the Parent-Subsidiary Tax Directive. Hybrid financial instruments that are treated differently for tax purposes in the State of the issuer and that of the holder typically involve cross-border profit-participating loans or convertible preference shares that produce deductions for the issuer without matching taxable receipts for the holder, thus giving rise to advantages from mismatches between different national tax treatments and from the standard international rules for the relief of double taxation.

The amendment is relevant only to jurisdictions that have chosen to provide an exemption for distributions; the "credit" option remains unchanged (this may be because credit regimes are less susceptible to exploitation through the use of hybrid instruments, as the effect of a deduction in the issuer's jurisdiction will generally be to reduce the credit that is available in the holder's jurisdiction).

Member States had until December 31, 2015, to transpose the amendment into their domestic laws.

III. Anti-Tax Avoidance Directive

A more general approach to the issue of hybrid mismatches (both structures and transactions) is taken in the ATAD, which provides that, to the extent a hybrid mismatch results in a double deduction, only the Member State in which the payment concerned has its source is allowed to give the deduction; to the extent a hybrid mismatch results in a deduction without inclusion, the Member State of the payer is to deny a deduction for the payment.[2]

For these purposes, a "hybrid mismatch" refers to a situation between a taxpayer in one Member State and an associated enterprise in another Member State, or to a structured arrangement between parties in different Member States where differences in the legal characterization of a financial instrument or entity result in one of the following outcomes: (1) a deduction for the same payment, expense or loss is given both in the Member State in which the payment has its source, the expense is incurred or the loss is suffered and in another Member State ("double deduction"); or (2) a deduction is given for the payment in the Member State in which the payment has its source without a corresponding inclusion for tax purposes of the same payments in the other Member State ("deduction without inclusion").[3]

Member States must transpose the hybrid mismatch measure set out in the ATAD into their domes-

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tic law by December 31, 2018, at the latest, and must apply it from January 1, 2019 onwards.

IV. ATAD 2 Proposal

The hybrid mismatch measure set out in the ATAD applies only in intra-EU situations and not in third country situations. This means that, for example, U.S. check-the-box situations are not targeted by that measure. For this reason, the preamble to the ATAD states that although Member States have agreed on guidance, within the framework of the Code of Conduct for Business Taxation Group, on the tax treatment of hybrid entities[4] and hybrid PEs[5] within the European Union, as well as on the tax treatment of hybrid entities in relation to third countries, it is still necessary to enact binding rules; it was thus critical that further work be undertaken on hybrid mismatches between Member States and third countries, as well as on other hybrid mismatches, such as those involving PEs.[6] In its statement on hybrid mismatches, the Council asked the Commission to put forward a proposal by October 2016 on hybrid mismatches involving third countries, with a view to providing rules consistent with, and no less effective than, the rules recommended by the OECD BEPS report on BEPS Action 2, in the hope of reaching agreement by the end of 2016.

On February 21, 2017, the Council reached a compromise on the ATAD 2 Proposal.[7] According to recital (8) of the ATAD 2 Proposal, it is appropriate to include rules on hybrid mismatches with third countries in the ATAD where at least one of the parties involved is a corporate taxpayer, or, in the case of reverse hybrids, an entity in a Member State, as well as rules on "imported mismatches." Consequently, the rules in Article 9 and 9b under the ATAD 2 Proposal (see below) should apply to all taxpayers that are subject to corporate tax in a Member State, including PEs (or arrangements treated as PEs) of entities resident in third countries; the rules in Article 9a should apply to all entities that are treated as transparent for tax purposes by a Member State. In order to ensure proportionality, it is necessary to address only the cases where there is a substantial risk of tax being avoided through the use of hybrid mismatches. It is therefore appropriate to cover mismatches that arise between a head office and a PE, or between two or more PEs of the same entity, hybrid mismatch arrangements between the taxpayer and its associated enterprises, hybrid mismatches between associated enterprises, and mismatches resulting from a structured arrangement involving a taxpayer.[8] Mismatches that specifically pertain to the hybridity of entities should be addressed only where one of the associated enterprises has — at a minimum — effective control over the other associated enterprise. Consequently, in those cases, it is required that an associated enterprise be held by, or hold, the taxpayer or another associated enterprise through a participation in terms of voting rights, capital ownership or entitlement to receive profits of 50 percent or more. The ownership or rights of persons who are acting together must be aggregated for purposes of applying this test.

Article 1 of the ATAD 2 Proposal replaces and amends certain of the definitions set forth in the ATAD, and adds new definitions, thereby significantly expanding the scope of the initial ATAD hybrid mismatch measure.

Under the ATAD 2 Proposal, a "hybrid mismatch" within the meaning of Article 2(9) of the ATAD would henceforth refer to a situation involving a taxpayer or (with respect to Article 9(3)) an entity where:[9]

(1) A payment under a financial instrument gives rise to a deduction without inclusion outcome and:
   - The payment is not included within a reasonable period of time; and
   - The mismatch outcome is attributable to differences in the characterization of the instrument or the payment made under it.

(2) A payment to a hybrid entity[10] gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments made to the hybrid entity under the laws of the jurisdiction in which the hybrid entity is established or registered and the jurisdiction of any person with a participation in that hybrid entity.

(3) A payment to an entity with one or more PEs gives rise to a deduction without inclusion and that mismatch outcome is the result of differences in the allocation of payments between the head office and a PE or between two or more PEs of the same entity under the laws of the jurisdictions in which the entity operates.

(4) A payment gives rise to a deduction without inclusion because the payment is made to a disregarded PE.[11]

(5) A payment by a hybrid entity gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction.

(6) A deemed payment between a head office PE or between two or more PEs gives rise to a deduction without inclusion and that mismatch is the result of the fact that the payment is disregarded under the laws of the payee jurisdiction.

(7) A double deduction outcome occurs

Further clarification is provided to the effect that:

- A payment representing the underlying return on a transferred financial instrument will not give rise to a hybrid mismatch under (1) above, where the payment is made by a financial trader under an on-market hybrid transfer,[12] provided the payer jurisdiction requires the financial trader to include as income all amounts received in relation to the transferred financial instrument;
- A hybrid mismatch will only arise under (5), (6) or (7) above to the extent the payer jurisdiction allows the deduction to be set-off against an amount that is not dual-inclusion income; and
- A mismatch outcome will not be treated as a hybrid mismatch unless it arises between associated enterprises, between a taxpayer and an associated enterprise, between a head office and a PE, between two or more PEs of the same entity, or under a structured arrangement.

"Mismatch outcome" means a double deduction or a deduction without inclusion, where:

- A "double deduction" means the deduction of the same payment, expense or loss in the jurisdiction in which the payment has its source, the expense is in-

curred or the loss is suffered (the "payer jurisdiction") and in another jurisdiction (the "investor jurisdiction"); in the case of a payment made by a hybrid entity or PE, the payer jurisdiction is the jurisdiction in which the hybrid entity or PE is established or situated; and

- A "deduction without inclusion" means the deduction of a payment (or deemed payment between a head office and a PE or between two or more PEs) in any jurisdiction in which that payment (or deemed payment) is treated as made (the "payer jurisdiction") without a corresponding inclusion for tax purposes of that payment (or deemed payment) in the payee jurisdiction. The "payee jurisdiction" is any jurisdiction in which that payment (or deemed payment) is received, or is treated as being received under the laws of any other jurisdiction.

The following definitions are added:

- A "consolidated group for financial accounting purposes" means a group consisting of all entities that are fully included in consolidated financial statements drawn up in accordance with the International Financial Reporting Standards (IFRS) or the national financial reporting system of a Member State; and
- A "structured arrangement" means an arrangement involving a hybrid mismatch where the mismatch outcome is priced into the terms of the arrangement or an arrangement that has been designed to produce a hybrid mismatch outcome, unless the taxpayer or an associated enterprise could not reasonably have been expected to be aware of the hybrid mismatch and did not share in the value of the tax benefit resulting from the hybrid mismatch.

The ATAD 2 Proposal replaces the text of Article 9 of the ATAD, as follows:

- To the extent a hybrid mismatch results in a "double deduction," the deduction must be denied in the Member State that is the investor jurisdiction (new Article 9(1)(a)); where the deduction is not denied in the investor jurisdiction, the deduction must be denied in the Member State that is the payer jurisdiction (new Article 9(1)(b)). Nevertheless, any such deduction is eligible to be set off against dual-inclusion income, whether arising in a current or subsequent period.
- To the extent a hybrid mismatch results in a "deduction without inclusion," the deduction must be denied in the Member State that is the payer jurisdiction (new Article 9(2)(a)); where the deduction is not denied in the payer jurisdiction, the amount of the payment that would otherwise give rise to a mismatch outcome is to be included in income in the Member State that is the payee jurisdiction (new Article 9(2)(b)). However, a Member State may exclude from the scope of Article 9(2)(b) hybrid mismatches as defined in Article 2(9)(b), (c), (d) or (f); and, until December 31, 2022, from the scope of Article 9(2)(a) and (b), hybrid mismatches resulting from a payment of interest under a financial instrument to an associated enterprise where:
  - The financial instrument has conversion, bail-in or write-down features;
  - The financial instrument has been issued with the sole purpose of satisfying loss absorbing capacity requirements applicable to the banking sector and is recognized as such in the taxpayer's loss-absorbing capacity requirements;
  - The financial instrument has been issued: in connection with financial instruments with conversion, bail-in or write-down features at the level of a parent undertaking; at a level necessary to satisfy applicable loss absorbing capacity requirements; and not as part of a structured arrangement; and
  - The overall net deduction for the consolidated group under the arrangement does not exceed the amount that it would have been had the taxpayer issued the financial instrument directly to the market.
- A Member State must deny a deduction for any payment made by a taxpayer to the extent the payment directly or indirectly funds deductible expenditure giving rise to a hybrid mismatch through a transaction or series of transactions entered into between associated enterprises or as part of a structured arrangement, except to the extent one of the jurisdictions involved in the transactions or series of transactions has made an equivalent adjustment with respect to the hybrid mismatch.
- To the extent a hybrid mismatch involves disregarded PE income that is not subject to tax in the Member State in which the taxpayer is resident for tax purposes, that Member State is to require the taxpayer to include the income that would otherwise be attributed to the disregarded PE. This provision applies unless the Member State is obliged to exempt the income under a tax treaty entered into by that Member State with a third country.
- To the extent a hybrid transfer is designed to produce relief for tax withheld at source on a payment derived from a transferred financial instrument to more than one of the parties involved, the Member State of the taxpayer must limit the benefit of such relief in proportion to the net taxable income from the payment.

With respect to reverse hybrid mismatches, Article 9(a) specifies that where one or more associated non-resident entities holding in aggregate a direct or indirect interest in 50 percent or more of the voting rights, capital interests or rights to a share of profit in a hybrid entity that is incorporated or established in a Member State, are located in a jurisdiction or jurisdictions that regard the hybrid entity as a taxable person, the hybrid entity is to be regarded as a resident of that Member State and taxed on its income to the extent this income is not otherwise taxed under the laws of the Member State or any other jurisdiction. However, this rule does not apply to a collective investment vehicle, an investment fund or a vehicle that is widely-held, holds a diversified portfolio of securities and is subject to investor-protection regulation in the country in which it is established.

With respect to tax residency mismatches, Article 9(b) stipulates that to the extent a deduction for payments, expenses or losses of a taxpayer that is resident for tax purposes in two or more jurisdictions is deductible from the taxable base in both (all) jurisdictions, the Member State in which the taxpayer is resident must deny the deduction to the extent the

other jurisdiction allows the duplicate deduction to be set off against income that is not dual-inclusion income. If both jurisdictions are Member States, the Member State in which the taxpayer is not deemed to be resident under the tax treaty between the two Member States concerned is to deny the deduction.

Member States must adopt and publish the laws, regulations and administrative provisions necessary to comply with the measures discussed above by December 31, 2019, and must apply those provisions from January 1, 2020 onwards. However, as regards Article 9(a) (reverse hybrids), the applicable deadlines are December 31, 2021, and January 1, 2022, respectively.

NOTES

[1] On July 23, 1990, the Council adopted Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. As Directive 90/435/EEC had been substantially amended a number of times and further amendments needed to be made, it was recast by Council Directive 2011/96/EU of Nov. 30, 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (the "Parent-Subsidiary Tax Directive"). The two key-elements of the Parent-Subsidiary Tax Directive are the elimination of withholding tax on dividends paid by a qualifying subsidiary to a qualifying parent and the provision of either a partial or full dividends-received exemption or a credit for taxes paid on dividends received by a qualifying parent from a qualifying subsidiary. Effectively, this means that dividends distributed by a company in one Member State to a company holding a defined minimum percentage of the share capital of that company and located in another Member State will be exempt from withholding taxes in the source state and from all (or nearly all) corporate taxes on the dividends received in the recipient state.

[2] ATAD, Art. 9.1 and 9.2, respectively. It is noteworthy that the hybrid mismatch rule proposed by the Commission in its initial proposal required the residence state to adopt the characterization of the source state for both hybrid instruments and hybrid entities. This is different from the recommendations set out by the OECD, which explicitly opted not to recharacterize income. Presumably, this is why the characterization requirement was eventually abandoned in the ATAD.

[3] ATAD, Art. 2(9).

[4] Code of Conduct (Business Taxation) — Report to Council, 16553/14, FISC 225, December 11, 2014.

[5] Code of Conduct (Business Taxation) — Report to Council, 9620/15, FISC 60, June 11, 2015.

[6] ATAD, Recital (13).

[7] http://data.consilium.europa.eu/doc/document/ST-6333-2017-INIT/en/pdf.

[8] ATAD Proposal, Recital (12).

[9] ATAD 2 Proposal, Art. 1(1)(b).

[10] A "hybrid entity" is defined as any entity or arrangement that is regarded as a taxable entity under the laws of one jurisdiction and whose income or expenditure is treated as income or expenditure of one or more other persons under the laws of another jurisdiction.

[11] A "disregarded PE" means any arrangement that is treated as giving rise to a PE under the laws of the head office jurisdiction and is not treated as giving rise to a PE under the laws of the other jurisdiction.

[12] A "hybrid transfer" refers to any arrangement to transfer a financial instrument where the underlying return on the transferred financial instrument is treated for tax purposes as derived simultaneously by more than one of the parties to the arrangement; an "on-market hybrid transfer" means any hybrid transfer that is entered into by a financial trader in the ordinary course of business, and not as part of a structured arrangement.

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Philip McQueston is a senior associate in the tax department of A&L Goodbody, Solicitors. He is a qualified solicitor in Ireland and an Associate of the Irish Taxation Institute. He practices all areas of Irish taxation law and tutors and lectures in tax and business law at the Law School of the Law Society of Ireland. He has had articles published in the Irish Tax Review and is a contributing author to Capital Taxation for Solicitors, an Oxford University Press/Law Society of Ireland publication. He is a frequent speaker on Irish tax issues and is a former Vice President of the Tax Law Commission of Association Internationale des Jeunes Avocats (AIJA).

ITALY

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Giovanni Rolle, Partner of WTS R&A Studio Tributario Associato Member of WTS Global, is a chartered accountant and has achieved significant experience, as an advisor to Italian companies and multinational groups, in tax treaties and cross-border reorganizations and in the definition, documentation and defense of related party transactions. Vice-chair of the European branch of the Chartered Institution of Taxation, he is also member of the scientific committee of the journal "Fiscalità e Commercio internazionale". Author or co-author of frequent publications on Italian and English language journals, he frequently lectures in the field of International and EU taxation.

JAPAN

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Yuko Miyazaki is the head of the Tax Practice Group of Nagashima Ohno & Tsunematsu. She holds an LLB degree from the University of Tokyo and an LLM degree from Harvard Law School. She was admitted to the Japanese Bar in 1979, and is a member of the Dai-ichi Tokyo Bar Association and IFA.

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Terri Grosselin is a director in Ernst & Young LLP's Latin America Business Center in Miami. She transferred to Miami after working for three years in the New York office and five years in the Mexico City office of another Big Four professional services firm. She has been named one of the leading Latin American tax advisors in *International Tax Review*'s annual survey of Latin American advisors. Since graduating magna cum laude from West Virginia University, she has more than 15 years of advisory services in financial and strategic acquisitions and dispositions, particularly in the Latin America markets. She co-authored *Tax Management Portfolio—Doing Business in Mexico*, and is a frequent contributor to *Tax Notes International* and other major tax publications. She is fluent in both English and Spanish.

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José Carlos Silva is a partner in Chevez, Ruiz, Zamarripa y Cia., S.C., a tax firm based in Mexico. He is a graduate of the Instituto Tecnológico Autónomo de México (ITAM) where he obtained his degree in Public Accounting in 1990. He has taken graduate Diploma courses at ITAM in business law and international taxation. He is currently part of the faculty at ITAM. He is the author of numerous articles on taxation, including the General Report on the IFA's 2011 Paris Congress "Cross-Border Business Restructuring" published in Cahiers de Droit Fiscal International. He sits on the Board of Directors and is a member of the Executive Committee of IFA, Grupo Mexicano, A.C., an organization composed of Mexican experts in international taxation, the Mexican Branch of the International Fiscal Association (IFA). He presided over the Mexican Branch from 2002-2006 and has spoken at several IFA Annual Congresses. He is the Chairman of the Nominations Committee of IFA.

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David has more than nine years of experience in international tax services in Mexico and Colombia. He is focused on international tax structuring (international trading structures, holding structures, royalties and financing structures, intra-group services), anti-abuse and anti-BEPS rules, tax treaty interpretation, permanent establishment status analysis and transaction tax planning (M&As, restructuring and reorganization). David has contributed to several international tax law publications and seminars in the topic of treaty interpretation, anti-abuse rules and OECD/G20 BEPS project implementation.

THE NETHERLANDS

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Martijn Juddu is a senior associate at Loyens & Loeff based in their Amsterdam office. He graduated in tax law and notarial law at the University of Leiden and has a postgraduate degree in European tax law from the European Fiscal Studies Institute, Rotterdam. He has been practicing Dutch and international tax law since 1996 with Loyens & Loeff, concentrating on corporate and international taxation. He advises domestic businesses and multinationals on setting up and maintaining domestic structures and international inbound and outbound structures, mergers and acquisitions, group reorganizations and joint ventures. He also ad-

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Maarten J.C. Merkus is a tax partner at Meijburg & Co. Amsterdam. He graduated in civil law and tax law at the University of Leiden, and has a European tax law degree from the European Fiscal Studies Institute, Rotterdam.

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Since 1996 Maarten has been practicing Dutch and international tax law at Meijburg & Co. Maarten serves a wide range of clients, from family-owned enterprises to multinationals, on the tax aspects attached to their operational activities as well as matters such as mergers, acquisitions and restructurings, domestically as well as cross-border. His clients are active in the consumer and industrial markets, travel leisure and tourism sector and the real estate sector.

In 2001 and 2002 Maarten worked in Spain. At present Maarten is the chairman of the Latam Tax Desk within Meijburg & Co, with a primary focus on Spain and Brazil.

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Bastiaan de Kroon is a senior tax manager at KPMG Meijburg & Co., Amsterdam. After graduating in tax law at the University of Amsterdam, Bastiaan joined KPMG Meijburg & Co in February 2001. Bastiaan practises mainly in the field of international corporate tax and advises on cross-border transactions and reorganizations.

SPAIN

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Luis Briones is a tax partner with Baker & McKenzie, Madrid. He obtained a degree in law from Deusto University, Bilbao, Spain in 1976. He also holds a degree in business sciences from ICAI-ICADE (Madrid, Spain) and has completed the Master of Laws and the International Tax Programme at Harvard University. His previous professional posts in Spain include inspector of finances at the Ministry of Finance, and executive adviser for International Tax Affairs to the Secretary of State. He has been a member of the Taxpayer Defence Council (Ministry of Economy and Finance). A professor since 1981 at several public and private institutions, he has written numerous articles and addressed the subject of taxation at various seminars.

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Eduardo Martínez-Matosas is an attorney at Gómez-Acebo & Pombo, Barcelona. He obtained a Law Degree from ESADE and a master of Business Law (Taxation) from ESADE. He advises multinational, venture capital and private equity entities on their acquisitions, investments, divestitures or restructurings in Spain and abroad. He has wide experience in LBO and MBO transactions, his areas of expertise are international and EU tax, international mergers and acquisitions, cross border investments and M&A, financing and joint ventures, international corporate restructurings, transfer pricing, optimization of multinationals' global tax burden, tax controversy and litigation, and private equity. He is a frequent speaker for the IBA and other international forums and conferences, and regularly writes articles in specialized law journals and in major Spanish newspapers. He is a recommended tax lawyer by several international law directories and considered to be one of the key tax lawyers in Spain by Who's Who Legal. He is also a member of the tax advisory committee of the American Chamber of Commerce in Spain. He has taught international taxation for the LLM in International Law at the Superior Institute of Law and Economy (ISDE).

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Lucas specializes in the tax planning of cross-border investments and restructurings, as well as in tax advice concerning mergers and acquisitions, private equity (fund structuring, carried interest, planning of acquisitions and disinvestments), structured finance (project finance, asset finance, securitization and film financing) and wealth management. He joined Baker & McKenzie Madrid in 2006, where he works in the tax department. Prior to this, Lucas worked in tax consultancy at Garrigues from 2004 until 2006. He obtained his Business and Economic Sciences Degree from the Granada University (Spain), and his Law degree from Granada University (Spain), summa cum laude, Master's degree in Taxation from the "Centro de Estudios Garrigues" (Spain). He has been a member of the Madrid Bar Association since 2006.

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Alfonso Sancho is an Associate at Baker & McKenzie. He obtained his Law Degree at the Universidad Pontificia Comillas de Madrid - ICADE (Spain) in 2009. In 2010, he received his Master in Business Law from the Instituto de Empresa of Madrid (Spain). He is specialized in transfer pricing. He works with multinational companies, supporting them in documenting, managing, designing and implementing transfer pricing policies, in accordance with their business models and considering the overall tax implications.

SWITZERLAND

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Walter H. Boss is a graduate of the University of Bern and New York University School of Law with a Master of Laws (Tax) Degree. He was admitted to the bar in 1980. Until 1984 he served in the Federal Tax Administration (International Tax Law Division) as legal counsel; he was also a delegate at the OECD Committee on Fiscal Affairs. He was then an international tax attorney with major firms in Lugano and Zürich. In 1988, he became a partner at Ernst & Young's International Services Office in New York. After having joined a major law firm in Zürich in 1991, he headed the tax and corporate department of another well-known firm in Zürich from 2001 to 2008. On July 1, 2008 he became one of the founding partners of the law firm Poledna Boss Kurer AG, Zürich, where he was managing partner prior to joining Bratschi Wiederkehr & Buob.

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Silvia Zimmermann is a partner and member of Pestalozzi's Tax and Private Clients group in Zürich. Her practice area is tax law, mainly international taxation; inbound and outbound tax planning for multinationals, as well as for individuals; tax issues relating to reorganizations, mergers and acquisitions, financial structuring and the taxation of financial instruments. She graduated from the University of Zürich in 1976 and was admitted to the bar in Switzerland in 1978. In 1980, she earned a doctorate in law from the University of Zürich. In 1981-82, she held a scholarship at the International Law Institute of Georgetown University Law Center, studying at Georgetown University, where she obtained an LLM degree. She is Chair of the tax group of the Zürich Bar Association and Lex Mundi, and a member of other tax groups; a board member of some local companies which are members of foreign multinational groups; a member of the Swiss Bar Association, the International Bar Association, IFA, and the American Bar Association. She is fluent in German, English and French.

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Jonas Sigrist qualified both as an attorney-at-law and a Swiss certified tax expert. He graduated with summa cum laude from the University of Zurich, where he specialized in international taxation and social security contributions. Jonas has developed broad experience in acquisitions, mergers, spin-offs, reorganizations, relocations, and tax reliefs. His tax practice also covers international employment and employee stock and option plans. His client portfolio varies from multinationals to small and medium-sized companies in life sciences, commodities, financial services, and other sectors. He joined Pestalozzi's tax department as an associate in 2009, after he gained several years of experience in corporate taxation with a Big Four accounting firm and as a consultant in financial services. He has regular speaking engagements and frequently publishes in tax journals.

UNITED KINGDOM

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Charles Goddard is a partner with Rosetta Tax LLP, a U.K. law firm which specializes in providing "City" quality, cost-effective tax advice to businesses and professional services firms. Charles has wide experience of advising on a range of corporate and finance transactions. His clients range from multinational blue-chip institutions to private individuals. The transactions on which he has advised include corporate M&A deals, real estate transactions, joint ventures, financing transactions (including Islamic finance, structured finance and leasing), and insolvency and restructuring deals.

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James Ross is a partner in the law firm of McDermott Will & Emery UK LLP, based in its London office. His practice focuses on a broad range of international and domestic corporate/commercial tax issues, including corporate restructuring, transfer pricing and thin capitalization, double tax treaty issues, corporate and structured finance projects, mergers and acquisitions and management buyouts. He is a graduate of Jesus College, Oxford and the College of Law, London.

UNITED STATES

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Patricia R. Lesser is associated with the Washington, D.C. office of the law firm Buchanan Ingersoll & Rooney PC. She holds a licence en droit, a maitrise en droit, a DESS in European Community Law from the University of Paris, and an MCL from the George Washington University in Washington, D.C. She is a member of the District of Columbia Bar.

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Peter Glicklich is a partner in the corporate tax group. For over 25 years, Peter has counseled North American and foreign-based multinationals on their domestic and international operations and activities. Peter advises corporations in connection with mergers and acquisitions, cross-border financings, restructurings, reorganizations, spin-offs and intercompany pricing, in diverse fields, including chemicals, consumer products, real estate, biotechnology, software, telecommunications, pharmaceuticals and finance. He has worked with venture funds, investment banks, hedge funds, commodities and securities dealers and insurance companies. Peter is a contributing editor of the *Canadian Tax Journal*, and a contributor to the *Tax Management International Journal*. He was a national reporter for the International Fiscal Association's project on Treaty Non-discrimination, and is the author of *BNA Tax Management Portfolio: Taxation of Shipping and Aircraft*. Peter is a frequent speaker and author of numerous articles. Presently, Peter is the Finance Vice-President and an Executive Committee member of IFA's USA Branch, and a member of the U.S. Activities of Foreign Taxpayers and Foreign Activities of U.S. Taxpayers Committees of the Tax Sections of the American Bar Association; the International Committee of the Tax Section of the New York State Bar Association; and Tax Management Advisory Board — International. Peter is included in *The International Who's Who of Corporate Tax Lawyers 2004*, *The Best Lawyers in America*, and *Super Lawyers*. Peter graduated with high honors from the University of Wisconsin — Madison and received his J.D. (cum laude) from the Harvard Law School. Peter joined the firm as a partner in 2003.