Advisory Panel on
Canada's System of
International Taxation

Thin Capitalization Regimes in Selected Countries

Ernst & Young LLP

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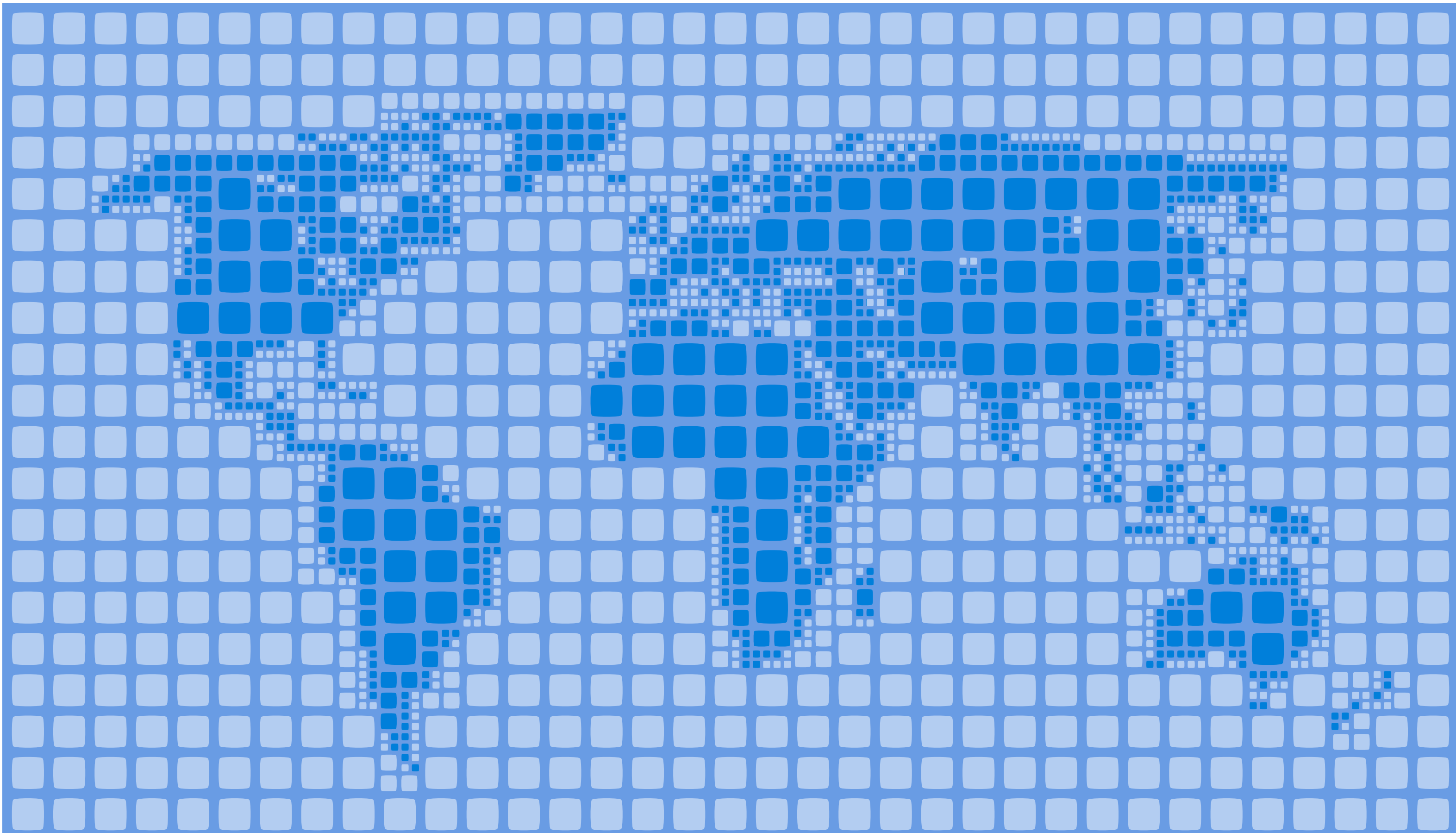

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Australia

Australia's thin capitalization rules permanently deny interest and other debt-related deductions to the extent that the debt attributable to the Australian operations of a multinational group exceeds a prescribed level. The maximum allowable level is generally based on 75 percent of the Australian taxpayer's Australian adjusted net assets. There are opportunities to increase the thin capitalization ratio based on certain arm's-length factors or a worldwide debt-to-equity ratio. The current Australian thin capitalization rules were effective as of July 1, 2001. The current rules were first conceived in 1998 when the Australian government commissioned an independent committee to undertake a review of Australia's business tax measures. The policy intention was to ensure that the Australian operations of multinational groups do not bear an excessive level of debt relative to their global operations and to prevent multinational entities from taking advantage of the differential tax treatment of debt and equity to minimize their Australian tax.

Taxpayers subject to rules

Australia's thin capitalization rules apply to the following entities:

- Australian entities that operate internationally (referred to as "outward" entities); and
- Australian entities that are foreign controlled and foreign entities that operate in Australia (referred to as "inward" entities).

An "entity" for the purpose of these rules is very broad and includes:

- an individual;
- a body corporate;
- a body politic;
- a partnership;
- any other unincorporated association or body of persons, but not a non-entity joint venture;
- a trust and trustee; and
- a superannuation fund and trustee.

The following entities are excluded from the application of the thin capitalization rules, even if they are an entity described above:

- an entity that does not claim any interest and debt-related deductions;
- an entity (together with its associates) that has annual interest expense and debt-related deductions of less than AUD 250,000;

- an Australian entity operating internationally, that is not foreign controlled and whose foreign investments and assets represent 10 percent or less of its total Australian and foreign assets; and

- certain bona fide securitization vehicles.

Where an entity forms part of an Australian consolidated group for tax purposes, the thin capitalization rules apply to the consolidated group, as if it were a single entity for tax purposes.

Outward entity

An "outward" entity is any Australian entity which is the direct or indirect "controller" of at least one "Australian-controlled foreign entity" or which carries on business in another country at or through a permanent establishment in that country. The thin capitalization rules for outward groups also apply to any other Australian entity that is an "associate entity" of such an entity. To determine whether an outward group is subject to the thin capitalization provisions, it is necessary to consider the definitions of "Australian-controlled foreign entity" and "Australian controller".

- *Australian-controlled foreign entity*: For this purpose, an Australian-controlled foreign entity is a controlled foreign company (CFC), a controlled foreign trust (CFT) or a controlled foreign corporate limited partnership (CFCLP). Whether a foreign entity is a CFC, CFT or CFCLP is determined in accordance with Australia's CFC rules.

- *Australian controller*: An Australian entity is the controller of a foreign entity in certain situations, as follows:

  - if the foreign entity is a CFC — the Australian entity holds a beneficial interest in the CFC of at least 10 percent; or the CFC is actually controlled by five or fewer Australian entities and the Australian entity has a voting membership interest of at least one percent;

  - if the foreign entity is a CFT — the Australian entity holds a beneficial interest in the CFT of 10 percent or more;

  - if the foreign entity is a CFCLP — the Australian entity is a general partner (i.e., whose liability is not limited) in the partnership or holds a beneficial interest in the CFCLP of 10 percent or more.

There are complicated rules of what constitutes a beneficial interest in a CFC, CFT or CFCLP.

Inward entity

An "inward" entity is an Australian entity that is "controlled" by foreign entities or a foreign entity that carries on business in Australia at, or through, a permanent establishment. For this purpose, the provisions contain an expansive and complicated definition of "foreign controlled Australian entity". Broadly, the concept was adapted from the definition of a CFC under

Australia's CFC regime. In simple terms and subject to some exclusions, an entity is a foreign-controlled Australian entity if it is an Australian company, trust or partnership where one of the following conditions exists:

- at least 50 percent of the beneficial membership interests in the Australian entity are held or controlled by five or fewer foreign entities;
- at least 40 percent of the beneficial membership interests in the Australian entity are held or controlled by a single foreign entity, except where another person actually controls the entity; or
- an Australian company that is actually controlled by five or fewer foreign entities.

In determining whether beneficial membership interests in an Australian entity are held or controlled by a foreign entity, any interests held by associates of the foreign entity are also included.

There are some additional conditions that must exist in order for an Australian trust to fall within the ambit of these rules.

Scope of rules

Australia's thin capitalization rules apply to limit the deductibility of interest and other debt-related deductions on all debt attributable to the Australian operations of a multinational group.

Approach

"Debt deductions" as defined, may be permanently disallowed under the thin capitalization rules. Separate thin capitalization rules apply to an authorized deposit-taking institution (ADI). An ADI is an entity that is registered to carry on a banking business in Australia.

For purposes of these computations, a financial instrument is classified as debt or equity by reference to the debt-to-equity rules which were introduced in conjunction with the thin capitalization rules. These rules classify all financial instruments by reference to a very prescriptive substance over form approach. The classification of an instrument under these provisions generally governs the Australian tax treatment of all returns on these instruments (with some modifications and exceptions).

With respect to non-ADI entities, the thin capitalization provisions require the taxpayer to calculate its "Maximum Allowable Debt" level, which is compared to its "Adjusted Average Debt". The thin capitalization rules require an ADI to calculate its "Minimum Capital Amount" which is compared to its "Adjusted Average Equity Capital".

The relevant concepts for the computation are as follows:

Non-ADI Entities

Maximum Allowable Debt

The method for calculating the Maximum Allowable Debt depends on whether the relevant taxpayer is part of an "inward" or "outward" group. If the relevant taxpayer is classified as part of both an "inward" and "outward" group, the Maximum Allowable Debt for the taxpayer is determined according to the calculations for "outward" groups.

Outward groups

The Maximum Allowable Debt of a relevant taxpayer that is part of an "outward" group and is not an ADI is equal to the largest of the following amounts:

1. Safe Harbour Debt Amount
2. Arm's-length Debt Amount
3. Worldwide Gearing Debt Amount

1. Safe Harbour Debt Amount

The calculation of the Safe Harbour Debt Amount is based on the asset and liability information contained in the entity's balance sheet prepared in accordance with recognized Australian accounting standards. The Australian equivalent of the International Financial Reporting Standards (IFRS) were introduced as the new Australian accounting standards for annual reporting periods beginning January 1, 2005 and must be used for purposes of the taxpayer's thin capitalization calculations for income tax years commencing on or after January 1, 2005. The calculation of the Safe Harbour Debt Amount is based on an eight-step method as follows:

Step 1 — Determine the average value of Australian assets

- Australian assets means all assets held directly by the relevant Australian entity, including all debt and equity investments (although such amounts may be excluded in subsequent steps). There are certain options available to the taxpayer to determine the value of its assets as described below.

Step 1A — Reduce the Step 1 amount by the average value of all excluded equity interests

- Excluded equity interests are those equity interests issued by the Australian entity that have been or will be on issue for less than 180 days. This exclusion is intended to prevent short term equity interests from being issued by the taxpayer to increase the Australian asset base prior to year-end.

Step 2 — Reduce the Step 1A amount by associate entity debt

- Associate entity debt includes amounts owing from associate entities of the Australian taxpayer. The definition of "associate entity" for these purposes is complex, and in broad terms, encompasses Australian entities (which are themselves subject to the thin capitalization provisions) in which the relevant taxpayer has a specified interest. In order to constitute associate entity debt, the debt instrument needs to have arm's-length terms and conditions.

Step 3 — Reduce the Step 2 amount by associate entity equity

- Associate entity equity includes all equity instruments owned by the taxpayer in associate entities, including certain cost-free debt instruments not included at Step 2.

Step 4 — Reduce the Step 3 amount by controlled foreign entity debt (not applicable for inward entities)

- Controlled foreign entity debt includes all debt instruments issued by controlled foreign entities to the relevant Australian entity that results in an interest cost to the controlled foreign entity.

Step 5 — Reduce the Step 4 amount by controlled foreign entity equity (not applicable for inward entities)

- Controlled foreign entity equity includes all equity instruments held by the Australian entity in controlled foreign entities, including certain cost-free debt instruments not included at Step 4.

Step 6 — Reduce the Step 5 amount by non-debt liabilities

- This includes all Australian liabilities held that are not debt or equity interests based on an accounting balance sheet.

Step 7 — Multiply the result of Step 6 by 75 percent

Step 8 — Add to Step 7 the relevant taxpayer's associate entity excess amount

- Step 3 excludes any equity investments held by the Australian entity in an associate entity. Step 8 allows the Australian entity to access any extra debt carrying capacity held by associate entities. The available excess is in proportion to the Australian entity's beneficial interest in the associate entity.

Significant modifications are made to the Safe Harbour Debt method used above for financial entities. Financial entities are defined to be an entity, other than an ADI, that is any of the following:

- a registered corporation under the Financial Sector (Collection of Data) Act 2001;
- a securitization vehicle;

- an entity that:
  - is a financial services licensee within the meaning of the Corporations Act 2001 whose licence covers dealings in at least one of the financial products mentioned in paragraphs 764A(1)(a), (b) and (j) of that Act; or
  - under paragraph 911A(2)(h) or (l) of the Corporations Act 2001, is exempt from the requirement to hold an Australian financial services licence for dealings in at least one of those financial products;

  and carries on a business of dealing in securities, but not predominantly for the purposes of dealing in securities with, or on behalf of, the entity's associates;
- an entity that:
  - is a financial services licensee within the meaning of the Corporations Act 2001 whose licence covers dealings in derivatives within the meaning of that Act; or
  - under paragraph 911A(2)(h) or (l) of the Corporations Act 2001, is exempt from the requirement to hold an Australian financial services licence for dealings in such derivatives;

  and carries on a business of dealing in such derivatives, but not predominantly for the purposes of dealing in such derivatives with, or on behalf of, the entity's associates.

In addition, financial entities may choose to be treated as an ADI in certain circumstances.

2. Arm's-length Debt Amount

This amount is equal to the amount of debt that the Australian operations of the relevant group could be reasonably expected to have obtained from an independent commercial lender on an arm's-length basis if the Australian operations of the group were assessed independently from its non-Australian operations. The determination is generally based on, but not limited to, the following factors and assumptions:

Factual assumptions

- The commercial activities of the Australian entity do not include the ownership of any associate entity debt.
- The entity carried on the Australian business that it actually carried on during the year.
- Any guarantee or security provided in respect of the Australian business operations by its associates was not actually provided.

Relevant factors

- The functions performed, the assets used and the risks assumed by the entity in relation to its Australian operations.
- The terms and conditions of the debt actually held.
- The assets provided as security in relation to that debt.
- The Australian entity's ability to meet its debt obligations as and when they fall due.
- The profits of the Australian operations and the return on investment.
- The general state of the Australian economy.

The Australian Taxation Office has released a detailed Taxation Ruling which outlines the methodology that taxpayers should follow in determining the Arm's-length Debt amount. The methodology is based on the transfer pricing guidelines of the Organisation for Economic Co-operation and Development (OECD), with a number of assumptions and factors outlined above that would be provided to a third party lender in determining the amount that could be obtained on an arm's-length basis. This method is not used frequently by taxpayers as a result of the factors and assumptions, and the subjectivity involved.

3. Worldwide Gearing Debt Amount

This amount is determined as a variation to the Safe Harbour Debt calculation and can allow an outward entity that is not also considered to be an inward entity to adopt an increased Maximum Allowable Debt level having regard to the external debt and equity levels of the relevant entity's worldwide group.

A modified calculation of Maximum Allowable Debt can be calculated where a percentage of greater than 75 percent can be adopted for the purposes of Step 7 of the Safe Harbour debt calculation above. The alternate percentage is calculated by reference to the entity's "worldwide debt" and "worldwide equity".

To illustrate, the method used in calculating the Worldwide Gearing Debt Amount for an outward investor (non ADI) is as follows:

Step 1 — Determine the average value of the worldwide debt and divide it by the average value of worldwide equity for the year

Step 2 — Multiply the result of Step 1 by 12/10

Step 3 — Add the number 1 to the result of Step 2

Step 4 — Divide the result of Step 2 by the result of Step 3

Step 5 — Multiply the result of Step 4 in the Safe Harbour Debt Amount calculation (see above)

Step 6 — Add to the result of Step 5, the taxpayer's associate entity excess amount

For example, if the average worldwide debt and the average worldwide equity are $400 million and $100 million, respectively, the modified percentage would be calculated as follows:

Step 1 — $400 ÷ $100 = 4

Step 2 — 4 × 1.2 = 4.8

Step 3 — 1 + 4.8 = 5.8

Step 4 — 4.8 ÷ 5.8 = 82.8 %

The taxpayer could then adopt a greater than 75 percent threshold for purposes of Step 7 in the Safe Harbour Debt Amount calculation.

Certain modifications are made to the worldwide gearing debt method used above for financial entities.

Inward groups

For a taxpayer that is an inward entity and not an ADI, the Maximum Allowable Debt is calculated as the greater of the Safe Harbour Debt Amount and the Arm's-length Debt Amount. The calculation of the Safe Harbour Debt Amount is modified for relevant taxpayers that are part of an inward group as indicated above, by excluding Steps 4 and 5 in the computation.

Again, this test is modified for financial entities that are not ADIs.

Adjusted Average Debt

In calculating the entity's Adjusted Average Debt, the total amount of all interest-bearing debt is reduced by certain amounts of "associate entity debt" that have been issued to the taxpayer by an associate entity. This corresponds with Step 2 of the Safe Harbour Debt calculation and is designed to ensure that amounts which are on-lent to associate entities by the Australian entity are effectively excluded from the thin capitalization calculation.

In addition, for an "outward" entity, this amount is also reduced by any "controlled foreign entity debt" issued to the taxpayer by controlled foreign entities. This amount similarly corresponds with Step 4 of the Safe Harbour Debt calculation.

Essentially, both the Adjusted Average Debt and Safe Harbour Debt are reduced for amounts being on-lent to associate entities or controlled foreign entities. The policy behind this adjustment is to represent that the interest expense of the Australian entity is offset by the interest income derived by it from associate or controlled foreign entities.

In calculating the Maximum Allowable Debt using the Safe Harbour Method and the Adjusted Average Debt, the calculation requires the "average" value of various items over the relevant income tax year. There are three methods that can be applied and depending on the value of Australian assets, debt instruments, associate entity debt and equity instruments, each of these methods may give rise to different results. The methods are as follows:

1. Opening and closing balances method — average value is calculated on the first and last day of the relevant income year.

2. Three measurement days method — average value is calculated on the first day, a mid-point and last day of the relevant income year.

3. Frequent measurement period — average value is calculated on a quarterly or more frequent measurement basis of the relevant income year.

In calculating Maximum Allowable Debt using the Safe Harbour Method and Adjusted Average Debt, an entity is required to identify and value its "assets" and "non-debt liabilities". The calculation relies on accounting concepts and definitions, and in this regard, assets can be revalued in accordance with the relevant Australian accounting standards. For assets that are revalued by an independent valuator (or the internal valuation methodology is agreed by an external valuator), the taxpayer must retain adequate records. Taxpayers need not actually reflect the higher asset values in their financial accounts provided that any such revaluation would be allowable under the applicable accounting standards had the taxpayer so chosen.

More recently, the Australian government has announced amendments that may allow taxpayers to recognize certain intangible assets at higher values than the accounting standards allow for thin capitalization purposes. Although these rules have not yet been introduced as law, they are likely to be prescriptive in their application.

ADI entities

The term ADI is defined to mean a body corporate that is an ADI for the purposes of the Banking Act 1959. In essence, it is a body corporate which is authorized by the Australian Prudential Regulation Authority (APRA) under the Banking Act 1959, to carry on a banking business in Australia. It also includes other authorized bodies such as building societies and credit unions. In addition, the rules apply to certain financial entities which are not ADIs but which choose to be treated as ADIs for thin capitalization purposes.

There are separate thin capitalization rules for ADIs which vary depending on whether the relevant taxpayer is an outward or inward investing entity (as defined in the rules).

- An outward investing entity (ADI) is broadly an Australian bank, and groups that contain an Australian bank, that have foreign subsidiaries and/or branches.

- An inward investing entity (ADI) is broadly a foreign bank that carries on its banking business at or through permanent establishments in Australia.

The thin capitalization rules impose a limit on the extent to which the Australian operations of Australian or foreign banks can be funded by debt. The thin capitalization rules applying to ADIs are based on the methodology of the capital adequacy requirements prescribed by APRA. Under the capital adequacy regime, the ADI's assets are risk weighted, such that assets that have higher risk (such as loans to corporate entities) require more capital than assets that have low risk (such as government bonds). APRA may also require a specific amount of capital to be held for certain assets, such as goodwill and investments in life and general insurance subsidiaries.

Similarly, the thin capitalization rules for ADIs use risk-adjusted assets rather than book values of assets to calculate the Safe Harbour Minimum Capital Amount and the Worldwide Capital Amount, and will require additional capital to be held against certain Australian assets. The thin capitalization rules that apply to Australian ADIs require a Minimum Capital Amount to be used in calculating the taxable income of ADIs derived from Australian operations.

A taxpayer must calculate its Minimum Capital Amount and compare this to its Adjusted Average Equity Capital for an income year. The Minimum Capital Amount is the least of the following amounts:

1. Safe Harbour Capital Amount;
2. Arm's-length Capital Amount; and
3. Worldwide Capital Amount (outward groups only).

Thus, ADIs are required to determine their Minimum Capital Amount in accordance with all three tests and apply the one that provides the least favourable limit.

Treatment of disallowed interest

A proportionate amount of all "debt deductions" is denied permanently to the extent that the "Adjusted Average Debt" exceeds the "Maximum Allowable Debt" for non-ADI entities. For ADIs, the permanent denial of all "debt deductions" arises to the extent that the "Adjusted Average Equity Capital" is less than the "Minimum Capital Amount". A "debt deduction" of an entity for an income tax year is a cost incurred by the entity which would otherwise be deductible for Australian tax purposes. Such costs include interest and amounts in the nature of interest as well as incidental expenses, such as borrowing costs and bank fees.

Interest that is disallowed under the Australian thin capitalization rules or under transfer pricing principles is not treated as a deemed dividend. The denial of the interest deduction does not impact its characterization as interest for Australian withholding tax purposes. The Australian domestic interest withholding tax rate is 10 percent, with very few exceptions.

Other measures and planning

Australia has a legislative framework for dealing with arrangements under which profits are shifted out of Australia, primarily through the application of its transfer pricing rules. The transfer pricing provisions impose arm's-length standards in relation to:

- the supply or acquisition of property or services under an "international agreement" between separate legal entities; and
- the internal dealings of a multinational enterprise, i.e., dealings between the head office and a branch (permanent establishment) or between branches.

In addition to Australia's transfer pricing provisions, royalties derived by a non-resident are subject to withholding tax unless an exemption applies. The term "royalty" is broadly defined and the normal rate of royalty withholding tax is 30 percent. However, the rate of withholding tax is reduced where the royalties are paid to a resident of a country with which Australia has a tax treaty. In some treaties, the definition of royalty is also narrowed for this purpose.

Australia also has general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 ("Part IVA"). These provisions apply:

- when a taxpayer enters into a scheme (broadly defined for this purpose);
- the taxpayer obtains a tax benefit from the scheme (also broadly defined); and
- having regard to a number of specific factors identified in the legislation, it could objectively be concluded that the scheme was entered into for the dominant purpose of obtaining a tax benefit.

If Part IVA applies to a scheme, the Commissioner of Taxation may cancel the tax benefit, make compensating adjustments and impose substantial penalties.

Part IVA is a provision of last resort and it does not apply unless a tax benefit derived by a taxpayer is otherwise allowable under tax law. For example, it does not apply if a deduction is not allowable in any event under the general deduction provisions, or if the transaction is set aside by some other specific anti-avoidance measure.

France

The current French rules were introduced for fiscal years beginning on or after January 1, 2007 and as outlined below, are more restrictive than previous rules which only applied to interest payable on debt owing to certain direct parent companies. France's thin capitalization rules apply to interest payable on debt owing to any related party. The revised rules contain two tests — an arm's-length interest rate test, and a second test based on (depending on which provides the most favourable result) a debt-to-equity ratio of 1.5:1, a limitation based on 25 percent of adjusted earnings or a limitation based on interest income. Interest denied under the arm's-length interest rate test is permanently denied, whereas interest denied under the second test has an indefinite carryforward period but is subject to a phaseout of five percent per year from the second subsequent year.

Taxpayers subject to rules

The restrictions on interest deductibility under the thin capitalization rules apply to:

- corporations;
- partnerships; and
- branches.

The rules apply on a stand-alone entity basis and are not applied on a consolidated basis.

Scope of rules

The rules apply to interest payable on debt owing to any related party (i.e., companies directly or indirectly owned by the same ultimate shareholder, or de facto, managed by the same ultimate entity). A related party can include a trust or partnership. Interest payable on debt owing to a third party is not included in the scope of the thin capitalization rules even if guaranteed by a related party. Moreover, the rules do not apply either to interest paid by entities acting as cash pools which borrow to fund their cash pooling activities and to interest paid by financial institutions. Generally, an entity that acts as a cash pool is the leader of the cash pool that borrows from related parties and onlends to other related parties.

Related-party interest is deductible for tax purposes to the extent that it satisfies two tests: the Arm's-length Test (Test 1) and the Thin Capitalization Test (Test 2).

Approach

Test 1: Interest Rate Arm's-length Test

The interest rate cannot exceed the greater of the following two rates:

- The average of the annual interest rate on loans granted by financial institutions which carry a floating rate and have a minimum term of two years (5.41 percent for fiscal years ending on December 31, 2007 as defined under the French Tax Code).
- The interest rate at which the company could have borrowed from any unrelated financial institution in similar circumstances. The French Administrative Guidelines released in 2008 state that the debtor must be able to demonstrate that the rate used is actually a market rate. Debt instruments used for comparison should have features similar to the related-party debt (e.g., amount, duration, credit risk, foreign exchange risk). A loan offer from a third party or a transfer pricing study might be acceptable but taxpayers have been following the published rate as there has been no experience in dealing with the French tax authorities on the market rate determination.

The portion of the interest expense that exceeds the amount calculated under the greater of these two rates is not deductible. The amount of interest that meets the Arm's-length Test (Test 1) must also satisfy the thin capitalization requirements below (Test 2).

Test 2: Thin Capitalization Test

Interest that exceeds the greatest of the following three amounts is subject to restrictions on deductibility:

1. Debt-to-equity ratio threshold:

   $$\text{Interest which meets the Arm's-length Test} \times \frac{\text{150 percent of net equity or share capital}^{1}}{\text{Indebtedness owing to related companies}}$$

2. Earnings threshold

   25 percent × [net operating income + financial income + tax deductible interest expense under the Arm's-length Test[2] + amortization allowances (excluding exceptional amortization allowances) + specific lease payments]

3. Interest income threshold: Corresponds to interest income received by the French company from related companies.

These amounts are determined on a stand-alone legal entity basis. The portion of the interest expense that exceeds the greatest of these amounts is not deductible unless the excess is less than €150,000.

1 Net equity or share capital is determined at the start or end of the fiscal year at the option of the company.

2 Tax deductible interest expense under the Arm's-length Test includes only related party interest.

The revised thin capitalization rules include a safe harbour provision. The thin capitalization rules do not apply if the taxpayer's debt-to-equity ratio is less than the consolidated debt-to-equity ratio of the worldwide group.

The taxpayer's debt-to-equity ratio at year-end is determined as follows:

$$\frac{\text{Stand-alone total indebtedness (i.e., all indebtedness)}}{\text{Stand-alone net equity}}$$

The consolidated debt-to-equity ratio of the worldwide group at year-end is determined as follows:

$$\frac{\text{French and non-French affiliated companies indebtedness (excluding inter-company debt)}}{\text{French and non-French affiliated companies net equity less acquisition costs of the shares in controlled entities and after elimination of intra-group operations}}$$

Consolidated financial statements of the group can be prepared using French Generally Accepted Accounting Principles (GAAP), U.S. GAAP and IFRS. The consolidated group includes any entity that has direct or indirect control of the French taxpayer and any entity in which the French taxpayer has direct or indirect control. Thus, it could include the entire worldwide group. The characterization of a financial instrument as debt or equity is based on its economic substance under specific French guidelines.

Treatment of disallowed interest

The total amount of disallowed interest is the sum of the disallowed interest under both tests. As discussed above, disallowed interest under Test 1 is non-deductible and cannot be carried forward; whereas, disallowed interest under Test 2 can partly be carried forward to subsequent fiscal years. The non-deductible portion of interest under the Thin Capitalization Test can be carried forward to future taxation years and is deductible up to the amount of the Earnings Threshold (defined above) in a particular taxation year. There is a five percent reduction per year from the second subsequent year in the amount of non-deductible interest carried forward.

Interest which is not tax deductible under the Arm's-length Test is deemed to be a constructive dividend and is eligible for reduced rates of withholding tax under France's tax treaties. Interest which is not deductible pursuant to the Thin Capitalization Test retains its character as interest.

Other measures and planning

As a general principle, interest, management fees, royalties, and other similar payments between related companies must be at arm's length. The difference between the actual amount and the amount determined based on arm's length principles will be considered to be a transfer of income and result in a denial of the excess expenditures. The excess amount is recharacterized as a deemed dividend.

France has also implemented another interest deduction limitation rule that applies on any borrowing by the taxpayer to acquire a related French company, and the taxpayer and the target company are included in the same consolidated group for French tax purposes (even if the consolidated tax group is created several years after the acquisition). The rationale of this rule is to prohibit an artificial leveraging of the French consolidated group. The rule is limited in scope as it does not apply if the borrower does not elect to file its tax return as part of a French consolidated tax group. The limitation results in a reduction of the interest expense of the entire French tax consolidation group computed as follows:

$$\frac{\text{Interest expense of the tax consolidated group} \times \text{share acquisition price}}{\text{Average amount of debt of the French tax consolidated group}}$$

This rule applies to the year of acquisition and the subsequent eight taxation years. If the share acquisition price is funded entirely by a capital contribution by a related party (non-debt funded) there should be no reduction in the interest expense as no portion relates to the acquisition of a related French company.

Germany

Germany's thin capitalization rules were recently amended and apply to 2008 and subsequent taxation years. Germany's new rules include a general limitation rule and a special interest limitation rule. The general limitation rule applies to related party debt and requires that interest paid on related party debt be based on arm's-length terms. The special interest limitation rule for corporate and trade tax purposes is based on earnings (e.g., net interest expense on all debt cannot exceed 30 percent of adjusted earnings). For trade tax purposes, there is a further restriction on deductibility (25 percent of all interest deductible under the special interest limitation rule is non-deductible). Interest denied under the general interest limitation rule is permanently denied, whereas interest denied under the special interest limitation rule has an indefinite carryforward period (except the 25 percent portion for trade tax purposes that is permanently non-deductible).

Taxpayers subject to rules

Germany's thin capitalization rules apply to all taxpayers subject to German taxes.

German thin capitalization rules apply to the German consolidated tax group. There are no industry specific thin capitalization rules that apply to certain categories of taxpayers such as financial institutions.

Scope of rules

There are several rules that could apply to restrict the deductibility of interest. The general interest limitation rule applies only to interest paid to a related party. In contrast, the special interest limitation rule and trade tax limitation rule apply to all interest, including interest paid to third parties.

Approach

General limitation rule

Under the general interest limitation rule, interest paid to a related party is deductible if the interest rate is based on arm's-length terms.

The general limitation rule applies to partnerships that earn active business or trading income. In some cases, an investment partnership that earns investment income from managing an asset portfolio could be subject to these restrictions. German real estate investment trusts are also subject to these restrictions.

Special interest limitation rule

The special interest limitation rule for corporate tax and trade tax (the so called "interest barrier rule") applies to all interest, including interest paid to third parties.[3]

This rule applies to net interest expense (i.e., the excess of interest expense over interest income). According to the interest barrier rule, interest expense is disallowed if the "excess net interest expense" exceeds 30 percent of taxable earnings before interest, taxes, depreciation and amortization (EBITDA). Taxable EBITDA is determined based on financial statements prepared using German accounting principles with adjustments for additions and deductions made in computing German taxable income such as non-taxable dividends. Notwithstanding these restrictions, the net interest expense is fully tax deductible if the company:

1. is not a member of a group;

2. incurs net interest expense of not more than €1 million per year; or

3. has an equity ratio that is equal to or higher than the worldwide equity ratio.

The escape clause in 3. above states that if the equity ratio of the German group is greater than the worldwide equity ratio, the 30 percent interest limitation does not apply. This exception is applicable only if, at the level of each group entity, less than 10 percent of the net interest expense is paid to a more than 25 percent shareholder that is not part of the worldwide consolidated group (or to a third party with recourse to such shareholder).

The equity ratio (i.e., total equity divided by total asssets) is based on the worldwide consolidated balance sheet prepared under IFRS or U.S. GAAP as compared to the equity ratio of the German business balance sheet prepared under the same accounting standard. The German business comprises all members of a consolidated group for this purpose. The German balance sheet's equity ratio is subject to a number of complex technical adjustments, such as a deduction for unconsolidated subsidiaries (i.e., subsidiaries that do not form part of the German tax consolidated group). Presently, the escape clause rules have a number of unresolved technical issues (e.g., treatment of intercompany receivables and payables, valuation of assets and book values, and the treatment of step-ups in basis for accounting purposes). German tax authorities are expected to issue regulations which would provide further guidance in this area.

The characterization of a financial instrument for the purposes of the escape clause is based on its characterization for German tax purposes, which, in turn, is based on the economic substance of the financial instrument. Convertible or profit participating loans and bonds are generally viewed as liabilities for German tax purposes. These types of loans are subject to German withholding tax, whereas "plain vanilla" loans are not subject to German withholding tax.

3 The German corporate income tax rate, including solidarity surcharge, is 15.825 percent. The German trade tax rate depends on the cities/municipalities in which the German company has its operations and is on average 14 percent. Thus, the combined average income tax rate is 29.825 percent.

To satisfy the escape clause, there is a deduction for the book value of unconsolidated subsidiaries (i.e., subsidiaries that do not form part of the German business/tax consolidation) as outlined above. This deduction reduces the total equity and total assets. As a result of this adjustment, it will be difficult to satisfy the escape clause in most situations.

Under the special interest limitation rule for trade tax purposes, 25 percent of the interest expense, which is deductible under the interest barrier rule as explained above, is added back for trade tax purposes.

Finally, interest expense of a partnership is not deductible if the cumulative withdrawals of the partners and the losses of the partnership exceed the contributions of the partners and the profits of the partnership ("excess withdrawal"). Excessive withdrawals, contributions and retained earnings from prior years (1999 and later years only) are considered when determining the basis for the non-deductible interest expenses. In the event that this calculation results in an excessive withdrawal, six percent of the excessive withdrawal will be added back to the income of the partnership. However, the addback is capped by the actual interest expense, reduced by €2,050, paid by the entity in the given year.

Treatment of disallowed interest

The non-deductible portion of the interest expense under the special interest barrier rule can be carried forward indefinitely. The carryforward is forfeited in full if more than 50 percent of the shares of the respective company are directly or indirectly transferred to one acquirer or on a pro rata basis (if more than 25 percent but less than 50 percent of the shares are directly or indirectly transferred to one acquirer). There are also other circumstances (e.g., merger) where the interest carryforward can be forfeited.

Interest denied under the general interest limitation rule, the special interest limitation rule for trade tax purposes, and the special partnership rule is permanently non-deductible and cannot be carried forward.

Interest expense that is non-deductible under the general interest limitation rule is the only interest that is recharacterized as a dividend for tax purposes and subject to German dividend withholding taxes. The tax treaty regulations for dividends also apply for constructive dividends (i.e., the recipient of the dividend can claim treaty benefits subject to German anti-treaty shopping rules).

Other measures and planning

There are an array of transfer pricing rules aimed at limiting earnings stripping through intercompany management and service fees. These fees must be based on the arm's length principle, and the computation and transfer pricing methodology must satisfy certain documentation requirements. Services must be performed and charged on the basis of a detailed (written) contract which must be finalized prior to the commencement of any services. It should be noted that there were changes to the transfer pricing rules effective in 2007 to combat the transfer of business functions without appropriate compensation to another jurisdiction.

Under the European Union (EU) parent-subsidiary directive (applicable to dividends), the EU license directive (applicable to royalties) or Germany's tax treaties, the withholding tax on royalties and dividends is reduced to rates between zero percent and 15 percent. Stringent anti-treaty shopping rules apply to prevent payments that would otherwise be subject to German withholding tax from being made to entities located in the EU or treaty jurisdictions where those entities have insignificant business operations.

Germany has a broad anti-abuse rule based on economic substance. Under this rule, a structure or transaction can be generally voided for tax purposes if the sole purpose of the structure or transaction is to avoid German tax and is not supported by a business purpose. For example, if the German taxpayer were to dispose of assets, any gain would be taxable. However, the German taxpayer could transfer the assets to a corporation on tax-deferred basis and then sell the shares of the corporation. Ninety-five percent of the gain on the sale of shares would be exempt from tax. If such restructuring was not supported by a business purpose, the anti-abuse rule could apply. The application of the anti-abuse rule is supported by numerous case law rulings.

These base erosion and anti-abuse rules are intended to avoid the artificial shifting of income to another jurisdiction through the use of loan structures, transfer of economic functions for insufficient compensation, and by service or other charges with no or insufficient economic rationale.

German taxpayers should ensure that interest expense or other intercompany charges are based on the arm's length principle to avoid any transfer pricing adjustments. In connection with the revisions to the thin capitalization rules, taxpayers can consider making use of the escape clause to increase its deductible interest expense and forming a consolidated tax group (i.e., a German Organschaft) to increase taxable EBITDA or to avoid equity adjustments when calculating the equity ratio for purposes of the escape clause.

Italy

Italy's current thin capitalization regime entered into force on December 28, 2007. The changes were introduced in conjunction with reductions to both corporate income tax and local tax rates. The Government offered only a basic explanation for the changes. In abolishing the old rules they advised that the application of thin capitalization rules to related party loans and the recharacterization of excess interest as dividends were often challenged by the European Court of Justice (ECJ) and were quite artificial when a group of companies were taken into consideration. Following the various inquiries of the ECJ on alleged violations of the freedom of establishment and of discrimination among domestic and European rules, the thin capitalization rules based on asset-to-equity ratios were eliminated and replaced with a new set of rules based on EBITDA. The new rules apply to all interest payable on all debt and restrict net interest expense to 30 percent of the company's EBITDA. Non-deductible interest has an indefinite carryforward period.

Taxpayers subject to rules

The following taxpayers are subject to the specific rules regarding the deductibility of interest expense:

- corporations; and
- branches.

Scope of rules

Under the new rules, the restrictions on the deductibility of interest apply to interest payable on all debt.

Approach

The restrictions apply to net interest expense (i.e., excess of interest expense over interest income). The net interest expense is deductible to the extent it does not exceed 30 percent of the company's EBITDA ("EBITDA threshold"). For the 2008 and 2009 taxation years, there is a nominal EBITDA threshold of €5,000 and €10,000, respectively.

Financial institutions are not subject to the EBITDA limitation. However, a law decree was introduced in 2008 that if passed would restrict the deductibility of a financial institution's net interest expense to 97 percent and 96 percent of its net interest expense in 2008, and 2009 onwards, respectively.

For the purposes of these rules, EBITDA may include the EBITDA of a foreign subsidiary (more precisely, earnings before taxes, depreciation and amortization as foreign interest expense is taken into account if the subsidiary is leveraged) to the extent that:

- the Italian company owns more than 50 percent of the shares of the foreign subsidiary (directly or indirectly);
- the Italian company and the foreign subsidiary have the same taxation year-end; and
- the foreign subsidiary's financial statements have been audited by authorized auditors.

EBITDA is determined based on Italian, local or IFRS accounting principles.

Furthermore, in the case of a consolidated tax group, if the interest expense exceeds the EBITDA threshold of the taxpayer, the excess interest expense is deductible by the Italian consolidated tax group to the extent that an excess EBITDA threshold exists at the level of the other companies included in the consolidation. The EBITDA threshold is determined at the level of each legal entity, and there are no adjustments to EBITDA for intercompany transactions.

Effective for taxation years that begin on or after January 1, 2010, excess EBITDA (i.e., the portion of the 30 percent EBITDA exceeding the net interest expense) for a taxation year can be carried forward indefinitely.

Italy does not have a specific set of rules that restrict the deduction of interest payable on hybrid instruments. The characterization of a financial instrument is based on its economic substance and interest payable thereon, cannot be linked, directly or indirectly, with the earnings of the company and its subsidiaries.

Treatment of disallowed interest

The disallowed portion of interest expense can be carried forward indefinitely and deducted in future taxation years (up to the 30 percent of the leveraged company's EBITDA in those years). Moreover, there is no recharacterization of the interest as a dividend and the denied interest is eligible for reduced rates of withholding tax under Italy's income tax treaties.

Other measures and planning

There are no specific rules that deal with other payments to related parties such as management fees, royalties, and other similar payments, except that these arrangements must be based on the arm's length principle. Expenses payable to related and unrelated parties resident in tax havens are usually non-deductible unless the recipient carries on real business activities or the specific transactions have a valid business purpose. Italy has a list of countries that are considered to be tax havens.

There are no specific anti-abuse rules with respect to the deductibility of interest expense, but the tax administration may argue that certain "listed restructurings" were finalized for no other valid economic purposes but that of artificially leveraging the company. A "listed restructuring" would include, for example, a transformation, merger, demerger, voluntary winding-up, distributions to shareholders of net equity excluding distributable reserves, and a transfer of business to a related Italian company. This argument would be based on the general anti-abuse provision. If successful, the Tax Administration may recharacterize the transaction and deny the interest deduction.

Under the new rules, the taxpayer could acquire other subsidiaries with positive EBITDA in order to increase its leverage capacity in Italy. In addition, partnerships are not subject to the new rules, and can therefore be leveraged without any restrictions. Any income or loss of the partnership is not included in computing the Italian partner's EBITDA.

Japan

Japan's thin capitalization rules were enacted on April 1, 1992, following the recommendation of the Government's Tax Commission in 1991. The thin capitalization rules restrict the deductibility of interest and guarantee fees paid or accrued to foreign related parties if the debt-to-equity ratio exceeds a certain ratio. The debt-to-equity ratio of the average balance of interest-bearing debts owing to foreign related parties cannot exceed three times the average balance of equity owned by foreign related parties. However, the rules will not apply if the average balance of total interest-bearing debts of the corporation does not exceed three times the average balance of total equity. Interest that is disallowed under the thin capitalization rules cannot be carried forward.

Taxpayers subject to rules

Japan's thin capitalization rules apply to:

- Japanese corporations; and
- Japanese branches of foreign corporations.

The rules apply on an entity-by-entity basis. Japan does not have any industry specific thin capitalization rules that apply to certain categories of taxpayers (e.g., financial institutions).

Scope of rules

Interest expense subject to the thin capitalization rules includes:

- interest on loans;
- discount on bills;
- bond discount;
- interest on security deposits;
- interest on savings accounts of banks; and
- other expenses whose economic nature is similar to interest.

Guarantee fees are considered expenses and fall within the scope of the rules. Interest is measured on a gross basis. If interest received by the foreign related party is taxed in Japan as income attributable to a permanent establishment of the foreign related party, the interest is not subject to the thin capitalization rules.

Approach

The thin capitalization rules apply when both of the following conditions are met:

1. the average balance of total interest-bearing debts of the corporation exceeds three times the average balance of total equity; and

2. the average balance of interest-bearing debts owing to foreign related parties exceeds three times the average balance of equity owned by the foreign related parties.

Therefore, even if the taxpayer's total debt-to-equity ratio exceeds 3:1, the thin capitalization rules will not apply if the ratio of debts owing to and equity owned by the foreign related parties does not exceed 3:1, and vice versa.

Foreign related parties are defined as a non-resident individual or a foreign corporation which has one or more of the following special relationships with the interest-paying Japanese corporation or branch:

1. a non-resident individual or foreign corporation owns 50 percent or more of the outstanding stock of the Japanese corporation directly or indirectly;

2. the foreign corporation and Japanese corporation are owned 50 percent or more by the same shareholder directly or indirectly; or

3. a non-resident individual or foreign corporation can substantially control business decisions of the Japanese corporation.

Debt owing to a partnership would be considered to be owing to the partners. In respect of debt owing to a trust, this debt could be considered to be a foreign related party debt based on the specific facts.

Generally, the amount of disallowed interest is the interest expense corresponding to the portion of foreign related party debt that exceeds three times the average balance of total equity. The amount of disallowed interest is computed according to a formula.

Debts are defined as interest-bearing debts. The average balance must be calculated based on the accounting values by applying a reasonable method. As a general practice, the average ending balance of each month is typically used as a reasonable method. The characterization of a financial instrument is based on its legal form, although its economic substance cannot be ignored. In addition, there is no specific set of rules that apply to interest payable on hybrid debt. The characterization principles apply in determining whether a financial instrument is debt or equity.

Thin capitalization rules also apply to third party debts guaranteed by foreign related parties. Such debts are treated as interest-bearing debts owing to foreign related parties in calculating the debt-to-equity ratio. Furthermore, interest on such debts as well as guarantee fees payable to the foreign related parties should be treated as interest paid or accrued on foreign related party debts. Interest paid on third party debts guaranteed by foreign related parties is not subject to the thin capitalization rules if the lender is a Japanese bank or a Japanese branch of a foreign bank.

The average balance of total equity is equal to the amount of the average balance of total assets, less the amount of the average balance of total liabilities. Japanese GAAP should be used in determining these amounts. If a corporation has negative earnings (i.e., a deficit), the average balance of total equity may not be less than the total of capital and capital surplus for tax purposes at the end of the fiscal year.

The debt-to-equity ratio of 3:1 is a safe harbour ratio; however, a corporation may elect to use a debt-to-equity ratio based on a comparison to the debt-to-equity ratio of a Japanese corporation which is engaged in the same type of business and is similar to the corporation in size or other conditions. Generally, where the debt-to-equity ratio of the comparable Japanese corporation is more than 3:1, it may be preferable to elect to have this option apply. The corporation using a similar Japanese corporation's ratio must attach a statement for the election to its tax return and must keep information to show that the ratio is reasonable compared to the debt-to-equity ratio of the similar Japanese corporation.

Treatment of disallowed interest

Under thin capitalization rules, disallowed interest may not be carried forward. Disallowed interest expense is not recharacterized as a dividend distribution.

Other measures and planning

In addition to the thin capitalization rules, the interest rate on debt owing to foreign related parties cannot exceed an arm's-length rate. The reduced withholding tax rates under most of Japan's tax treaties do not apply to the excess, except under the Japan-U.S. income tax treaty. In the latter case, a five percent rate applies to the excess. Japan also has transfer pricing principles that apply to payments made to related parties (e.g., management fees, rents, royalties) which require these payments to be based on arm's-length terms.

In Japan, it is possible to borrow from a foreign related party to acquire foreign subsidiaries and deduct the related interest expense (subject to thin capitalization restrictions). However, Japan has a general anti-avoidance provision which could apply to a family corporation's transactions and allow the taxing authority to recharacterize the transaction. In this regard, a family corporation is defined as a corporation which is more than 50 percent owned, directly or indirectly, by three or fewer shareholders. The provision is intended to address those transactions that a reasonable business person would consider unreasonable or unnatural, if there were no tax benefits arising from the transaction.

Netherlands

The Netherlands has a number of provisions that are relevant for determining the deductibility of interest and are aimed at preventing base erosion. The rules were effective as of January 1, 2004. Under these rules, interest payable on net debt owing to related parties cannot exceed three times the company's average equity plus €500,000. Interest that is disallowed under the thin capitalization rules is permanently denied.

Taxpayers subject to rules

All entities subject to the Netherlands corporate income tax are subject to the thin capitalization restrictions, including:

- corporations;
- branches; and
- non-transparent partnerships.

Transparent partnerships are not subject to the rules as the partners would be subject to thin capitalization rules on debt of the transparent partnership.

In the case of a tax consolidation (i.e., fiscal unity), the head of the fiscal unity is the only taxpayer recognized for purposes of the thin capitalization rules. There are no industry-specific sets of rules that apply to certain categories of taxpayers such as financial institutions.

Scope of rules

Interest on net debt owing to related parties is subject to the thin capitalization provisions. Debt owing to a third party can be reclassified as related party debt for purposes of the thin capitalization rules. This reclassification will occur if a related party has issued a guarantee to a third party creditor and the third party creditor would not have granted the loan to the Dutch taxpayer if such guarantee was not provided. A related party could include a trust or partnership. To determine if the guaranteed debt is included as related party debt it is necessary to determine if the guarantee has resulted in an increase in the quantum of the loan. Guarantees in these circumstances are deemed to be related party debt. Guarantees on third party debt that result in more favorable interest rates or payment terms, would not be considered to be related party debt.

Approach

The thin capitalization rules provide two ratios to determine the amount of excess debt.

The first ratio is a fixed ratio. The average debt may not be more than three times the company's average fiscal equity plus €500,000. For the purpose of this ratio, debt is defined as the excess of the company's loans payable over loans receivable, and includes all debt. The balance sheet

for tax purposes is used to determine the average debt and equity. Effective January 1, 2007, the definition of loan was broadened to include finance lease receivables and payables and hire-purchase receivables and payables. As a result, the debt of leveraged lease companies is reduced by netting it against their finance lease receivables. Average equity is based on an average of the beginning and end of the year equity for tax purposes.

The classification of a financial instrument as debt or equity is generally based on its legal form, except in the case of financial leases which are classified as debt.

The second ratio allows the company to elect to apply a group ratio when filing its tax returns. Under this alternative, the company may apply the commercial consolidated debt-to-equity ratio of the international group of which it is a member. If the company's commercial debt-to-equity ratio does not exceed the debt-to-equity ratio of the consolidated group, the tax deduction for interest on related party debt is not disallowed under the Dutch thin capitalization rules. The international group includes all entities in the worldwide group to which the Dutch taxpayer belongs, including the ultimate parent company. The consolidated financial statements of the worldwide group prepared under recognized accounting principles (e.g., IFRS, U.S. GAAP) would be used to determine the debt-to-equity ratio for the consolidated group.

In addition to the thin capitalization provisions, interest on related party debt must be calculated based on an arm's-length interest rate.

Treatment of disallowed interest

Under the thin capitalization rules, any disallowed interest is permanently denied. Interest that is disallowed under the thin capitalization rules is not recharacterized as a dividend, and there is no withholding tax on interest under Dutch tax law. Interest that is in excess of arm's-length amount is recharacterized as a dividend and subject to Dutch withholding tax and eligible for reduced rates under the Netherlands' tax treaties.

Other measures and planning

The Netherlands' tax laws also deny any interest paid, including related borrowing costs and currency exchange results, by a Dutch taxpayer on a related party loan to the extent that the loan relates to one of the following transactions (Article 10a):

1. dividend distributions or repayments of capital by the taxpayer or by a related Dutch company to a related company or related individual resident in the Netherlands;
2. capital contributions made by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands in a related company; or
3. the acquisition or enlargement of an interest by the taxpayer, by a related Dutch company or by a related individual resident in the Netherlands in a company that is related to the taxpayer after this acquisition or enlargement.

A related company is:

a. an entity in which the taxpayer holds at least a one-third interest;

b. an entity that holds at least a one-third interest in the taxpayer;

c. an entity in which a third party holds at least a one-third interest while the third party also holds at least a one-third interest in the taxpayer; or

d. an entity that forms part of a tax consolidated group together with the taxpayer.

The third party acquisition was added to the list of tainted transactions (listed in #1–3 above) effective January 1, 2007. In addition, the escape clause previously available where the creditor was subject to at least 10 percent income tax on its profit determined under Dutch standards was effectively eliminated January 1, 2008 as this escape clause will not be applicable in cases where the tax inspector renders it plausible that either the transaction or the loan lacks sufficient business purpose.

Prior to January 1, 2008, to satisfy the exceptions to Article 10a, taxpayers had to either: (1) provide a business purpose for both the transaction and the loan, or (2) provide evidence that the recipient of the interest income was effectively subject to tax that was considered reasonable. In 2007, it was added to the code that this should be a rate of at least 10 percent based on Dutch principles. Taxpayers, often routed financing through a low-tax jurisdiction, such as Cyprus, to ensure the recipient was subject to tax of at least 10 percent, such that Article 10a generally did not apply and it would relatively be straightforward to satisfy the "subject to tax" exception.

As of January 1, 2008, the "subject-to-tax" exception exists but it will be virtually, if not impossible, to rely upon. Under the changes, if the Dutch tax authorities render it plausible that either the transaction or the loan lacks business purpose, this exception will not apply and interest on an intergroup loan to fund a tainted transaction will be denied. It is likely that any financing through a low-tax jurisdiction such as Cyprus, will fail the business purpose requirement for the loan. As a result, it will be virtually impossible to implement an intergroup tainted transaction and erode the Netherlands tax base. Taxpayers will need to rely on exception (1) above (i.e., be able to justify the business purpose for both the transaction and the loan). If the loan can be traced to an indirect third party loan, then article 10a should not apply. It may be possible to satisfy the "subject to tax" exception, if the recipient pays tax at least equal to 90 percent of the Netherlands tax rate, but despite a request to do so this 90 percent threshold is not granted as a safe harbour percentage. It should be noted that the Dutch tax authorities will most likely no longer provide a ruling on Article 10a transactions. Thus, taxpayers can expect increased scrutiny of any interest expense incurred on a tainted transaction and satisfying the business purpose for the financing and the transaction will prove most difficult.

For all intercompany payments such as management fees and royalties, the Netherlands also requires that these transactions be based on arm's-length terms. The Netherlands' transfer pricing rules are based on the OECD model.

As part of a thin capitalization plan, a taxpayer could consider increasing its equity by acquiring subsidiaries to which the participation exemption applies. The participation exemption is an exemption from tax on any income or capital gain realized on the disposition of the shares in cases where the taxpayer or a related group own five percent or more of the paid-in capital of the taxpayer. The entity cannot be a low-taxed participation (e.g., requires active business assets of at least 50 percent) to qualify for the participation exemption.

Hybrid loans

Under the hybrid loan provisions, any interest paid, including the related currency fluctuations, on such loans are not deductible by the debtor. Such amounts are recharacterized as dividends.

In decisions of the Dutch Supreme Court, loans have been recharacterized as informal capital contributions in the following circumstances:

- the loan agreement is deemed to be a sham transaction because the parties involved actually intended to make a capital contribution to the subsidiary;
- the loan is granted to a company that is incurring large losses at the time the loan is granted, and it is evident to the lender that the debtor will not be able to wholly or partly repay the loan; and
- the loan is granted under such conditions that the lender, through the loan, effectively takes on the risks associated with investing in the activities of the company similar to the risks taken by a shareholder ("hybrid loan").

The determination of whether a loan is a hybrid loan is based on Dutch case law. A hybrid loan has the following features:

- the interest paid on the loan is entirely or almost entirely dependent on the profits of the company;
- the loan is subordinated to all other creditors; and
- the loan has a maturity date of more than 50 years or can be called only in the event of liquidation or bankruptcy of the borrower.

A hybrid loan recharacterized as equity can qualify for the participation exemption.

Interest-free or low-interest loans

If the taxpayer has borrowed from a related entity and the loan has no fixed term, or a term of more than 10 years, while legally or actually no compensation has been agreed to for the loan, or a compensation which is more than 30 percent lower than that which independent parties would have agreed upon, compensation for that loan and mutations in the value of that loan are not deductible. If the redemption date is moved to a later time the loan is deemed to have had the new redemption date as of the time of granting the loan.

There are no general anti-avoidance provisions under Dutch tax law. An abuse of law doctrine exists, but it is rarely applied by the Supreme Court. In addition, it is questionable whether this doctrine can be applied given the detailed set of anti-abuse rules with respect to interest deductibility.

New Zealand

In a 1991 policy statement the Government expressed a general policy goal of reducing taxes imposed on non-residents, subject to the tax treatment accorded to the non-resident taxpayer in its domestic jurisdiction. On July 13, 1995, the Government released details of its integrated international tax package incorporating transfer pricing, thin capitalization and an extended foreign investor tax credit regime. The Ministers of Finance and Revenue noted that the reforms would ensure that all foreign investors pay tax at the same rates as residents by blocking opportunities for non-residents to lower their New Zealand taxes through transfer pricing or thin capitalization techniques. The rules apply to interest payable on all debt. Under the rules, the New Zealand Group's total debt-to-asset ratio cannot be greater than 75 percent; and cannot exceed 110 percent of the worldwide group debt-to-total asset ratio. If the ratio exceeds both thresholds, the excess interest is permanently denied.

Taxpayers subject to rules

New Zealand thin capitalization rules apply to:

- non-resident individuals;
- non-residents who have a branch or fixed establishment in New Zealand (unless a single New Zealand resident holds a 50 percent or greater direct ownership interest in the non-resident provided another non-resident does not hold a 50 percent or greater direct ownership interest in the New Zealand resident);
- a New Zealand resident company in which a non-resident owns at least 50 percent or has control by other means (the most common category); and
- non-qualifying trusts that are 50 percent or more settled by a single non-resident person.

Scope of rules

New Zealand's thin capitalization rules limit the amount of interest that can be deducted when the taxpayer's debt-to-asset ratio exceeds certain thresholds. The rules apply to all interest payable by the taxpayer.

Approach

An interest allocation approach based on a debt-to-asset ratio operates to limit interest deductions in New Zealand where:

- the New Zealand Group's total debt-to-total asset ratio is greater than 75 percent; and
- the New Zealand Group's total debt-to-total asset ratio is greater than 110 percent of the worldwide group debt-to-total asset ratio.

New Zealand Group

The thin capitalization ratios are calculated on a "New Zealand Group" basis. There are various rules to determine the "New Zealand parent" and "New Zealand group". Broadly speaking, a taxpayer's New Zealand group comprises the New Zealand parent and all the New Zealand entities under its control. The New Zealand parent is usually the top-tier New Zealand entity, which is directly owned by non-residents.

Total debt

Debt for the purposes of the thin capitalization rules is defined as the sum of the outstanding balances of all "financial arrangements" entered into by the taxpayer where:

- the financial arrangement provides funds to the taxpayer; and
- the financial arrangement gives rise to an amount which would be an allowable deduction to the taxpayer (i.e., interest).

A "financial arrangement" is defined as a debt or debt instrument, and any arrangement whereby a person obtains money to be repaid at a future date. Therefore, "total debt" in the thin capitalization calculation is total interest-bearing debt. Items such as short-term creditors, provisions and accruals are not included in debt for the purposes of the thin capitalization rules. Interest-free loans are also excluded as this type of financial arrangement would not give rise to an allowable deduction as no interest expenditure is incurred.

New Zealand does not have any specific rules that relate to interest payable on hybrid debt. Certain company debentures are regarded as equity for tax purposes and therefore, interest is recharacterized as dividends. The Government has also recently released draft legislation for consultation that would result in interest payable on certain "stapled securities" being denied as a deduction.

Total assets

There are various options available for calculating the "total assets" for tax purposes. Total assets can be valued using any one (or a combination) of the following methods:

- values shown in the financial accounts;
- net current value of the assets; or
- if permitted under New Zealand GAAP, a combination of the financial account values and net current values

provided that the values used are in accordance with a GAAP method.

Measurement dates and currency

The amount of "total debt" and "total assets" must be measured, at the election of the taxpayer, on the basis of:

- the daily average total debt and total asset balances;
- the quarterly average total debt and total asset balances; or
- the year-end total debt and total asset balances (as per the annual financial statements).

The assets and debt must be in New Zealand currency and generally foreign denominated assets and debt must be converted at the closing spot rate on the date of measurement.

On-lending concession

The on-lending concession requires the debts and assets of the taxpayer to be reduced by any amounts on-lent to unassociated third parties. Generally, an amount borrowed to loan to an unrelated party is excluded from both the debt and assets of the taxpayer.

Worldwide debt percentage

Calculation of the worldwide group debt percentage can be extremely complex, and most companies seek to maintain a New Zealand ratio of 75 percent or less to avoid the need to consider the worldwide group position.

A taxpayer's worldwide group is the group which comprises the taxpayer, other members of the New Zealand group (e.g., other New Zealand entities under the New Zealand taxpayer's control) and all persons not resident in New Zealand required to be included in consolidated group accounts with the taxpayer, including the New Zealand taxpayers' ultimate non-resident parent.

The worldwide group debt percentage is calculated broadly in a similar manner to the New Zealand group debt percentage.

The amount that cannot be claimed as a deduction is calculated using a formula as follows:

$$(I - GI - IFD) \times \frac{(TNZD - NZDA)}{TNZD} \times \frac{(NZDP - TDP)}{NZDP}$$

where:

I = the total interest deductions that have been claimed by the taxpayer

GI = the sum of all allowable deductions in respect of amounts payable to other companies within the taxpayer's "New Zealand Group"

IFD = the sum of all allowable deductions which do not form part of "total debt" in the thin capitalization calculation

TNZD = the "total debt" for thin capitalization purposes (i.e., interest-bearing debt) before an allowance is made for the on-lending concession

NZDA = amount of on-lending concession

NZDP = the taxpayer's New Zealand "group debt percentage"

TDP = the allowable "group debt percentage", i.e., 75 percent

Where no allowance needs to be made for GI, IFD or the on-lending concession (NZDA), the simplified formula would be:

$$I \times \frac{(NZDP - TDP)}{NZDP}$$

For example, assume debt = \$800M and assets = \$800M. Debt is comprised of: 65 percent senior debt at interest rate 8.9 percent and 35 percent subordinated debt at interest rate 10.9 percent. The total interest expense claimed as a deduction is calculated as:

$$\begin{aligned} I &= [(0.65 \text{ x } 800) \times 8.9\%] + [(0.35 \text{ x } 800) \times 10.9\%] \\ &= [520 \text{ x } 8.9\%] + [280 \text{ x } 10.9\%] \\ &= 46.28 + 30.52 \\ &= 76.8 \end{aligned}$$

The total interest deduction claimed is \$76.8M.

NZDP = 100 % (800 / 800)

TDP = 75 %

Assuming no on-lending,

$$\begin{aligned} I \times \frac{(NZDP - TDP)}{NZDP} &= 76.80 \times (100\% - 75\%) / 100\% \\ &= 76.80 \times 25\% / 100\% \\ &= 19.2 \end{aligned}$$

Therefore \$19.2M would be denied permanently.

Treatment of disallowed interest

To the extent total interest deductions exceed the 75 percent interest-bearing debt-to-asset ratio, the excess interest is permanently denied as a deduction. Interest disallowed under the thin capitalization rules is not treated as a deemed dividend. It retains its character as interest subject to New Zealand non-resident withholding tax. Interest disallowed under transfer pricing principles is treated as a deemed dividend. In these circumstances, the disallowed interest would be subject to dividend withholding tax rates.

Other measures and planning

In addition to the thin capitalization regime, the New Zealand tax base is also protected through the transfer pricing regime. The transfer pricing legislation in New Zealand covers transactions between associated non-residents and residents. The legislation broadly follows the OECD Transfer Pricing Guidelines. The transfer pricing regime requires that cross-border transactions between related parties be carried out at arm's length. Any cross-border related party transactions are subject to the regime, e.g., management fees, royalties, franchise fees, intercompany interest charges.

New Zealand's general anti-avoidance provision deals with tax avoidance arrangements and denies any tax benefits of an avoidance arrangement. As mentioned, the thin capitalization regime is designed to limit an interest deduction if a non-resident allocates what is considered to be an excessive amount of its worldwide debt to its New Zealand operations. In most cases, the legislation effectively permits debt levels below the thin capitalization thresholds. In the absence of any other (non-commercial) factors, debt raised within the level of the safe harbour regime should fall outside the scope of the general anti-avoidance provision.

In addition to the general anti-avoidance provision, there is a specific anti-avoidance provision in relation to the thin capitalization regime. Where there are temporary fluctuations in the total assets or debt balances to defeat the intent and application of the thin capitalization rules, those temporary fluctuations must be ignored when performing the thin capitalization calculation.

Basic tax planning undertaken by New Zealand taxpayers includes ensuring the company is adequately capitalized, making use of the on-lending concession, making appropriate grouping elections, and performing asset valuations. Consideration is also given to refinancing the New Zealand group as part of new acquisitions and group restructurings.

Thin capitalization rules for banks

Effective July 1, 2005, new thin capitalization rules apply to foreign-owned registered banks operating in New Zealand. The rules determine the extent to which interest is deductible to the New Zealand business of the foreign-owned bank as part of calculating its New Zealand income for tax purposes. Banks are denied interest deductions if they have insufficient equity for tax purposes to support their New Zealand business.

The rules compare the equity of the New Zealand banking business with a legislatively prescribed level of equity based on four percent of the bank's New Zealand risk-weighted exposures. If there is a deficiency in the New Zealand equity compared with the required equity, interest is denied on the shortfall.

Proposed changes to the thin capitalization rules

Proposed legislation will extend the thin capitalization rules to apply to all New Zealand companies with controlled foreign companies unless it has:

- 90 percent or more of its assets in New Zealand; or
- less than $250,000 of interest deductions.

Companies will be required to apportion their interest deductions if their New Zealand group debt percentage is greater than 75 percent. The apportionment is based on the 75 percent safe harbour or 110 percent of the worldwide group debt percentage, whichever is higher.

Existing rules will be used to measure "total debt" and "total assets" except that fixed rate shares issued to New Zealand taxpayers will be treated as debt, equity investments in CFCs will not be included in assets, and "worldwide debt" will exclude liabilities that do not provide funds and liabilities that do not give rise to deductions (except fixed rate shares will be treated as debt).

Sweden

Sweden does not have any thin capitalization rules. There are general provisions providing for a deduction in respect of interest. There is also a limitation if the return on the investment is exempt from Swedish tax by virtue of a double tax treaty but it does not apply when the return is in the form of tax-free dividends from holdings in foreign shares. In addition, the interest rate must be based on the arm's length principle. If the interest rate on debt owing to a related party is not an arm's-length rate, the excess interest is treated as a deemed dividend and potentially subject to Swedish withholding tax depending upon the residency of the recipient of the payment.

There is currently a debate in Sweden concerning the lack of thin capitalization rules or any other rules with the same purpose. The debate started after a case from the Supreme Administrative Court in 2007. The case involved the introduction of leverage in an intragroup refinancing structure, a method commonly used. The Tax Agency claimed that the structure should be regarded as tax avoidance. The Supreme Administrative Court, on the other hand, found that this was not tax avoidance and based its decision on a previous ruling with similar circumstances.

Sweden has anti-avoidance and withholding tax avoidance provisions which could apply where the sole purpose of the transaction is to avoid tax. The general anti-avoidance rule would not prevent foreign multinationals from leveraging their Swedish operations with a significant proportion of debt and minimal equity. It is expected that some form of limitation on interest deductions will be introduced in the future.

Other measures and planning

Sweden has transfer pricing guidelines that govern payments, such as management fees, rents, royalties and other similar payments made to related parties. These types of payments must be based on arm's-length terms.

United Kingdom

The existing thin capitalization rules (Schedule 28AA ICTA 1988) apply for all accounting periods ending on or after July 1, 1999. These rules replaced older, pre-self assessment legislation. In 2004, changes were introduced which extended the thin capitalization rules to apply to UK-UK transactions. The rules apply to interest payable on all related party debt and there is no prescribed "safe harbour" level of debt. The rules are based on arm's length principles and require the term of the loan, interest rate and repayment terms be at arm's length. In addition, the UK taxpayer cannot be thinly capitalized, which requires a determination of whether the amount of the loan is consistent with the amount that would have been granted by a third party. Disallowed interest under thin capitalization rules cannot be carried forward.

Taxpayers subject to rules

The following taxpayers are subject to UK thin capitalization rules:

- corporations,
- partnerships, and
- branches.

In the case of partnerships, these entities are generally treated as transparent for UK tax purposes and their assets and income are attributed to the partners. Interest deductions in respect of related party borrowings by the partnership would therefore be claimed by the partners, and thin capitalization principles may apply to the partners where the partners are themselves within the scope of UK tax either by being a UK corporation or because of a UK permanent establishment of the partnership. Generally, UK branches have not historically deducted interest costs in calculating UK chargeable profits. UK domestic legislation provides that the profits of a permanent establishment should be calculated as if it were a stand-alone enterprise with notional capital attributed to the UK operations. In the event that interest is claimed as a deduction by the branch, it is necessary to consider the "attribution of capital", thin capitalization and transfer pricing rules.

Scope of rules

Interest is generally deductible in the same period as the interest expense accrues in the company's financial statements. However, where interest payable to a non-UK related party remains unpaid for more than 12 months after the end of the accounting period in which it accrued, it is deductible on a paid basis.

There may be a restriction on the deductibility of interest where the quantum or terms (including interest rate) of intergroup debt are considered not to be at arm's length.

The UK thin capitalization rules apply in respect of interest payable on debt owing to UK and non-UK group companies and debt owing to third parties that has been guaranteed by a related party. A group company includes a company that is related to the taxpayer.

Approach

In order to ascertain if the loan is at arm's length it is necessary to look at two aspects of the loan:

1. Are the terms of the loan, including the interest rate and the repayment terms, at arm's length?

2. Is the company thinly capitalized?

There are no "safe-harbour" levels of debt included within UK tax legislation to determine whether a company is thinly capitalized, and thus, it is necessary to determine whether the quantum of the loan is consistent with that which would have been made by an independent third party. These determinations are based on an extensive transfer pricing analysis based on OECD guidelines. As an indication of the debt levels that may be acceptable, the UK Tax Authorities have published non-binding guidance indicating that they would consider a debt-to-equity ratio of 1:1 and interest coverage ratio of 3:1 as its benchmarks; however, higher ratios can often be negotiated based on industry norms. Ultimately, the final test will always be based on an arm's-length amount and terms for the UK borrower.

When considering the thin capitalization position of the UK borrowing company, it is necessary to look at the projected results (both the balance sheet and profit and loss account) of the borrower and its subsidiaries, on the basis that it is the combined results that an unconnected third party would take into account in determining the quantum of a loan. For this purpose, the UK does not distinguish between UK and non-UK subsidiaries — consequently, the earnings of UK and non-UK subsidiaries can be used to support the UK debt. If the borrower is a UK holding company, the thin capitalization position would be evaluated by including related party debt of its subsidiaries. For example, in assessing the interest coverage ratio, the interest expense would include interest expense of the UK holding company and its subsidiaries which would be compared to the consolidated EBITDA of the same group.

In classifying a financial instrument as debt or equity, UK tax authorities will respect the legal form of a financial instrument as there is no general principle of "substance over form" or "economic equivalence" under UK tax law. However, the UK tax authorities have issued guidance on what is considered to be debt or equity for the purposes of assessing thin capitalization.

Taxpayers may enter into an advance thin capitalization agreement with the UK Tax Authorities where they agree to keep within certain financial ratios, such as debt-to-equity and interest coverage ratios. The ratios which are considered acceptable by the UK tax authorities will vary by industry.

There is no separate set of thin capitalization rules that apply to a particular category of taxpayers (e.g., financial institutions). Financial institutions, such as banks and insurance companies are regulated by the Financial Services Authority (FSA), which requires certain levels of equity and long-term debt capital to protect depositors. The levels of capital, though based on international requirements laid down by the Bank of International Settlements, are negotiated with each bank by the FSA. In practice, UK banks will have more equity and often less long-term debt than is required by the FSA.

Treatment of disallowed interest

Where a portion of the interest expense is disallowed, the deduction is permanently denied. Where a treaty clearance is given on a loan, the reduced UK withholding tax rate on interest does not apply to the non-arm's-length amount. However, under UK domestic law a claim may be made such that no UK withholding tax is payable on the interest which is disallowed due to thin capitalization restrictions. This means that a compensating adjustment claim for the part of the interest payment that exceeds the arm's-length amount can be made alongside a treaty claim for exemption from deduction at source. In such cases, where the relevant treaty provides for a nil rate of withholding tax, the two claims together if approved will result in no UK withholding tax.

Other measures and planning

Transfer pricing rules

The UK transfer pricing rules apply to other transactions and payments between connected persons such as royalties, licence fees, and management fees. These arrangements should be based on arm's-length terms and be representative of what an unconnected third party, trading on the same terms, would pay.

Anti-avoidance rules

In addition to the UK's thin capitalization rules, where the introduction of debt into the UK is considered to have been undertaken principally for the avoidance of UK tax, there may be a proportion of interest deductions disallowed for UK tax purposes under "loans for unallowable purposes" and the "avoidance involving tax arbitrage" provisions. These next two rules must always be considered in any transaction where there is an interest deduction, and are applied based on the specific facts.

The "loans for unallowable purpose" rules deny an interest deduction if the main purpose is to obtain a tax benefit. At present, the test of business purpose is applied narrowly to the borrower and is generally ineffective, but there are proposals which would expand the scope to examine the purpose of the group as a whole in entering into the transaction. This will bring the business purpose test more in line with the business purpose test in the arbitrage provisions which look at the overall purpose of a scheme or arrangement.

The "avoidance through arbitrage" provisions were introduced to counteract certain cross-border UK financing arrangements involving hybrid entities or hybrid instruments, which have a main purpose of obtaining a UK tax advantage. The arbitrage rules were introduced in 2005 in direct response to the UK Tax Authorities' perception that hybrid entities and instruments were being used to erode the UK tax base with no corresponding income pick-up.

Broadly speaking, where there is sufficient commercial purpose for the borrowing in question (i.e., a third party acquisition), these rules are less likely to apply.

Thin capitalization planning

Where a UK company ("guarantor"), which is not within the same UK subgroup as the borrower, guarantees the debt of a thinly-capitalized UK group company, the "excess debt" is deemed to be that of the guarantor and the guarantor can claim a deduction in respect of interest paid on this deemed debt, subject to the guarantor's own thin capitalization restrictions. As such, where a UK company is thinly capitalized, the use of a guarantee can avoid the disallowance of an interest deduction in the group, provided that the guarantor has sufficient substance to support the debt it is guaranteeing. For tax purposes, the borrower and the guarantor are both treated as paying a proportion of the interest on the debt. The borrower obtains a deduction for the arm's-length amount of interest, and the guarantor obtains a deduction for the interest which is in excess of arm's length (i.e., portion denied under thin capitalization provisions).

United States

Under U.S. thin capitalization rules, section 163(j) of the U.S. Internal Revenue Code ("Code Section 163(j)") restricts the deductibility of interest. Code Section 163(j) generally applies to interest paid or accrued by the payor corporation in its taxable years beginning after July 10, 1989. The overall policy rationale for these rules is to preserve the income tax base of U.S. corporations (and foreign corporations engaged in a U.S. trade or business) by preventing claims for deductions of disproportionate amounts of interest expense, particularly where the related interest income would be received by a foreign related party that is wholly or partially exempt from U.S. federal income tax. Various changes to these rules have been proposed since 2003, but none have been enacted into law to date. More recently, on Wednesday, November 28, 2007 the Treasury sent Congress a congressionally mandated report, *Report to the Congress on Earnings Stripping, Transfer Pricing, and U.S. Income Tax Treaties* (the "Treasury Report"), describing current issues regarding U.S. earnings stripping rules.

The Treasury Report focuses on the ability of foreign-controlled domestic corporations (FCDCs) to shift income outside of the United States through the use of related party deductible interest payments. The Treasury concluded that it is not possible to accurately quantify the extent of earnings stripping by FCDCs generally, but noted strong evidence of earnings stripping by the subset of FCDCs consisting of corporations that have implemented so-called inversion transactions (i.e., forming a parent corporation that is a resident of a foreign low-tax jurisdiction).

The Treasury concluded that additional information is needed to determine whether FCDCs that have not inverted are engaging in earnings stripping and to help identify a means of preventing it. In order to obtain this additional information and further the administration of Code Section 163(j), the IRS released in draft Form 8926, "Disqualified Corporate Interest Expense Disallowed Under Section 163(j) and Related Information". This form, once adopted, is intended to be required to be filed for taxation years ending on December 31, 2008. Additionally, on February 4, 2008, the Administration released its proposed 2009 Budget, which included proposals to tighten the rules of Code Section 163(j) in the case of expatriated (i.e., "inverted") corporations.

The U.S. rules apply to interest payable on foreign related party debt. If the U.S. affiliated group's debt-to-equity ratio exceeds 1.5:1, the lesser of the group's exempt related person interest expense and excess interest expense is denied deductibility and is carried forward indefinitely. Generally, exempt related person interest expense is based on the proportion of the interest expense that is subject to a lower rate of withholding tax under a U.S. tax treaty as compared to the U.S. domestic withholding tax rate on interest of 30 percent. Excess interest expense is an earnings-based test and applies if the net interest expense exceeds 50 percent of the adjusted taxable income.

Taxpayers subject to rules

The U.S. thin capitalization rules in Code Section 163(j) apply to:

- U.S. corporations; and
- foreign corporations with income that is effectively connected with a U.S. trade or business.

It should be noted that Code Section 163(j) is to be applied on an "affiliated U.S. group" basis. In other words, when a foreign corporation is the common parent of at least two U.S. subsidiaries, the U.S. affiliated group consists of the U.S. corporations in which the parent owns stock representing at least 80 percent (of vote and value), as well as lower tier U.S. subsidiaries in which the parent and/or its subsidiaries own stock representing at least 80 percent (of vote and value).[4]

There are no industry-specific thin capitalization rules that apply to certain categories of taxpayers such as financial institutions.

Scope of rules

The rules limit the deductibility of interest paid or accrued on debt payable to or guaranteed by foreign related parties, to the extent that the interest payment is exempt from U.S. withholding tax (referred to as "disqualified interest").

Approach

The steps to determine the amount of disallowed interest are generally as follows:

Step 1 — Determine if the taxpayer is a member of an affiliated group and identify all members of the group

Step 2 — Determine if the debt-to-equity ratio of the taxpayer or the affiliated group exceeds 1.5:1

Step 3 — If the debt-to-equity ratio exceeds 1.5:1, determine the amount of interest expense of each taxpayer, if any, on debt payable to or guaranteed by foreign related parties

Step 4 — Determine the exempt related person interest expense (ERPIE)

Step 5 — Determine the excess interest expense (EIE) of the taxpayer (or affiliated group). This computation should also take into account the carryforward of any prior year excess limitation amounts recognized in the three-year carryforward period

Step 6 — Determine the lesser of ERPIE and EIE

4 The proposed regulations (Prop. Reg. Section 1.163(j)-5(a)(3)) appear to result in the inclusion of a 50 percent owned entity in the affiliated group. According to a well-regarded treatise (Leavey, *U.S. Taxation of Foreign Controlled Businesses*), the 50 percent threshold in the "proposed" regulation was inserted unintentionally and is expected to be corrected in the final regulations. Accordingly, we believe it is reasonable to take the position that for purposes of the earnings stripping calculations, at least 80 percent-owned subsidiaries should be included in the affiliated group.

As noted above, in general, where a U.S. corporation (or a foreign corporation engaged in a U.S. trade or business) has a debt-to-equity ratio exceeding 1.5:1 in a taxable year, the lesser of the corporation's ERPIE or EIE for the taxable year is denied deductibility.

The first category of ERPIE consists of interest that would be fully deductible but for Code Section 163(j), where the interest is attributed to indebtedness owing to a "related person", and the interest is either wholly or partially exempt from U.S. tax in the hands of the related payee, after taking into account the effect of any applicable U.S. tax treaties. A related person is generally a person that does not deal at arm's length with the debtor.

The second category of ERPIE consists of interest paid or accrued on a loan from an unrelated party:

1. to the extent that the U.S. does not impose gross-basis tax (e.g., withholding tax) on the interest;
2. a person related to the debtor guaranteed the loan; and
3. the related person that guaranteed the loan is either exempt from U.S. income tax or is a foreign person.

Even if these conditions are met, interest will not be ERPIE if the debtor controls the guarantor, or in some cases, where the interest on the indebtedness would have been subject to net basis tax if it had been paid to the guarantor.

If the interest payment is subject to a reduced rate of U.S. withholding tax under a U.S. tax treaty, it is only considered exempt to the extent of the ratio of: (i) 30 percent less the rate imposed under the treaty, (ii) to 30 percent. For example, if the U.S. withholding tax rate on interest payments is 10 percent in a particular treaty (e.g., the current Canada-U.S. Tax Treaty, before application of the Fifth Protocol), two-thirds of any interest payment made by a U.S. corporation to a foreign related party would be considered to be ERPIE for purposes of Code Section 163(j).

Code Section 163(j) defines "guarantee" very broadly. The term includes any assurance, even a conditional assurance, that another person's obligation will be paid. For example, under the statutory definition, certain "comfort letters" could constitute guarantees.

As stated above, Code Section 163(j) applies in a taxable year only where the debt-to-equity ratio of a corporation (or an affiliated group as the case may be) exceeds 1.5:1 and there is EIE.

In calculating the debt-to-equity ratio of a corporation (or affiliated group), "equity" is calculated by subtracting total liabilities from total assets at year-end. "Debt" for this purpose is composed of the company's total liabilities less accrued operating expenses and accounts payable that have been outstanding for less than 90 days. Anti-abuse rules exist in order to deter manipulation of the year-end balance sheet in order to prevent the application of the earnings stripping provisions.

The Code does not prescribe specific rules for calculating the debt-to-equity ratio for purposes of Code Section 163(j). In 1991, the Treasury published proposed regulations for the administration of Code Section 163(j) that contained standards for the calculation of this ratio. These standards do not carry the force of law, but are generally adopted by taxpayers for tax planning and compliance purposes.

According to the proposed regulations, "the debt of a corporation means its liabilities determined according to generally applicable tax principles". Similarly, the proposed regulations define "equity" to mean "the sum of money and the adjusted basis of all other assets of the corporation reduced (but not below zero) by the taxpayer's debt …. Whether an item constitutes an asset shall be determined according to generally applicable tax principles."

The proposed regulations also contain specific rules for the calculation of this ratio. For example, the proposed regulations exclude certain "short-term liabilities" and "commercial financing liabilities" from the definition of "debt" for purposes of this ratio, and provide that "in determining the debt of a corporation that owns an interest in a partnership (directly or indirectly through one or more pass-through entities), liabilities of the partnership shall be treated as liabilities incurred directly by each partner …". In addition, the proposed regulations contain an anti-rollover rule which provides that "decreases in a corporation's aggregate debt during the last 90 days of its taxable year shall be disregarded to the extent that the corporation's aggregate debt is increased during the first 90 days of the succeeding taxable year."

EIE is the amount by which net interest expense (the excess of a corporation's or affiliated group's total interest expense over its total interest income, including amounts owing to and from related and unrelated parties) for the year exceeds a statutorily defined limitation. This statutorily defined limitation is the sum of 50 percent of the corporation's (or the affiliated group's) "adjusted taxable income" plus any "excess limitation carryforward". Conceptually, "adjusted taxable income" is the pre-tax, pre-net interest cash flow generated by business operations. The excess limitation amount for a taxable year is merely the amount by which 50 percent of the corporation's adjusted taxable income exceeded its net interest expense for a particular year. The excess limitation carryforward is the sum of the excess limitation amounts, if any, for a three year carryforward period, reduced by any portion of the carryforward used in a preceding year.

For the above reasons, the calculation of EIE, as well as ERPIE, must be performed on an annual basis in order to determine the amount of a corporation's or affiliated group's disqualified interest for that taxable year.

Treatment of disallowed interest

If all or a portion of disqualified interest is non-deductible for a particular tax year, such interest may be carried forward indefinitely until it becomes deductible. Such interest becomes deductible to the extent that such disqualified interest, when aggregated with disqualified interest in a successive year, does not exceed the deductibility limitations described above. The disallowed interest remains eligible for reduced rates of withholding tax under U.S. tax treaties.

Other measures and planning

Code Section 482 and the related regulations set out a regime for disallowing various payments such as management fees and royalties paid by a U.S. corporation (or a foreign corporation engaged in a U.S. trade or business) to a related party to the extent that such payments are not based on arm's-length terms and conditions.

In addition to the interest deductibility provisions, various judicial doctrines, such as the "economic substance" doctrine, the "sham transaction", and the "step-transaction" doctrine prohibit the use of artificial transactions to create interest expense deductions, especially in the context of transactions between related parties. In addition, there is a well-developed body of case law under which U.S. federal courts have considered whether an instrument should be treated as debt or equity for federal income tax purposes, in view of the overall intentions of the parties, the terms and conditions of the loan, the history of the actual dealings of the parties (e.g., payment history), and the hypothetical ability of the borrower to obtain similar financing from an unrelated party.

Generally, any planning by U.S. corporate taxpayers involves monitoring their debt-to-equity ratio, as well as the amount of their "net interest expense" and "adjusted taxable income" on an annual basis, with a view to estimating their borrowing capacity, and the amount of interest expense they could potentially incur without that interest becoming potentially disqualified under the thin capitalization rules.

Interest paid in equity

Code Section 163(l) disallows the deduction for interest expense paid or accrued on indebtedness of a corporation that is payable in equity of the issuer or a related party. Nonconvertible recourse debt that is repayable only with a fixed amount of cash is not included in the types of debt instruments to which this rule is intended to apply. If the interest is required to be paid by issuing shares of the debtor or transferring shares held by the debtor in another entity, for example, the interest deduction would be denied. It may also be denied if the creditor has the option to receive equity in satisfaction of the interest and there is substantial certainty that this option would be exercised.

Interest payable to related foreign persons

Accrual basis taxpayers are generally allowed to deduct interest expense as it accrues, not just when it is paid. Under Code Sections 163(e)(3) and 267(a)(3), interest owed to a related foreign person is generally deductible only when paid.

Interest payable to hybrid entities

In certain circumstances, Code Section 894(c) and the related regulations deny the benefits of reduced U.S. withholding taxes under a U.S. income tax treaty to income derived by a foreign person through a U.S. partnership or other fiscally transparent entity such as a limited liability company (LLC) that is treated as a disregarded entity for U.S. federal income tax purposes.

Specifically, Treas. Reg. Section 1.894–1(d) provides that U.S. withholding taxes applicable to certain types of passive income (e.g., interest, dividends, etc.) received by an entity that is fiscally transparent under U.S. tax law (e.g., LLC), should not be subject to treaty-reduced rates of withholding tax in cases where the owner of the fiscally transparent entity (e.g., Canco) is a foreign person that is treated as not fiscally transparent under the laws of its jurisdiction, and under that foreign law, the entity receiving the income (e.g., LLC) is treated as not fiscally transparent.

As a case in point, where Canco is the sole owner of an LLC (which is treated as a disregarded entity for U.S. federal income tax purposes), the LLC receives U.S. source interest income, and Canadian tax law treats the LLC as being not fiscally transparent, then unless a specific U.S. statutory exemption applies, Canco should be treated as being subject to U.S. withholding tax on this U.S. source interest income at the statutory rate of 30 percent without reduction by an applicable U.S. income tax treaty.

Treas. Reg. Section 1.894-1(d) also sets out rules for the potential recharacterization of certain interest payments by domestic reverse hybrid entities (i.e., domestic U.S. entities that are treated as fiscally transparent for foreign tax purposes but as not fiscally transparent for U.S. tax purposes) as dividends for U.S. federal income tax purposes.

Uniform capitalization rules

The "uniform capitalization" rules can require a taxpayer to capitalize a portion of its interest expense if the taxpayer produces real or tangible personal property that has:

1. a long useful life (i.e., any real property or property with a class life of at least 20 years);
2. an estimated production period exceeding two years; or
3. an estimated production period exceeding one year and a cost exceeding $1 million.

The uniform capitalization rules can also apply to interest expense of a taxpayer that does not produce any such property but that is part of a consolidated U.S. federal income tax return with a taxpayer that does produce such property. Specifically, if the aggregate production expenditures incurred by a taxpayer on property under production in a given year exceeds that taxpayer's outstanding indebtedness, then a portion of the interest expense of other members of the producing taxpayer's U.S. consolidated group may be required to be capitalized.

Interest on applicable high-yield discount obligations

Code Section 163(e)(5) applies to defer, and in some cases, deny the deductibility of accrued interest on "applicable high-yield discount obligations" (AHYDO). An AHYDO is defined under Code Section 163(i) as a corporate debt instrument having:

1. a more than five-year maturity;
2. a yield to maturity of five percentage points over the applicable federal rate when issued; and
3. "significant original issue discount" (OID), defined generally as an excess of "back-loaded" OID accruals over actual interest payments.

In general, OID on an AHYDO is not deductible until paid, and a portion of the discount in excess of six percentage points over an IRS-determined interest rate is non-deductible and is treated as a dividend received by corporate creditors.

These rules should be considered in a cross-border transaction. However, based on the current interest rate environment in the U.S., most debt instruments are not structured to meet the definition of an AHYDO.

Debt-financed acquisitions

Code Section 279 disallows interest on debt incurred in certain debt-financed corporate acquisitions. Generally, this rule applies to interest paid or incurred on "corporate acquisition indebtedness" defined by Code Section 279(b) as any corporate obligation evidenced by a bond, debenture, note, certificate, or other evidence of indebtedness that is issued after October 9, 1969, and that meets a four-part test. The four-part test is as follows:

1. the obligation is issued to provide consideration for the acquisition of another corporation's stock or another corporation's assets under a plan for the acquisition of at least two-thirds (in value) of the target's business assets (excluding money);
2. the obligation is subordinated either to the claims of the issuing corporation's trade creditors or to a substantial amount of its unsecured debt, whether outstanding or subsequently issued;
3. the obligation either is convertible into the issuing corporation's stock or is part of an investment unit or other arrangement that includes an option to acquire stock of the issuing corporation; and
4. the issuing corporation's debt-to-equity ratio exceeds two to one, or its projected earnings do not exceed three times the interest to be paid or incurred on the debt.

As a practical matter, it is unlikely that the obligation would be subordinated to the claims of the corporation's trade creditors or a substantial amount of its unsecured debt. These debt instruments are relatively uncommon in a cross-border context, and could raise questions about whether the debt is a bona-fide debt for U.S. tax purposes.

Appendix A: Key Features of Regime by Country

Components of Thin Capitalization Regime	Australia	France	Germany	Italy	Japan
√–Yes x–No n/a–Not applicable TP–Transfer pricing principles					
Arm's Length Principle within Thin Capitalization Rules	√-1	√-1	x	x	x
Debt-to-Equity Ratio Approach	x	√	x	x	√
Debt-to-Asset Ratio Approach	√-2	x	x	x	x
Earnings Limitation Approach	x	√	√	√	x
Inclusion of External Debt	√	x	√	√	√-1
Guaranteed Debt	n/a	x	√-1	n/a	√
Safe Harbour Based on Worldwide Debt-to-Equity Ratio	√-3	√	√	x	√-2
Sharing of Excess Thin Capitalization Limitation	√-4	x	√-2	√	x
Carryforward of Excess Thin Capitalization Limitation	x	x	x	√-1	x
Permanent Denial of Interest	√	√-2	√-3	x	√
Deemed Dividend on Denied Interest	x	√-3	√-4	x	√-3
Interest Rate Determination Outside of Thin Capitalization Rules	TP	√-4	TP	TP	TP
Other Payments to Non-arm's-length Non-residents	TP	TP	TP	TP	TP
Effective Date of Application of Current Thin Capitalization Rules	2001	2007	2008	2008	1992
Applicable to Net Interest Expense/Net Debt	√-5	√-5	√-5	√	x
De Minimis Threshold	√-6	√-6	√-6	√-2	x
Characterization of Financial Instrument	√-7	√-7	√-7	√-3	√-4
Specific Rules Applicable to Hybrid Debt	x	x	x	x	x
Special Thin Capitalization Regimes (e.g., financial institutions)	√-8	x	x	x-4	x
Internal Leverage Transaction Permitted (e.g., return of capital, dividend)	√-9	x-8	√-8	√-5	√-5
Foreign Subsidiaries Excluded	√	x	x-9	x	x
Exemption/Credit System for CFCs	E	E	E	E	C

Components of Thin Capitalization Regime	Netherlands	New Zealand	Sweden	United Kingdom	United States	Canada
√–Yes x–No n/a–Not applicable TP–Transfer pricing principles						
Arm's Length Principle within Thin Capitalization Rules	x	x	n/a	√	√-1	x
Debt-to-Equity Ratio Approach	√	x	n/a	√-1	√	√
Debt-to-Asset Ratio Approach	x	√-1	n/a	√-1	x	x
Earnings Limitation Approach	x	x	n/a	√-2	√	x
Inclusion of External Debt	√-1	√-2	n/a	√-3	x-2	x
Guaranteed Debt	√	n/a	n/a	√	√	x
Safe Harbour Based on Worldwide Debt-to-Equity Ratio	√-2	√	n/a	√-4	x	x
Sharing of Excess Thin Capitalization Limitation	√-3	√-3	n/a	√-5	√-3	x
Carryforward of Excess Thin Capitalization Limitation	x	x	n/a	x	√	x
Permanent Denial of Interest	√	√	n/a	√	x	√
Deemed Dividend on Denied Interest	√-4	√-4	√-1	x	x	√-1
Interest Rate Determination Outside of Thin Capitalization Rules	TP	TP	TP	TP	TP	TP
Other Payments to Non-arm's-length Non-residents	TP	TP	TP	TP	TP	TP
Effective Date of Application of Current Thin Capitalization Rules	2004	1995	n/a	1999	1989	1981
Applicable to Net Interest Expense/Net Debt	√	√-5	n/a	x-6	√	x
De Minimis Threshold	√-5	√-6	n/a	x	x	x
Characterization of Financial Instrument	√-6	√-7	n/a	√-7	√-4	√-2
Specific Rules Applicable to Hybrid Debt	√	x	n/a	√	√	x
Special Thin Capitalization Regimes (e.g., financial institutions)	x	√-8	n/a	x	x	x
Internal Leverage Transaction Permitted (e.g., return of capital, dividend)	x-7	√	√	√	x-5	√-3
Foreign Subsidiaries Excluded	√-8	x - 9	x	x-8	x	x-4
Exemption/Credit System for CFCs	E	C	E	C-9	C	E

Notes to Appendix A

Australia

1. Applicable to both "outward" and "inward" entities.
2. Average debt cannot exceed 75 percent of adjusted net assets. Assets are based on book values (possibility to revalue assets).
3. Outward entities only can increase Maximum Allowable Debt based on worldwide debt/equity ratio.
4. Excess safe harbour amount of an associate entity is available to the Australian taxpayer.
5. On-lending concession available to reduce debt owing to a controlled foreign entity or an associate entity.
6. Rules do not apply where interest expense is less than AUD 250,000.
7. Proscriptive rules based on substance over form.
8. Rules for an authorized deposit-taking institution (ADI) and a financial entity that is not an ADI.
9. No specific set of rules to deny an interest deduction on an internal leverage transaction but require business purpose.

France

1. Test 1 only.
2. Test 1; Test 2 indefinite carryforward but phase-out of five percent per year from the second subsequent year.
3. Test 1 only.
4. Test 1 only.
5. Partial Test 2 — interest expense deductible up to the amount of interest income.
6. Rules do not apply if interest expense is less than € 150,000.
7. Economic substance based on French guidelines.
8. Interest is not deductible in case of borrowing to acquire a French related company and a French consolidated tax group is formed with French related company. Business purpose requirement for other internal leveraging transactions.

Germany

1. For purposes of computing debt-to-equity ratio under the safe harbour method.
2. If the taxpayer is part of a German tax consolidated group.
3. Interest denied under trade tax rule, partnership rule and general interest limitation rule.
4. Interest denied under general interest limitation rule only.
5. Not applicable to interest denied under trade tax rule or general interest limitation rule.
6. Rules do not apply if interest expense is less than € 1 million.
7. Based on economic substance.
8. No specific set of rules to deny an interest deduction on an internal leverage transaction but require business purpose.
9. Except under escape clause (i.e., safe harbour debt-to-equity ratio).

Italy

1. As of January 1, 2010.
2. Nominal amount for 2008 and 2009 only.
3. Based on economic substance.
4. Partnerships are outside scope of the thin capitalization rules.
5. No specific set of rules to deny an interest deduction on an internal leverage transaction but require business purpose.

Japan

1. Third party debt only included for purposes of one of the ratios.
2. Safe harbour to use a debt-to-equity ratio based on industry average or comparisons.
3. Recharacterization only if interest is in excess of arm's-length amount under transfer pricing principles.
4. Generally based on legal form.
5. No specific set of rules to deny an interest deduction on an internal leverage transaction but require business purpose.

Netherlands

1. Third party debt only included for purposes of debt/equity ratio.
2. Only if guarantee was provided to enable taxpayer to obtain additional funding.
3. If taxpayer is part of a fiscal unity.
4. Only if interest is in excess of an arm's-length amount under transfer pricing principles.
5. Thin capitalization rules do not apply if debt is less than € 500,000.
6. Generally based on legal form under case law, economic substance in the case of a financial lease.
7. Unless valid business reasons to justify the transaction and the loan.
8. Interest deduction denied on borrowing to fund a share acquisition unless valid business reasons to justify the transaction and the loan (i.e., third party acquisition).

New Zealand

1. Exclude non-interest bearing debt from debt, on-lending concession, and revaluation of assets possible.
2. Rules only apply if foreign controlled. Proposals to extend rules to all New Zealand companies with controlled foreign companies.
3. Applies to New Zealand group of taxpayers.
4. On-lending concession available to reduce debt owing to a controlled foreign entity or an associate entity.
5. Proposal whereby rules would not apply if interest expense is less than $250,000.
6. Based on economic substance.
7. Foreign-owned registered banks operating in New Zealand require equity of four percent based on risk-weighted exposures.
8. Proposal to exclude foreign subsidiaries from assets.
9. Taxable immediately with credit. Proposal to change timing of income inclusion based on receipt of dividends.

Sweden

1. Only if interest is in excess of an arm's-length amount.

United Kingdom

1. Informal as determination based on arm's-length principles.
2. Interest coverage ratio would be considered in determining arm's-length amount of interest.
3. Third party debt only included for purposes of debt-to-equity ratio of the UK taxpayer.
4. Proposal to reduce debt-to-equity ratio of United Kingdom to worldwide debt-to-equity ratio.
5. Interest on guaranteed debt could be deducted by UK guarantor if not part of same UK subgroup as borrower.
6. Could negotiate with UK tax authorities to exclude interest-bearing debt if there was a back-to-back loan arrangement in place.
7. Based on legal form, guidelines exist to determine whether debt vs. equity.
8. No specific set of rules but require business purpose.
9. Taxable with credit. Proposal to introduce an exemption-based system.

United States

1. Based on case law.
2. Interest on debt owing to third parties included in calculating adjusted taxable income.
3. Rules apply to U.S. affiliated group.
4. Combination of legal form and economic substance.
5. Certain corporate acquisitions under section 279 of the Code.

Canada

1. Only if interest is in excess of an arm's-length amount.
2. Based on legal form.
3. No specific set of rules to deny an interest deduction on an internal leverage transaction but require business purpose.
4. No, but consider the general anti-avoidance rule.