Tax-efficient cross-border finance structures: opportunities and constraints

The increasing budget requirements of European countries and their implications for taxpayers
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Tax-efficient cross-border finance structures: opportunities and constraints

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Programme

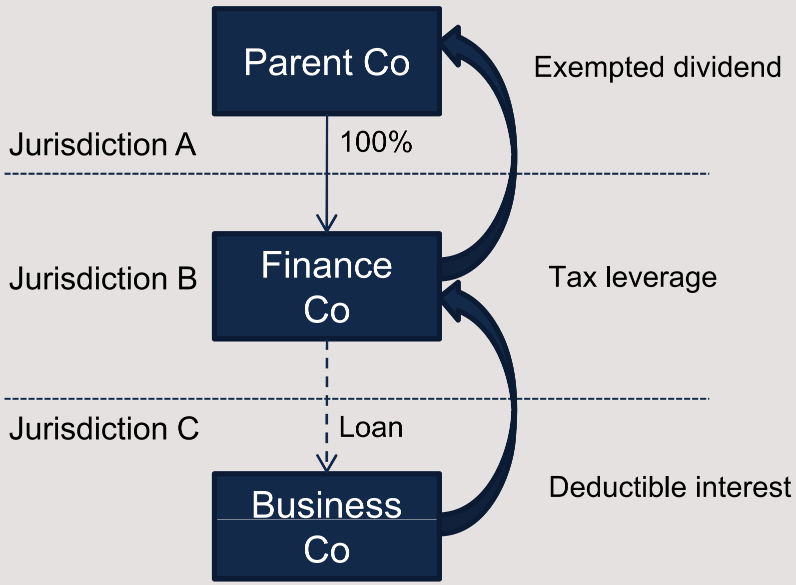
— Hybrid debt financing: identification and illustration of tax efficient financing structures for European groups willing to develop cross border business activities within Europ:

- Overview of the general tax issues.
- Example of efficient international structures implying:
  - — France as a parent company;
  - — Belgium and Luxembourg as finance companies;
  - — Poland, Czech Republic, Hungary, Slovakia and France as business companies.

— Cross-border debt forgiveness: overview of tax implications and possible tax optimizations (France, Luxembourg, Belgium and Poland)

Chapter I: Hybrid Debt Financing

— Target structure



— The tax efficiency of the structure relies on the combination of:

- the tax deduction of the interest charge paid by Business Co to Finance Co;
- the exemption of withholding tax on interest payments between C and B;
- the exemption/partial taxation of the interest profit of Finance Co or the deduction of a notional interest charge;
- the exemption of the dividend distributed by Finance Co to Parent co;
- the exemption of withholding tax on the dividends paid from B to A.

I. General tax issues

— Tax issues for Business Co:

- Tax deduction of the interest charge
  - — Tax treatment of the interest charge.
  - — Thin-capitalization limitations.
  - — Act of misconduct: free choice of finance sourcing.
  - — Abuse of law procedure triggering requalification as a dividend (i.e. non deduction).
  - — Other anti-abuse rules (transfer pricing, expenses paid to companies located in tax heavens?).
- Exemption of withholding tax in the Business Co jurisdiction:
  - — Beneficial owner (tax treaties, analysis under domestic law).
  - — Tax residence of Finance Co in the case the latter is not subject to tax in jurisdiction B.

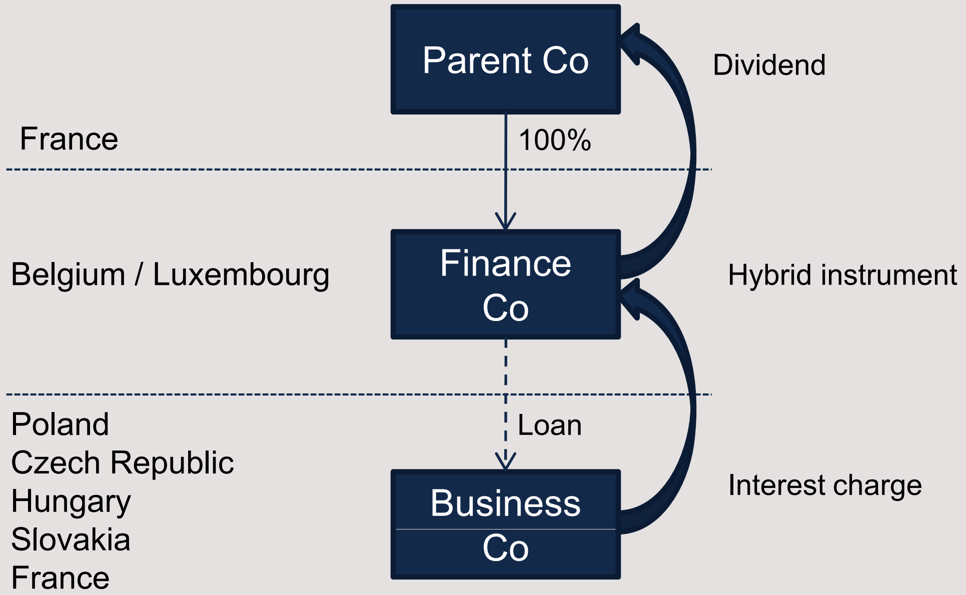
— Tax issues for Finance Co: existence of a tax leverage:

- Possibility:
  - — to tax interest profits under a specific exemption regime or to treat them as exempted dividends?
  - — or to deduct a notional interest charge on a net equity or capital basis?
- Anti-arbitrage clause in the Business Co jurisdiction?

— Tax issues for Parent Co:

- Conditions of the participation-exemption regime.
- Abuse of law procedure: risk to be considered as the creditor (see substance of Finance Co).

II. Example of international structures



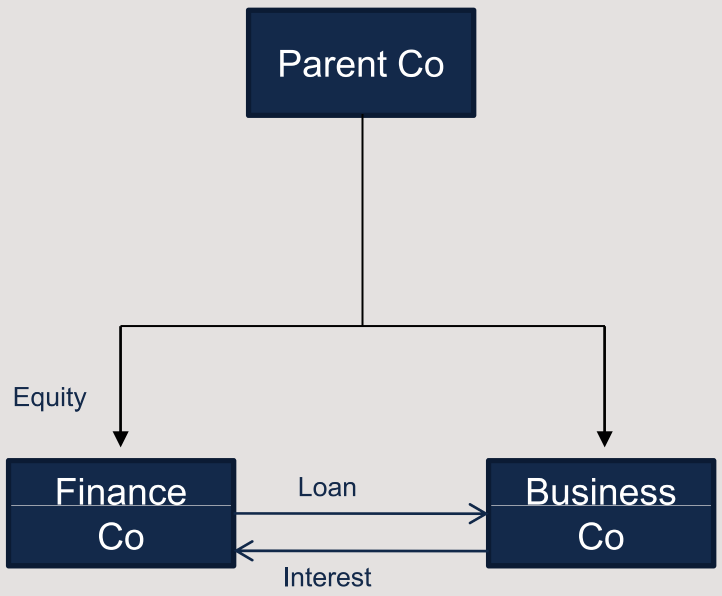
(1) Tax issues for Parent Co
France

— Participation-exemption regime:
  - Parent Co and Finance Co (in its local jurisdiction) must be subject to corporate income tax.
  - Parent Co must hold at least 5% of the capital and voting rights of Finance Co during a two-year minimum period.
  - Exemption up to 95% of the gross dividend.

— CFC rules:
  - Priviledged tax regime + Artificial arrangement set up to circumvent French tax legislation.
  - Taxation of income earned by Finance Co in France.

— Abuse of law exposure in the case of lack of substance of Finance Co:
  - Parent Co is deemed to be the creditor.
  - Taxation of the dividend as interest (33.1/3%).

(2) Tax issues for Finance Co Belgium



— Example of NID benefit for Belgian Finance Co

- Assumptions:
  - — Equity Belgian Finance Co: 1,000
  - — Interest rate interco funding: 4%
  - — No withholding tax on interest
  - — Corporate income tax rate: 33.99%
- Tax calculation of Belgian Finance Co:

— Accounting profit	40.00
— Less NID (3.425% in 2010)	34.25
— Taxable income	5.75
— Tax due	1.95
— Effective tax rate of Finance Co	4.88%

- Conclusion:
  - — Effective tax saving equals EU subsidiary domestic tax rate minus effective tax rate of Belgian Finance Co on interest amount

(2) Tax issues for Finance Co
Belgium

— The NID rate will be capped at 3% for large companies (3,5% for SME's) as of tax year 2012.

— The Belgian Government plans to introduce other modifications to the NID regime as of tax year 2013:

- Companies will no longer have the possibility to carry forward excess NID generated during tax year 2012 and subsequent tax years;
- NID carry forward generated before tax year 2012 remain available in subsequent tax years but the maximum deduction thereof will be limited to 60% of the taxable profit in any given subsequent tax year.

(2) Tax issues for Finance Co Luxembourg

- Luxembourg thin cap rules
  - Shareholder debt VS Third party debt.
  - Financing qualifying shareholdings.
  - Financing receivables (2011 Tax Authorities Transfer Pricing Circular).
- Luxembourg tax deductibility
  - Exclusively caused by the enterprise.
  - Connection with tax exempt income.
  - Arm’s length principle.
- Luxembourg WHTs
  - No Luxembourg WHTs, unless EU Savings Directive applies.
  - Arm’s length interest VS Hidden profit distributions.

(2) Tax issues for Finance Co Luxembourg

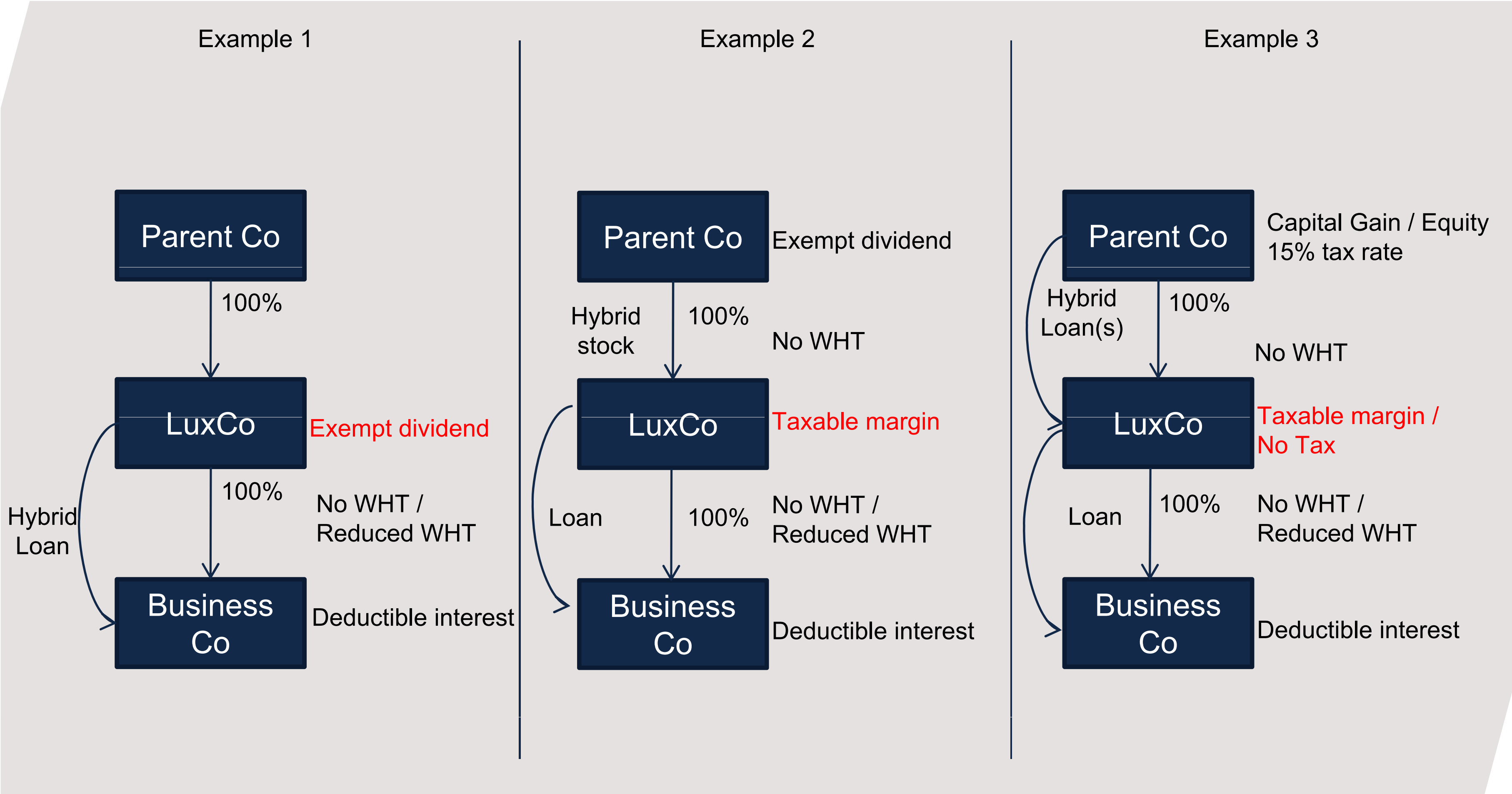
— Luxembourg taxation of interest income

- Interest income is fully taxable at 28.80%.

— Luxembourg typical financing structures

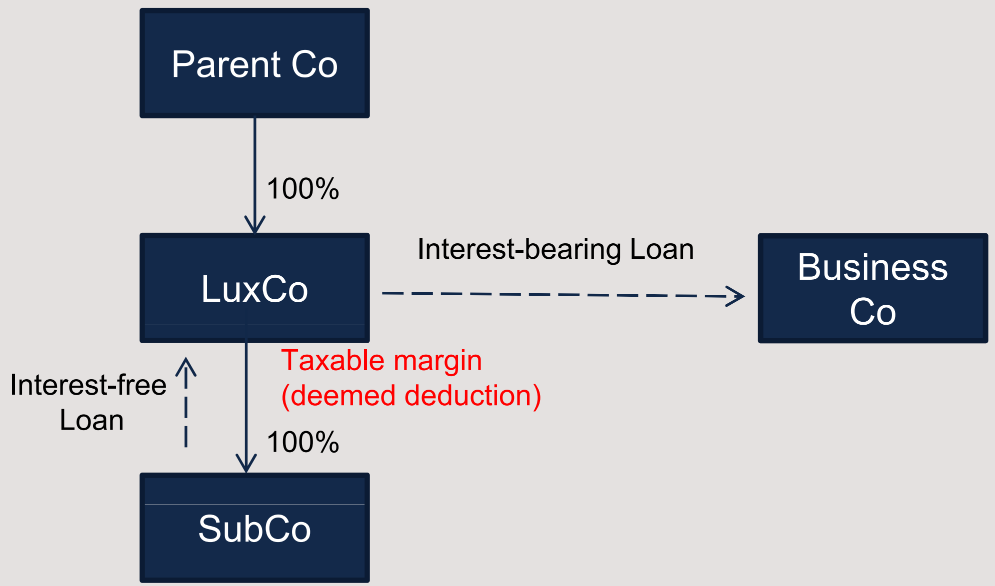
- Classic intermediary financing (“back-to-back financing”).
- Deemed interest deduction (offsetting interest with deemed interest expense).
- Hybrid financing instruments (hybrid and reverse hybrid / case-by-case analysis).

(2) Tax issues for Finance Co
Luxembourg: hybrid financing ideas



(2) Tax issues for Finance Co
Luxembourg: hybrid financing ideas

Example 4



(3) Tax issues for Business Co Poland

— Deduction of interest

- Interest is tax deductible when paid.
- Thin capitalisation rules (3:1) apply only to interest paid on a loan granted by a direct parent or sister company.
- No practical risk into reclassification of interest into dividend.

— Withholding tax

- As a rule 20% withholding tax applies, reduced by relevant tax treaties. After June 2013 Parent Subsidiary rule will fully apply to interest. Structuring interest payment is a way which would allow for exemption of interest from taxation under the Parent Subsidiary rule may result in application of thin capitalisation rules.
- The tax authorities usually do not challenge the beneficial ownership of the interest recipient. The interest recipient to benefit from the tax treaties should provide the payer with its tax residency certificate.

(3) Tax issues for Business Co
Czech Republic, Hungary, Slovakia

— Deduction of interest

- Interest is tax deductible on accrual basis in each jurisdiction.

— Thin capitalisation

- Ratio of 4:1 in Czech Republic.
- Ratio of 3:1 in Hungary on net debt. Any loan financing is covered.
- No thin capitalisation rules in Slovakia.

— Reclassification of interest into dividend

- No practical risk into reclassification of interest into dividend.

— Withholding tax

- 15% in Czech Republic. Tax treaties and EC Parent Subsidiary Directive can reduce the rate to zero.
- No withholding tax in Hungary.
- 19% in Slovakia. Tax treaties and EC Parent Subsidiary Directive can reduce the rate to zero.

(3) Tax issues for Business Co
France: tax deduction of the interest charge

- Tax deduction generally granted if loan debt is:
  - Contracted in the proper interest of the debtor company.
  - Properly recorded in its accounts.
- Thin capitalization rules
  - Interest rate ceiling: maximum deductible interests limited to the annual average of the effective interest rates applied by financial institutions.
  - Thin-capitalization rules: fraction of paid interests added back (1) in case of a thin-capitalization situation, which implies:
    - Amount borrowed by the debtor company exceeds 1.5 of its net equity ("global indebtedness") AND,
    - Interest paid by the debtor company exceeds 25% of its net profit before taxes ("interest coverage") AND,
    - Interest paid to affiliated companies exceeds the amount of interest received from them ("interest ratio").
- Finance sourcing & abnormal management decision
  - Risk of challenge by the French Tax Authorities (FTA) regarding the proper interest of the company.
  - Reluctance of the French Courts: FTA shall not intervene in the managing decisions of the company.

(1) No reintegration required if the fraction of interests < 150.000 € or if global indebtedness of the company ≤ of its group indebtedness.

(3) Tax issues for Business Co
France: tax deduction of the interest charge

— Abuse of Law

- The FTA may try to challenge the interest deduction, considering that the payment is actually a dividend. Cases where the Abuse of Law Comity:
  - — considered that the interest charge related to bonds convertible into shares are deemed to be non deductible dividends provided that:
    - The bond issue does not give rise to actual cash transfers but only to account recordings.
    - The financial structure of the issuing company does not really change.
    - The interest amount depends on the net results.
    - The interest profits are not taxed in the creditor jurisdiction.
  - — rejected the FTA position when a participating loan granted by a foreign (Luxembourg) company to a French subsidiary:
    - implies actual cash transfers and a modification of the financial structure of the debtor (short-term/long-term, net equity/liabilities);
    - whereas the interest charge is mainly determined on the basis of the subsidiary consolidated net result.

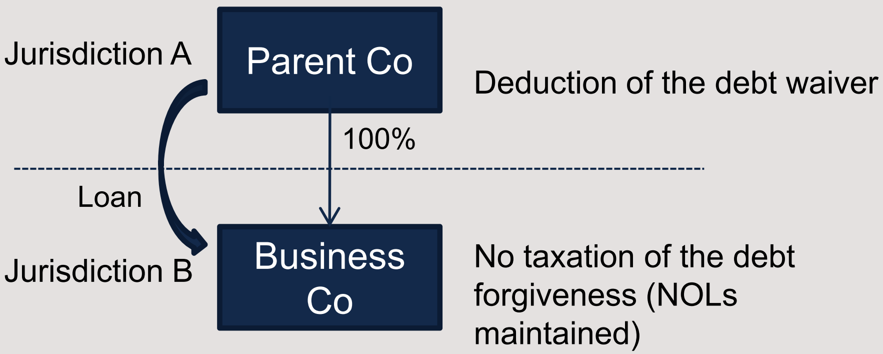
(3) Tax issues for Business Co
France: withholding tax exemption

— As from March 2010, interest paid by a French debtor to a non-resident company are exempt from withholding tax provided that the creditor is not located in a non cooperative state or territory (NCST):

- The French tax authorities accept to grant the exemption where interest is paid to a bank located in a Member State, even if the bank transfers the said interest to a creditor located in a non cooperative jurisdiction.
- The exemption granted by the European directive to directly linked companies is not useful anymore.

Chapter II: Cross-border debt forgiveness

— Target structure



— The tax efficiency of the structure relies on the combination of:

- the tax deduction of the charge resulting from the debt waiver granted by Parent Co;
- the exemption of the profit resulting from the debt forgiveness, so that the NOLs of Business Co are maintained.

(1) Debt Forgiveness in France

— Tax deduction of debt forgiveness in France:
- General rules of tax deduction:
  - Interest of the French parent company:
    - Non deductibility if abnormal management decision.
    - Group interest is irrelevant.
  - Two types of debt forgiveness:
    - Commercial: full deductibility.
    - Financial:
      - deductibility limited to the negative net equity of the foreign subsidiary.
      - The case law accepts under conditions the deductibility where the debtor (Business Co) is held by Parent Co through a wholly-owned subsidiary.
- So far, no limitation (case law, FTA guidelines) of the deductibility where the debt forgiveness is not taxable in the country of the debtor

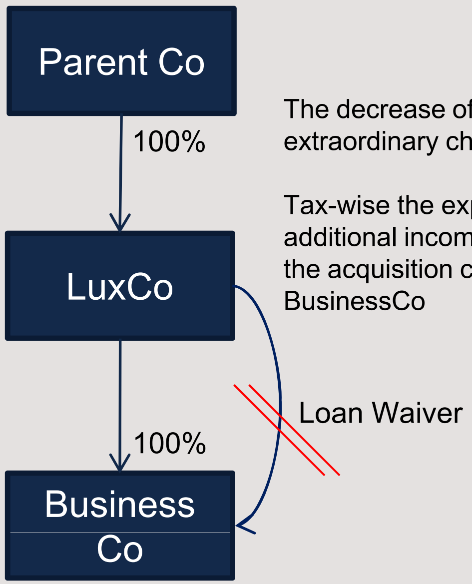
— Debt forgiveness taxable when the debtor is located in France

(2) Debt Forgiveness in Luxembourg

— Luxembourg debt forgiveness / waiver basic principles

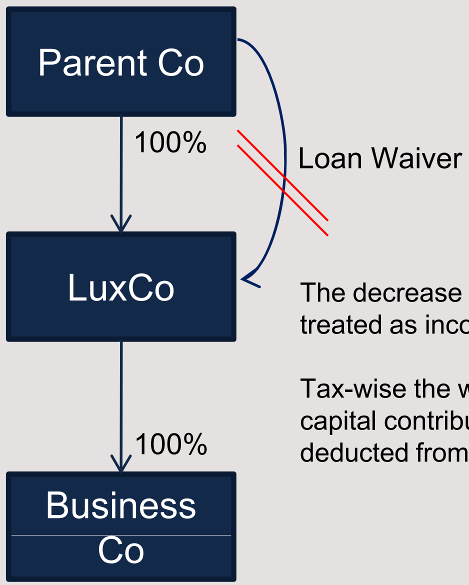
- The forgiveness of a debt to a LuxCo will increase the net assets of the latter.
- The profits of a LuxCo are computed according to the change of net assets.
- This type of transaction should trigger taxable income.
- A specific provision sets the conditions under which taxation of debts forgiven may be mitigated. The debt forgiveness may be deducted from the result of the year if it is pursued with the intention of financially re-establish the enterprise and to the extent that the result is a profit.
- Transfer pricing adjustment: the concept of Hidden Capital Contribution.

(2) Debt Forgiveness in Luxembourg
Concept of hidden capital contributions



The decrease of LuxCo's assets should trigger an extraordinary charge in the Lux GAAP accounts

Tax-wise the expense may be neutralized by additional income in connection with the increase of the acquisition cost of the participation in BusinessCo



The decrease of LuxCo's liabilities should be treated as income in the Lux GAAP accounts

Tax-wise the waiver may be treated as a hidden capital contribution and the income should be deducted from LuxCo's taxable basis

(3) Debt Forgiveness in Belgium

— General principles: between related parties

- Possibly: granting of abnormal or gratuitous advantages
- (“abnormal” means contrary to common business practice and “gratuitous” means granted in absence of sufficient consideration)
- The amount granted may be added to the taxable base of the Belgian creditor if the advantages are granted to a foreign group company; and/or
- Non deductibility of debt waiver at the level of the Belgian creditor; and
- The Belgian debtor may not offset any (carry forward) tax losses against the abnormal or gratuitous advantages received;
- In a cross border situation, possibly transfer pricing adjustments.

— Possibility to request a tax ruling on debt waiver

- Ruling commission has indicated that, depending on facts and circumstances, a debt waiver may **not** lead to granting **abnormal or gratuitous advantages** provided that:
  - — justified economic reasons are present; and
  - — “Better fortune” clause.

— Without a tax ruling:

- Tax courts take different viewpoints as to tax deductibility of debt waiver (and generally not deductibility).

(4) Debt Forgiveness in Poland

— Neither interest nor principal of the forgiven loan will be tax deductible for the Polish parent company.

— Forgiveness of the principal will constitute a taxable income of the Polish Business Co. Taxation of forgiven interest is debatable.