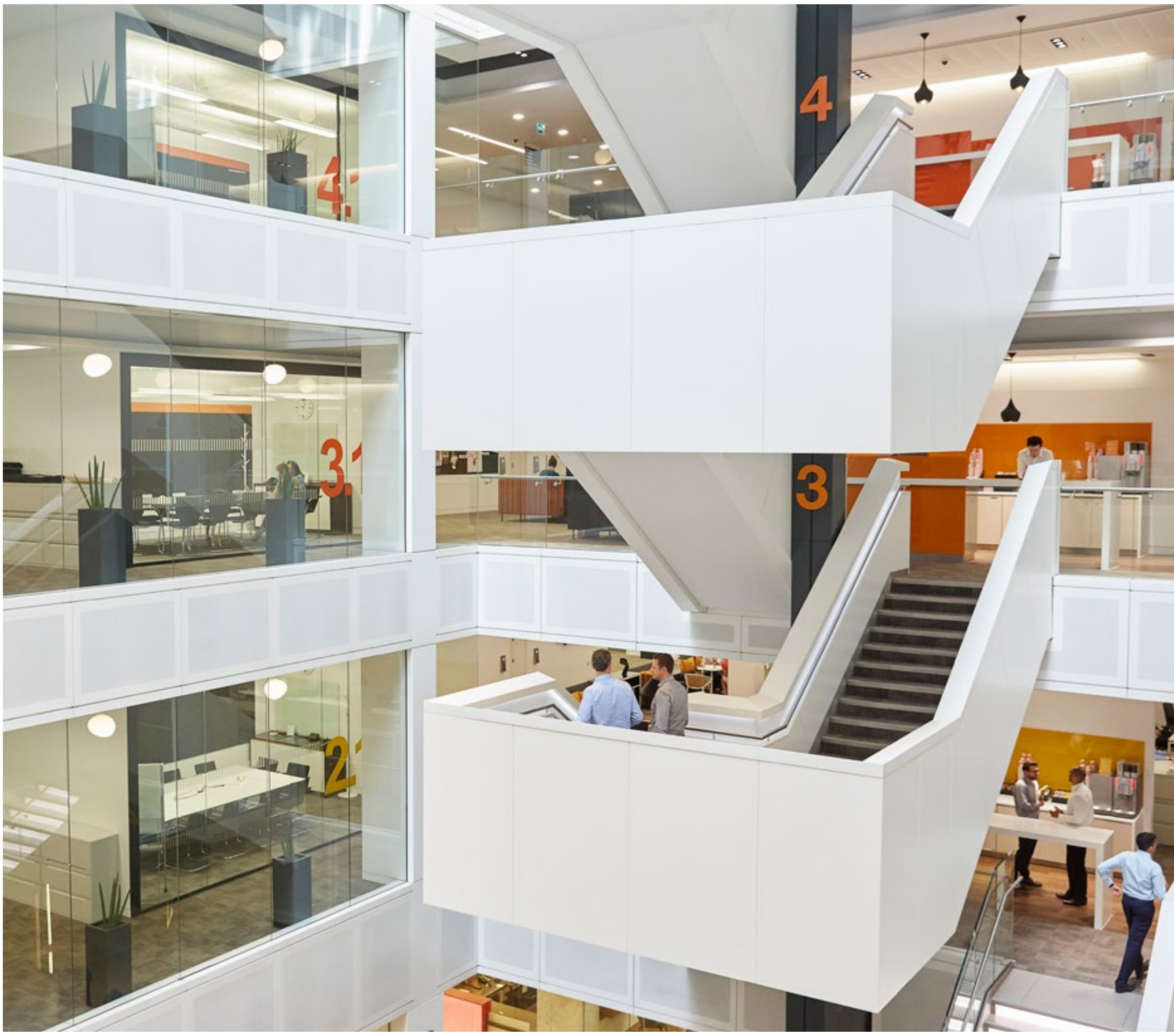
Financing options: Debt versus equity
A country overview



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Introduction

Background and aim of this book

This book provides an overview of the tax treatment of the provision of capital to a legal entity in the following countries: Egypt, Germany, Italy, Malaysia, Switzerland, The Netherlands, Turkey, United Kingdom, and United States. Separate chapters are dedicated to these countries.

Each country has its own set of rules to determine whether the capital provided to a legal entity takes the form of equity capital or takes the form of debt capital. The country chapters in this book describe the approach that each country adopts. The outcome is relevant for tax purposes as the expense may or may not be tax deductible for the payer, whereas the income may or may not be taxed in the hand of the recipient.

Historical context

In order to invest through a legal entity, such as a company, capital is needed. Generally, capital can take the form of either equity capital or debt capital. Both types of capital have different characteristics from a civil law point of view. Broadly speaking a shareholder will provide equity capital in return for shares (stock) which usually will incorporate voting rights. The shareholder is the owner of the legal entity and is not entitled to redemption of the capital provided to the entity. Debt capital will be provided by a lender. The lender is not an owner of the legal entity by virtue of the provision of a loan. Other than the shareholder, the lender is entitled to repayment of the capital provided to the entity as well as a remuneration during this provision of debt capital (interest). One could say in general terms that the lender takes less risk than a shareholder as in case of a liquidation of the legal entity, the liquidation proceeds will be distributed to the lender first, and then to the shareholder. The position of the shareholder is subordinated to that of the lender. Losses suffered by the legal entity will be at the expense of the equity provided by the shareholders.

For tax law purposes the question whether a provision of capital to a legal entity represents either equity capital or debt capital usually starts with following the civil law of the country under which law the legal entity is established. The tax law thus follows another more general branch of law. In a cross-border context, however, countries may not share the same view.

The compensation for providing equity capital is dividend. The compensation for providing debt capital is interest. From a tax point of view, the treatment most countries adopt is that the payment of dividend constitutes a non-deductible cost for the legal entity whereas the recipient will most likely not be taxed in order to prevent economic double taxation. As such, the shareholder may invoke a kind of a domestic exemption for dividends received, as a result of which he will not be taxed with (corporate) income tax for the dividend income. Within the EU, for instance, the EU Parent Subsidiary will generally make sure that the recipient of the dividend payment will not suffer economic double taxation. Conversely, most countries treat interest expenses, the compensation for providing debt capital, as a tax deductible expense at the level of the payer. In the hands of the payee, the interest income will be taxed.

Development of financing structures

This tax treatment provides for a consistent system within one legal system: the provision of equity leads to a non-deductible expense but will not lead to taxable income either, whereas the provision of debt leads to a deductible expense but also leads to taxable income. In a purely domestic context, the overall tax burden should not create a preference for one of the two sorts of capital. However, in a cross-border context the person providing the capital may have a bias to choose to provide debt capital instead of equity capital, specifically if parties are related parties. It may for instance be advantageous to provide debt capital from a country that has a lower tax rate than the country of the debtor. For example, an interest expense may be offset against taxable income of country A at a rate of 30%, where the interest income is taxed in country B at 15%. In this financing structure, related parties arbitrage between the tax rates of countries.

Another example is where a disparity exists between two countries with respect to the classification of the provision of capital as either debt or equity capital: mismatch. If country A treats the provision of capital to a legal entity established in country A as debt under its laws, any remuneration paid will constitute an interest expense in country A. Absent specific rules, the interest expense will be tax deductible in country A. If country B, where the provider of the capital is established, would treat the provision of this capital as equity capital, it may well be that the income is exempt. In this example, the disparity leads to a deduction of interest in country A where the income is not taxed in country B. The reason that this disparity can exist is that each country follows its own domestic rules to determine whether the capital provided to a legal entity constitutes equity capital or debt capital. In this financing structure, related parties arbitrage between the tax laws of countries. Within the EU, harmonization is taking place in this area *(see the last two paragraphs EU: amendments to the Parent-Subsidiary Directive and EU: Anti-Tax Avoidance Package including the Anti-Tax Avoidance Directive and CCCTB)*.

Countries have adopted anti-abuse rules to combat financing structures. Initially, countries restricted non-resident related party financing. More recently, countries limit interest expense more generally. We see the following trend. First, countries introduced thin-capitalisation rules for foreign related parties. The U.S. introduced earnings stripping rules already in 1989. Other countries followed by introducing their own thin-capitalisation rules. These rules essentially require an entity to be funded with a minimum amount of equity. A debt to equity ratio of 3:1 for instance applies. If the debt capital is insufficiently covered by equity capital, the interest expense related to the excess debt is not tax deductible. Then, countries extended the scope of their thin-capitalisation rules for related parties to back-to-back financing structures and to unrelated party debt. A back-to-back structure would for instance entail the provision of debt capital to company A from a third party, which in its turn would receive debt capital from a related party of company A. In this case, company A is indirectly leveraged with related party debt. Later, countries extended the scope of their thin-capitalisation rules to domestic lenders. Countries also started introducing both targeted anti-avoidance rules that disallow interest expense on certain transactions and arm's length tests. The first set of rules are for instance aimed at intragroup transactions. Under the latter set of rules the level of debt of an entity is compared to that of unrelated parties. More recently countries have chosen another approach than the thin-capitalisation approach: interest capping rules have been introduced. Under an interest capping approach, the deduction of interest expenses is limited to a percentage of the income of the entity that is provided with debt capital. The EBITDA (Earnings before Interest, Tax, Depreciation and Amortisation) is commonly used in this respect as a reference to the level of interest expenses. For instance, interest expenses are deductible to the point where these reach 30% of EBITDA of the entity at hand.

Both the OECD and the EU have taken up the glove in the battle against excess shareholder financing. The EU Parent Subsidiary has been amended such that no exemption is granted for income received that has led to a deduction at the level of the payer per 1 January 2016. The mismatch between the tax treatment in the payer country and the tax treatment in the recipient country has now been taken away. Furthermore, the European Commission has proposed introducing an interest capping approach in EU countries *(see EU: Anti-Tax Avoidance Package including the Anti-Tax Avoidance Directive and CCCTB)*. The OECD under its Action Plan against Base Erosion and Profit Shifting (BEPS) proposes several rules. In order to abolish mismatches, the OECD introduces so-called linking rules (BEPS Action Plan 2). As a result, one country should follow the other country's determination of capital as either equity or debt instead of using its own determination. By doing so, there can no longer be a disparity in the cross-border context: two countries now take the same view. Another suggestion of the OECD is to limit interest expenses to the group's total external interest cost (BEPS Action Plan 4): group-wide rules. Under the latter approach a group cannot deduct more interest expenses than interest expenses paid to third parties. The aim is to align the interest expense of individual entities with the interest expense of a group of companies. A group entity's interest expense is limited with reference to the actual position of the worldwide group.

Tax environment of financing

The international tax environment of financing is complex. Currently, there is no internally accepted uniform standard for determining whether an instrument constitutes debt capital or equity capital. As discussed in the previous chapter, states use different criteria for the characterization of financial instruments. Moreover, they may put emphasis on different factors in this respect. A particular instrument employed in a cross-border context may consequently be qualified differently by the states involved. Such a conflict of qualification may result in both double taxation and double non-taxation. The possibility of divergent qualifications especially exists with respect to hybrid financial instruments having some characteristics usually associated with debt and some characteristics usually associated with equity. And, even if states do agree on the classification of the income, they may nevertheless treat the yield differently for tax purposes.

There are two basic cross-border situations in which a state has to deal with the qualification of a capital investment and with the tax treatment of the return thereon. First, a state may have to deal with inbound capital investment from investors resident abroad. In this scenario, the state is characterized as 'state of source' and has to qualify the instrument to determine whether the outbound payment must be classified as either dividend or interest. Second, in case of an outbound capital investment of a resident investor in another state. In that case, the state is considered to be the 'state of residence' and has to qualify the instrument to determine whether the inbound payment must be classified as either dividend or interest.

The variety of financial instruments that incorporate elements of both equity and debt continues to grow. Differences in qualification thereof within and between tax jurisdictions create both risks and opportunities for tax payers. But above all, it makes it difficult to ascertain the right qualification of a specific instrument and the consequences for tax law purposes in the respective states. In addition questions arise as to qualification of financial instruments for bilateral tax treaty purposes. It must be established whether the remuneration on an investment should be classified as either 'interest' or 'dividend' for treaty purposes. The treaty qualification is of relevance because it may influence the allocation of taxing rights between the contracting states. In an EU context, questions concerning the applicability of the EU directives comes into play.

This chapter provides an overview of some general approaches in international tax law practice towards the qualification of financing instruments as either 'debt' or 'equity' for tax treaty purposes. It also describes the main consequences of the qualification of income as 'interest' or 'dividend'. In addition, some of the main features in this respect of the EU Parent-Subsidiary Directive and the EU Interest and Royalty Directive are briefly discussed.

General treaty/directive implications on financing

Qualification of financing instruments

Financial instruments and factors for the demarcation

Businesses requiring capital to fund their commercial activities can turn to the external[1] sources of finance of 'debt' and 'equity'. Instruments of debt, e.g. loans, are generally characterized by the unconditional liability requiring repayment and interest, while instruments of equity, e.g. shares, generally represent ownership in and control over an asset. The return on debt is usually fixed in advance while the return on equity is variable and depends on the performance of the business. And while debt is associated with credit risks, equity is associated with business risks. Even within one jurisdiction, differences can often be found between tax, regulatory and accounting definitions. In addition to the more traditional instruments, there is a large and growing variety of hybrid financial instruments with features of both debt and equity.

Despite the different definitions and qualification methods within and among national systems, there are some general characteristics of debt and equity that can be identified and used to distinguish one from another. Equity capital is usually associated with:

- 'corporate rights';
- 'ownership';
- 'control by means of voting rights';
- 'uncertain return on investment';
- 'return dependent on business results';
- 'business risks' and
- 'subordination in payment'.

The characteristics of debt capital include:

- the 'obligation to repayment of the principal sum';
- 'a predetermined and fixed return related to the principal amount';
- 'credit risks' and
- 'preference in payment'.

Qualification for tax treaty purposes

In a cross-border context, provided the states involved have conducted a bilateral tax treaty, a financial instrument must also be classified for treaty purposes. The tax treaty qualification is of relevance for the determination of the allocation rule applicable to the income, that is the return

[1] As opposite to the internal source of finance, the retained profits.

on the debt capital ('interest') and the return on equity capital ('dividends'). Most bilateral treaties are based on either the OECD Model Tax Convention (MTC), and in case of a developing state as contracting state on the UN MTC.

Tax treaty and the classification of income as 'dividends'

Essentially all bilateral tax treaties contain an allocation rule for cross-border dividends. So do the OECD MTC and the UN MTC. But because of the differences between the laws of states in this respect, the MTCs do not provide an autonomous and exhaustive definition of the term 'dividends'. Both the OECD and the UN have found it impossible to draft such a clause.[2] They do however describe the kind of income that in any case falls within the scope. The description of 'dividends' in the MTCs refers to a variety of forms in which states may recognize 'return on equity' for tax law purposes and leaves room for adaption in bilateral tax treaties. In essence, the underlying common notion is the distribution of profits, where the entitlement to such profits is constituted by corporate shares or rights.

The OECD MTC[3] nor the UN MTC[4] provide a classification method to identify 'return on equity', nor do they contain an autonomous definition of the term 'dividends'. Both MTCs do however provide an enumeration of payments regarded as dividend. The definition clarifies that for the purpose of the allocation article 'dividends' means *'income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.'*

The definition appears to be three-parted. The first part consists of examples of income considered as the return on equity capital found commonly in states. This phrase seems to be an closed definition. The second part refers to 'other rights participating in profits' but with the exclusion of debt-claims, broadening the scope. The third part refers to the '*income from other corporate rights*' and the classification of the income, more precisely the tax treatment, by the state of source. The qualification by the state of residence seems of no importance in this respect. The allocation rule applies, in principle, to all payments regarded as dividends by the state of source. Such payments may also include disguised distributions of profits in cash or money's worth and interest on loans insofar the lender effectively takes on business risks of the company. The reference to the national tax treatment of the income for the classification of the income for tax treaty purposes may cause some uncertainty for the taxpayer in the other state if unfamiliar with the various national tax laws. It should be noted that the definition as provided seems to be limited to the application of the allocation rule because it clarifies the interpretation of the term 'as used in this Article' instead of 'for the purposes of this Convention'. But the implications of this seem to be somewhat undefined.

Tax treaty and the classification of income as 'interest'

Essentially all bilateral tax treaties contain an allocation rule for cross-border interest. So do the OECD MTC and the UN MTC. Both the OECD MTC[5] and the UN MTC[6] provide an autonomous and closed definition of the term 'interest', but the scope appears to be limited to the interest income allocation rules. And although no reference is made to the classification of the income in the source or residence state, states may agree on including a reference to the national laws of one or both of them in their bilateral treaties.[7]

The definition states that 'interest' means '*term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds*

2 Commentary on Article 10 OECD MTC, paragraph 23, Commentary on Article 10 UN MTC, paragraph 14.

3 Article 10(3) OECD MTC: *"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."*

4 Article 10(3) UN MTC, *"The term "dividends" as used in this Article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident."*

5 Article 11 (3) OECD MTC: *"The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."*

6 Article 11(3) UN MTC: *"The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."*

7 Commentary on Article 11 OECD MTC, paragraphs 21 and 21.1.

or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.' In essence, all kinds of debt in every form fall within the scope. The term 'interest' does not include items of income which are dealt with under the article concerning the allocation rule with respect to dividends.[8] Remuneration on participating bonds and convertible bonds is considered interest for tax treaty purposes, unless the loan effectively shares the business risks of the debtor.[9]

Conflicts in qualification

According to the Commentary on OECD MTC, conflicts of qualification of an financial instrument and the classification of income between the two contracting states should be resolved by binding the state of residence to the classification of the state of source for the purpose of the method for elimination of double taxation.[10] But not all states agree on that position.[11]

Withholding taxation under OECD MTC and UN MTC

Allocation of taxing rights

In most cases, dividends paid by a corporation in one state to a shareholder in another state falls within the tax jurisdiction of both states. The same holds true for interest paid by a debtor in one state to a creditor in another state. If both states impose tax on the same income, juridical double taxation arises. To avoid international double taxation, MTCs provide for the allocation of taxing rights between the state of source and the state of residence. If the right to tax is exclusively attributed to one state, viz. 'shall be taxable only', usually the state of residence, the other state is precluded from taxing the income. If taxing rights are allocated to both states, viz. 'may be taxed'[12], the state of residence must provide relief to avoid double taxation by the exemption or credit method. Most bilateral tax treaties are based on either the allocation rules as included in the OECD MTC or the UN MTC.

Taxing rights are usually allocated to both the state of source and the state of residence. A tax treaty seldom prescribes exclusive taxation of dividend or interest. This holds true for tax treaties based on the OECD MTC as well as those based on the UN MTC. A generally accepted rule for the exclusive taxation of dividends or interest in either the source state or residence is also not likely to be agreed on in the foreseeable future. States take opposite views as to which of the contracting states should be granted exclusive taxing rights of such income under a tax treaty.

With respect to dividends, the Commentary to the OECD MTC states that exclusive taxation in the state of source is not acceptable as a general rule[13] and exclusive taxation in the state of residence not feasible.[14] The Commentary does observe that taxation by the state of residence would be appropriate for investment income such as dividends, but it also states that it seems unrealistic to expect source states to give up their right to tax. A similar compromise is reached with respect to the allocation of taxing rights on interest income.[15] Interest may be taxed in the state of source and the state of residence, but the taxing rights of the source state are limited by prescribing maximum tax rates.

Also tax treaties based on the UN MTC grant by way of compromise both the state of source and the state of residence the right to tax. But in contrast to the OECD MTC, the underlying preference is that dividends are taxed exclusively by the state of source. Nevertheless, current practice largely follows the OECD MTC approach. The taxing rights of the source state are even limited by prescribing maximum tax rates. A similar compromise is reached with respect to the allocation of taxing rights on interest income.[16]

Withholding taxation

The state of source often executes its taxing rights by means of a withholding tax. Under a tax treaty, the tax rate to be applied is limited. Both the OECD MTC and the UN MTCs effectively prescribe maximum tax rates to be applied by the state of source. Usually, a different maximum rate applies to dividends arising

[8] Commentary on Article 11 OECD MTC, paragraph 19.

[9] Commentary on Article 11 OECD MTC, paragraph 19 and Commentary on Article 10 OECD MTC, paragraph 25.

[10] Commentary on Articles 23a and 23b OECD MTC, paragraph 32.1 – 32.7.

[11] For example, the Netherlands.

[12] Article 10(1) and (2) OECD MTC and Article 10(1) and (2) UN MTC.

[13] Commentary to Article 10 OECD MTC, paragraph 5.

[14] Commentary to Article 10 OECD MTC, paragraph 6.

[15] Commentary to Article 11 OECD MTC, paragraph 3.

[16] Commentary to Article 11 UN MTC, paragraph 5.

[17] Commentary to Article 10 OECD MTC, paragraph 9.

[18] Article 3(1)(b) OECD MTC.

[19] Commentary to Article 10 OECD MTC, paragraph 13.

[20] Commentary to Article 10 UN MTC, paragraph 10.

[21] *Commentary to Article 10 UN MTC, paragraph 10.*

[22] Commentary to Article 6 UN MTC, paragraph 6.

[23] Commentary to Article 11 OECD MTC, paragraph 7.

[24] Commentary to Article 11 OECD MTC, paragraph 7.

[25] Commentary to Article 11 UN MTC, paragraph 10.

[26] Commentary to Article 11 UN MTC, paragraph 8.

[27] Commentary to Article 11 UN MTC, paragraph 9.

[28] Commentary to Article 11 UN MTC, paragraph 10.

from direct investment and portfolio investment. The maximum tax rate for interest is usually lower compared to dividends.

Maximum tax rates on dividends

Tax treaties based on the OECD MTC generally provide for different maximum tax rates to be applied by the state of source depending on the nature of equity investment. On portfolio investment dividends, the rate of tax in the state of source is as a rule limited to 15 per cent under the OECD MTC. According to the Commentary, this percentage appears to be reasonable since the underling corporate profits are also taxable in that state.[17] A lower maximum is provided for eligible direct investment dividends. A maximum of 5 per cent applies if the beneficial owner is a company, meaning any body corporate or any entity that is treated as a body corporate for tax purposes,[18] that meet the threshold. For this, the company must hold directly at least 25 per cent of the capital of the company making the dividend payment. The contracting states may agree on lower maximum tax rates and even on exclusive taxation in the state of residence.[19] Also, they may agree on a lower holding percentage.

Tax treaties based on the UN MTC also generally provide for maximum tax rates on portfolio and direct investment dividends to be applied by the state of source, but there are no maxima included in the UN MTC itself. These percentages are left to be set by the contracting states through bilateral negotiation. According to the Commentary, the Double Tax Convention (DTC) rates traditionally range between 15 and 25 percent for portfolio investment dividends and between 5 per cent and 15 per cent for direct investment dividends.[20] To attract investment in developing countries, some of the current DTCs based on the UN MTC provide for lower rates.[21] And, some DTC include special features as lower maximum tax rates for the contracting developed state compared to the contracting developing state. The demarcation between direct investment and portfolio investment differs compared to the OECD MTC. The threshold for direct investment is a 10% holding. The lower maximum rate applies if the beneficial owner is a company which holds directly at least 10 per cent of the capital of the company making the dividend payment. According to UN Commentary, this threshold is chosen because in some developing countries non-residents are limited to a 50 per cent share ownership. In such case, a 10 per cent holding is considered a significant portion of such permitted ownership.[22]

Maximum tax rates on interest

The taxing rights of the state of source with respect to interest are usually limited by treaties based on the OECD MTC by means of a maximum rate to be applied of 10 per cent. According to the Commentary, this percentage appears to be reasonable since the underling corporate profits financed out of the debt instrument are also taxable in that state.[23] Contracting states may agree upon a lower tax rate or on exclusive taxation in the state of residence.[24]

Tax treaties based on the UN MTC also limit the taxing rights of the state of source, but with an mutual larger variety in maximum percentages. The maximum tax rates for interest range from nil to 25 per cent.[25] The UN MTC does prescribe to apply a maximum tax rate on interest in the source state, but leaves the actual percentage to be established through bilateral negotiation. Traditionally, some states would rather prefer to grant the state of source an exclusive right to tax interest, based on the reasoning that interest is earned where the capital is used. In contrast, other states would prefer an exclusive right to tax to the state of residence to, among other, promote the mobility of capital.[26] Although in the end an agreement was reached on joined taxation, it was not possible to reach a consensus on a maximum percentage. According to the commentary, the maximum rate as adopted in the OECD MTC was considered to be too low.[27] Nevertheless, in current tax treaty practice, contracting states do agree on maximum rates at or below the OECD MTC rate of 10 per cent to attract investment.[28]

[29] The OECD's Action Plan on Base Erosion and Profit Shifting. See OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris, OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris, and the resulting reports, especially OECD (2014), *Neutralising the Effects of Hybrid Mismatch Arrangements*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

EU: Interest and Royalty Directive and Parent-Subsidiary Directive

The qualification of financial instruments and the classification of the yield thereon for both national tax purposes and bilateral tax treaties, falls within the competence of the EU Member States. In principle, EU law does not interfere. There is however secondary EU-law on the tax treatment of certain intra-EU dividend payments and interest payments. Several directives are issued for the approximation of national tax law systems of the Member States of the EU. With respect to corporate income taxation and financial instruments, the Parent-Subsidiary Directive and the Interest and Royalty Directive are the most relevant because they may cover the return on financial instruments. The EU Parent-Subsidiary directive aims to eliminate juridical and economical double taxation on profit distributions made by a subsidiary company resident in an EU Member State to a parent company resident in another EU Member State. The state of source may not levy a withholding tax and the state of residence must apply an exemption or credit method. But conditions apply. The EU Interest and Royalty Directive exempts interest payments from tax in the EU Member State of source if the conditions are met.

Qualification for EU directive purposes

The Parent-Subsidiary Directive applies to 'distributions of profits'. The actual term 'dividends' is not employed in the provisions containing the obligations of the EU Member States. It appears to be generally agreed on that the objective of the directive requires the notion of 'profit distribution' to be understood in a broad meaning. But the qualification of an instrument for directive purposes is left to the EU Member States. Both the state of source and the state of residence autonomously qualify the instrument and payment according their national tax laws. Obviously this may result in conflicts of qualification and possibly mismatches in tax outcomes. As of January 2016, the Parent-Subsidiary Directive has been amended to avoid double non-taxation in this respect.

The Interest and Royalty Directive applies to 'interest'. For the purposes of the directive the term 'interest' means 'income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures; penalty charges for late payment shall not be regarded as interest.'. The source state is not obliged to apply the directive to payments from debt-claims with certain characteristics of equity, i.e. 'payments from debt-claims which carry a right to participate in the debtor's profits', 'payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits' and 'payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue'.

Although this appears to be a closed definition, the national qualification of the state of source is relevant. An EU Member State – in its capacity as state of source – is not obliged to grant the benefits of the directive to payments which are treated as a distribution of profits or as a repayment of capital under its laws.

WHT under EU directives

An EU Member State may not levy a withholding tax on profit distributions falling within the scope of the Parent-Subsidiary Directive.

An EU Member State may also not levy a withholding tax on interest payments falling within the scope of the Interest and Royalty Directive.

Mismatches in tax effects

The OECD and G20 states aim achieve international consensus on rules to neutralize the effect of mismatch arrangements. This as part of addressing the current possibilities to 'Base Erosion and Profit Shifting' ('BEPS').[29] Most of the suggestions take form of 'linking rules',

rules that align the tax treatment payments on a financial instrument in one state with treatment in the other state to arrive at a balanced outcome. Payments are either tax deductible and taxed or tax non-deductible and eligible for a relief for double taxation.

Anti-avoidance and substance requirements

As discussed in the previous chapters, many jurisdictions apply a basic distinction by which interest payments are deductible in computing the taxable profits of the issuer, while dividend payments are not deductible. This tax benefit may create a bias towards debt financing, especially when the parties are related parties. Internationally, a country may also be concerned about the potential for erosion of its tax base.

Therefore, jurisdictions may adopt rules with the purpose of reducing or even eliminating the bias toward debt financing. This bias may become even more pronounced when payments cross borders, and the source jurisdiction treats a payment as a deductible interest while the jurisdiction in which the investor is a resident provides a participation exemption for what it considers to be a dividend ("hybrid mismatch").

In general, rules with the purpose of reducing or even eliminating the bias toward debt financing may be divided into two categories:

1. "reclassification" rules;
2. "anti-abuse" rules, such as the more targeted "thin capitalization" rules and "earnings stripping" rules, or general anti-abuse rules ("GAAR").

Reclassification rules

A number of countries attempt to reclassify financial instruments through the use of "economic substance", or through "substance over form" principles.

In some jurisdictions, the concept of debt versus equity for tax purposes follows the legal form of the transaction. This test relies primarily on the legal form of the transaction in determining the existence and relevance of payment obligations. In other jurisdictions however, the concept of debt and equity for tax purposes may differ from the concept of debt and equity that can be found in the jurisdiction's commercial law or accounting principles.

Under an "economic substance" or "substance over form" approach, all the facts and circumstances are considered to determine whether a financial instrument more closely resembles debt or equity. These rules may not only be used to characterize a financial instrument as debt or equity, but may also be used as well to recharacterize or reclassify a transaction in accordance with its substance.

Anti-abuse rules

Many countries require that the rate of interest paid with respect to loans from related parties is an at arm's length rate. In some cases, the interest that would be non-deductible as a result of the interest not being at an arm's length rate could be recharacterized as a dividend. A number of countries also require that the amount of debt cannot exceed an arm's length amount.

Thin capitalization rules

A common approach in a number of jurisdictions is the adoption of rules that establish a maximum debt to equity ratio, usually referred to as "thin capitalization rules". Under these rules, interest on debt that exceeds the maximum ratio would not be deductible in computing the taxable profit of the issuer of the loan. In practice, the allowable debt-equity ratio may vary considerably. Many jurisdictions have adopted a 3:1 ratio, but a 5:1 ratio can be found as well.

In some cases, the interest that would be non-deductible as a result of the maximum debt-equity ratio could be recharacterized as a dividend.

Earnings stripping rules

Another approach applied by a number of jurisdictions, limits the interest deduction by reference to the earnings of the issuer ("earnings stripping rules"). Under these rules, interest deductions are limited a to certain percentage of EBITDA (earnings before interest, taxes, depreciation and amortization). For instance, under the German "earnings stripping rules", interest deductions are limited to 30 per cent of EBITDA, while under Italian rules, interest expenses are fully deductible to the extent of interest income. Interest expenses that exceed interest income, however, are deductible up to 30 per cent of EBITDA.

General anti-abuse rules ("GAAR")

Finally, excessive interest deductions could be attacked through the application of a country's general anti-abuse rule ("GAAR") in order to recharacterize debt as equity when the arrangement was entered into with the (main or principle) objective of obtaining a tax advantage. The anti-abuse rule may as well be applied in attacking specific transactions in which the capital structure of an entity is modified to replace outstanding equity instruments with debt instruments, especially with respect to loan transactions between the entity and its shareholder(s).

Recent developments: OECD and EU

OECD: the BEPS Project

In 2013, the OECD announced its project against Base Erosion and Profit Shifting (BEPS). This project consists of 15 separate Action Plans with a view to addressing perceived flaws in international tax rules. After the publication of several discussion drafts in 2014 and 2015, the OECD published its final reports of the BEPS project on 5 October 2015. Of these reports, more specifically Action Plan 2 ("Neutralizing the Effects of Hybrid Mismatch Arrangements") and Action Plan 4 ("Limiting Base Erosion Involving Interest Deductions and Other Financial Payments") are addressing the equity versus debt discussion.

Action Plan 2 sets out a number of recommendations to neutralize the effect of hybrid mismatch arrangements. These recommendations are aimed at neutralizing the effect of cross-border hybrid mismatch arrangements, e.g. with respect to payments made under a hybrid financial instrument that produce multiple deductions for a single expense or a deduction in one jurisdiction with no corresponding taxation in the other jurisdiction.

The mobility and fungibility of money makes it possible for multinational groups to achieve favorable tax results by adjusting the amount of debt in a group entity. Therefore, Action Plan 4's recommended approach ensures that an entity's net interest deductions are directly linked to its level of economic activity, based on taxable earnings before deducting net interest expense, depreciation and amortization (EBITDA). This approach includes three parts: (i) a fixed ratio rule based on a benchmark net interest/EBITDA ratio; (ii) a group ratio rule which allows an entity to deduct more interest expense in certain circumstances based on the position of its worldwide group; and (iii) targeted rules to address specific risks.

EU: amendments to the Parent-Subsidiary Directive

In 2014, the European Union's Economic and Financial Affairs Council proposed an amendment to the EU Parent-Subsidiary Directive. This amendment was targeted at cross-border hybrid loan arrangements, and was aimed at neutralizing international mismatches that may arise due to international qualification differences of such loan arrangements. Following the amendment, hybrid loan arrangements are dealt with a linking rule; under this linking rule, the Member State where the parent company is located will no longer be allowed to exempt distributed profits to the extent that such profits are deductible by the subsidiary of the parent company. The Member States were to implement the amendment in their domestic tax laws by 31 December 2015 at the latest.

EU: Anti-Tax Avoidance Package including the Anti-Tax Avoidance Directive and CCCTB

On 28 January 2016, the European Commission presented its EU "Anti-Tax Avoidance Package" (ATAP). One of the 7 parts of this package was a proposed "Anti-Tax Avoidance Directive" (ATAD). On 21 June 2016, the EU-28 Finance Ministers reached political agreement on the ATAD. One of the key provisions in the ATAD is concerned with the deductibility of interest.

ATAD will introduce a rule restricting net borrowing costs to 30% of the taxpayer's EBITDA, optionally with a EUR 3m threshold. Standalone entities may be excluded from the scope. Within consolidated groups, Member States may allow full or partial deduction of exceeding borrowing costs under 'group ratio' conditions. Member States may exclude loans concluded before 17 June 2016, loans used to fund long-term EU public infrastructure projects, and financial undertakings. Carry-forward of non-deductible exceeding borrowing costs may be allowed without time limit (with an option also to include carry-back for up to 3 years or carry-forward of unused interest capacity for up to 5 years). A grand-fathering clause that will end at the latest on 1 January 2024 was agreed for national targeted rules which are "as effective as the fixed ratio rules" to be applied for a full fiscal year following the publication date of an OECD agreement on a minimum standard. Member States that wish to opt for this derogation will need to notify this before 1 July 2017 to the EC which will assess the effectiveness of the national targeted rules.

The ATAD also includes rules on hybrid mismatches to tackle 'double deduction'/'deduction no inclusion' outcomes caused by differences in the legal characterisation of a financial instrument. Application of those rules may result in the non-deductibility of the remuneration paid on a financial instrument. The ATAD, as it currently stands, targets mismatches within the EU. On 25 October 2016 however, as part of the October package – see below, the EC presented a proposal to complement these rules by broadening their scope to include EU corporate taxpayers engaged in a cross-border hybrid mismatch arrangement involving a third country.

On 25 October 2016, the EC announced plans for a corporate tax reform for the EU; the 'October-package'. As part of that package, the EC re-launched the proposal for a single set of uniform rules for the calculation of the taxable profits of multinationals active within the EU. The plans also include a tax base consolidation system and a tax base apportionment mechanism. This will be introduced in a staged approach. The first step will be a Common Corporate Tax Base (CCTB), i.e. rules on the common tax base. The second step will be the adoption of the Common Consolidated Corporate Tax Base (CCCTB), i.e. the rules on the consolidation. The tax rates to be applied will remain at the competence of the Member States. The CCCTB will be mandatory for groups with a consolidated annual revenue of EUR 750 million.

The CCTB/CCCTB plans include an interest deduction rule akin to the above described ATAD rule. In addition, the plans partially address the debt-equity bias by offering an allowance for growth and investment. The amount of a defined yield calculated on the mutation of the equity base will be added to the taxable base. I.e. an increase of equity results in an amount to be deducted from the taxable base, a decrease will lead to an amount to be included in the taxable base.

Egypt

In this article, we will be providing an overview of the forms of financing in Egypt. We will discuss the general economic aspects as well as the financial environment, the definition of a debt and equity and the tax consequences related to each form of financing. We will also provide an example of calculation for the Egyptian tax burden resulting from equity financing in comparison with the tax burden resulting from debt financing.

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General Economic and Investment Environment

- A number of rigorous changes have occurred in Egypt's political scene, President Mohamed Morsi was ousted from power and the constitution was suspended, Mr. Adly Mansour was appointed to act as Egypt's president during the transitional period until elections. The presidential elections were held in May 2014, which saw the election of Abdel Fattah el-Sisi, who is now the Egyptian president.

- The Egyptian economy faced an extreme downturn due to the circumstances that occurred and the Egyptian government faced a number of challenges regarding reviving growth, economic and political stability. Currently, the political and economic situation have become much more stable and growing than the past couple of years. The government along with the president focus mainly on expanding and stabilizing the economy, through encouraging investments as well as engaging in huge infrastructure projects.

- The GDP growth rate in July/September 2014/2015 was 6.8%.

- In addition, Egypt's budget deficit fell to 11.5% of its GDP in the fiscal year 2014-2015, ending in June 2015, as compared to the 12.2% recorded in the previous fiscal year. It is worth mentioning that, the budget deficit for FY14/15 was initially set at 10.8% of GDP.

- Despite the above, the Egyptian economy is a highly diverse economy and Egypt has strong financial and regulatory systems, all of which helped to reduce the effect of the crisis. Egypt is currently restructuring its political system to build stronger economic and investment environments. The Egyptian government has launched a strategy which focuses on 3 aspects; business reform, foreign direct investment attraction and investor care. This is aimed to reduce the business costs and to enhance the processes related to foreign investors by reducing the amount of licensing needed.

- However, investors are facing a number of challenges where the Egyptian companies have to comply with the Foreign Corrupt Practices Act and the UK Bribery Act 2010.

- Investments and business startup processes and requirements are expected to be less bureaucratic and less corrupted. In 2015, Egypt was the 88th country on the Corruption Perception Index.

- Obtaining credit and financing is not an easy process in Egypt, this is due to the high risk associated with lending. According to the World Bank's doing business guide, Egypt ranked the 71st in the ease of getting credit, however; Egypt's rank deteriorated to become the 79th at the beginning of 2016. Financing through equity in Egypt is possible through a number of ways, the first option is through an IPO, where the company can issue shares in the stock market (partially or entirely) in case the company is listed in the stock market. Alternatively, the company can sell unlisted shares to normal individuals seeking to invest their savings.

- Existing projects can finance their projects through increasing their capital and issuing shares, and they can sell the majority or minority of shares to the investors.
- Equity providers can be individuals, which are mainly known families that desire to invest their savings in shares, or through private equities and foreign direct investors.
- Grants are another mean of financing in Egypt, grants in the form of loans or equity financing are provided by a number of entities such as EBRD, IFC and USDA, such grants are usually provided to developmental projects or to start ups and small businesses.
- Debt is available in its conventional forms (loans and bonds) and in the Islamic finance forms. Leasing is also another form of financing, operating leases specifically is a common form of financing in Egypt. Factoring (with recourse or without recourse) is available in Egypt, where the owner of the receivables can sell the receivables to a third party.

Definition of terms “equity” and “debt” for tax purposes

- Debt includes all amounts related to loans and advances, and the debit interest includes all amounts chargeable by the creditor in return for the loans - advances of any kind obtained thereby, bonds and bills. The loans and advances include, for purposes of this item, bonds and any form of financing by debts through securities with a fixed or a variable interest rate.
- Equity includes paid up capital (“PUC”), in addition all reserves and dividends reduced by retained losses should serve as the basis for computing equity. The below formulas are provided by the law for the purpose of calculating the average equity and debt amounts:
  - Equity = Equity at the beginning of the financial year and equity at the end of the financial year, divided by 2.
  - However, if equity per the above equation is less than zero, then equity is equivalent to PUC for purposes of computing the debt to equity ratio in the context of thin capitalization.
  - Debt = Loans and advances at the beginning of the period and loans and advances at the end of the period, divided by 2.

Equity Financing

Contribution of equity

Stamp duty or similar taxes

- On the 29th of April 2013, a new law was issued to amend some articles of the existing stamp duty law, and add new articles.
- The stamp tax on the transfer of shares (0.1% on both the buyer and the seller) has been abolished by virtue of law no. 53 of 2014.
- Misr for Central clearing, Depository and Registry “MCDR” is a governmental agency that applies the central depository system, effects central registry of securities traded in the Egyptian capital market and undertakes clearing and settlement on securities traded in the capital market.
- The Egyptian Stock Exchange” is a governmental agency that operates and develops the market.

Capital gains

- A tax on capital gains was first imposed as of July 2014. Before that, there was no withholding tax imposed on capital gains in Egypt.
- Taxable capital gains are calculated as the difference between the acquisition cost and the fair market value / selling price.

Sale of listed shares by resident and non-resident shareholders

- A 10% capital gains tax is imposed on the capital gains realized upon the sale of listed Egyptian shares, by resident or non-resident shareholders (Companies and individuals). However, this tax has been put on hold for 2 years as of 17 May 2015, based on the amendments introduced by law no. 96 of 2015.

Sale of unlisted shares by resident shareholders

- Capital gains realised upon the sale of unlisted shares by resident individuals are subject to the personal income tax rates, at the relevant brackets. Please find below the personal income tax brackets, as per the provisions of the Egyptian income tax law.
  - EGP 0 - 6,500 0%
  - EGP 6,500 - 30,000 10%
  - EGP 30,000 - 45,000 15%
  - EGP 45,00 - 200,000 20%
  - More than EGP 200,000 22.5%
- However, in case the capital gains were realized by resident companies, these gains would be subject to a tax, at the rate of 22.5%.

Sale of unlisted shares by non-resident shareholders

- On the other hand, the capital gains realized upon the sale of unlisted Egyptian shares by non-residents would be subject to a capital gains tax at the rate of 22.5%. However; a relevant DTT (if any) can further reduce this rate or even eliminate it.

Tax imposed on the capital gains realised from the revaluation of assets

- Based on the Egyptian income tax law, the following shall be considered as a change in the legal form:

  - Merger of two or more resident companies.
  - Spin off of a resident company to two or more resident companies.
  - Conversion of a partnership to a corporation or conversion of a corporation to another.
  - Purchase or acquisition of 33% or more of shares or voting rights either from the perspective of the number or value in a resident company, against shares in the acquiring company.
  - Purchase or acquisition of 33% or more of the assets and liabilities of a resident company by another resident company.
  - Conversion of partnership into a corporation.

- Based on the Egyptian income tax law, the tax applied on the capital gains realized from re-evaluation, upon changing the legal form of a company may be deferred, provided that:

  - The company recognizes the assets and liabilities at book value, for tax calculation purpose.
  - The company calculates the tax depreciation on assets and carries forward the provisions and reserves based on their values before their valuation.
  - The company does not dispose the shares within three years.
  - The parties related to the transactions must all be tax resident in Egypt.

Payments of equity

- Payments of equity is possible to take the form of dividends distribution.

- Starting the 1st of July 2014, a 10% withholding tax has become imposed on the dividends paid by Egyptian companies to resident and non-resident shareholders.

- In case the recipients of the dividends are resident / non-resident companies or individuals, the 10% WHT can be reduced to 5%, if the following conditions were met together "qualifying dividends":

  - The shareholder holds more than 25% of the share capital or the voting rights of the subsidiary company; and
  - The shares are held for at least 2 years.

- Dividends received by a resident company / individual from another resident company would not be subject to CIT / personal income tax purposes at the level of the recipient company / individual, provided that all associated costs are not deductible.

- According to article 32 (BIS) of the executive regulations, the associated costs is the costs accrued or payable in the financial statements including interest accrued/payable on funds, loans or any other financing instruments as well as general and administrative costs that the investor bears due to carrying out the investment. It is worth noting that, in the context of this article, the depreciation and amortization fees are not included within the general and administrative costs.

- It is worth noting that, individuals are only taxed on the dividends income exceeding EGP 10,000.

- However, dividend income received by resident individuals whose annual investment portfolio does not exceed EGP 10,000, are not subject to tax.

- Dividends received by resident individuals from shares invested abroad are subject to the normal personal income tax rates (stated above), with a foreign tax credit allowed for any foreign taxes paid to the extent of the local tax payable.

- Moreover, in case an Egyptian entity holds at least 25% of another Egyptian company's shares, for at least 2 years, then the participation exemption rule should apply where 90% of the dividend income received by the Egyptian entity would be exempted from corporate income tax (i.e. only 10% of the dividend income would be subject to corporate income tax). Thus, the effective tax rate applicable in this case would be 2.25%.

Debt Financing

Granting of debt

Stamp duty

- A proportional tax at the rate of 0.4% annually (i.e. 0.1% per quarter) is imposed on the beginning balance of each quarter of credit facilities and loans and advances provided by Egyptian banks or branches of foreign banks during the financial year. In addition to the amounts utilized within this quarter. The bank and the customer each bear half of the tax. Loans from other establishments are not subject to this tax. Banks will be obliged to settle the stamp duty due during the first 7 days following the end of each quarter.

Withholding taxes

- An Egyptian entity making interest payments to a non-resident person, natural or juridical, must withhold tax at the rate of 20%, at the time of payment, however in case a double tax treaty exists between Egypt and the country of the non-resident person, this rate might be reduced. In addition, interest on loans with more than three years maturity are exempt from the 20% withholding tax according to the Egyptian income tax law.

- The interests on loans and credit facilities obtained by the government, local government units, or other public juridical persons, from sources abroad shall be exempted from the tax prescribed. Companies of the public sector, the public business sector, and the private sector shall also be exempted from this tax providing the loan or facility period shall be more than three years.

Deductibility

- The thin capitalization rule that applies in Egypt is a 4:1, debt to equity ratio. This means that companies cannot deduct the interest payments of debts that are more than 4 times their equity. The excess in debt over this ratio will not be accepted by the Egyptian tax authority and so the associated interest will not be treated as a tax deductible expense.

- The second requirement for interest payments to be considered a deductible expense, is that the interest rate should not be more than 2 times the discount rate declared by the Central Bank of Egypt which is currently 9.75%.

- In case the debt would be acquired through a related party, transfer pricing rules should also be taken into consideration in order for the interest to be considered a deductible expense.

- It is worth mentioning that, one of the conditions required to allow the deductibility of interest payments is that the loan should be related to the business activities of the debtor and should be supported by documents.

Determining the debt and equity for thin cap calculation purposes

- Debt = Loans and advances at the beginning of the period and loans and advances at the end of the period, divided by 2.

- Equity = Equity at the beginning of the financial year and equity at the end of the financial year, divided by 2.

- The following types of loans should be excluded from the calculation: interest free loans, loans with non-taxable interest, and loans with a grace period for settling the interest payments solely until the end of the loan period.

- Determining the equity, the following items represent the basis for calculation: the paid up capital in addition to all reserves, dividends and retained earnings (reduced by retained losses if any), providing the revaluation differences carried forward to the reserves shall be eliminated in case they are non-taxable. In case of retained or carry-forward losses, they must be used to reduce retained profits and reserves solely, the percentage is calculated on basis of total loans and advances in proportion to the remaining equity amount, after deducting the retained losses with a minimum of the paid up capital.

Typical Generic Structures

In Egypt, there are four typical forms of legal entities;

1. Joint stock company
2. Limited Liability company
3. Branch
4. Representative office.

Joint stock companies ("JSC")

- Under the joint stock company form, all activities are permitted, foreigners owning joint stock companies are not allowed to import, for the purpose of trading in Egypt.

- There has to be at least three shareholders and they can all be foreigners. And, the capital of a JSC should be at least 250,000 EGP or its equivalent in foreign currencies.

- Joint stock companies can be registered on the Egyptian stock exchange, and 10% of the company's annual net profits must be distributed among employees.

Limited Liability companies ("LLC"):

- Under the limited liability company form, all activities are permitted, foreigners owning limited liability companies are not allowed to import, for the purpose of trading in Egypt.

- There has to be at least two partners and they can all be foreigners. As for capital requirements, there are no minimum capital requirements.

- It is necessary to appoint one Egyptian manager where foreign managers will be employed by the company. Limited liability companies can't be registered in the Egyptian stock exchange. In case the capital exceeds 250,000 EGP, 10% of the company's annual net profits must be distributed among employees.

Branch

- The purpose of a Branch is to implement a specific contract in Egypt, and there are no capital requirements, it is only required to a deposit of 5,000 EGP. The manager of the branch can be an Egyptian or a foreigner.

- A branch may deduct a head office charge of an amount up to 10% of its net annual taxable income.

Representative office companies

- Representative office companies are established for the limited purpose of studying the markets without practicing a commercial activity.
- No partners are required and no capital is required, however the parent company should transfer a minimum of 1,000 USD to be deposited in the representative office's account under foundation.
- All representative office expenses should be transferred from the head office abroad. The manager of the representative office can be an Egyptian or a foreigner.

Calculations and Matrix for General Decision

Information

Description	Rate
Corporate tax rate	22.5%
Withholding tax rate	20%
Stamp tax imposed on loans	0.4%
Capital gains tax imposed on the gains realized from selling securities, whether listed or not or whether disposed by residents or non-residents.	10% for listed shares (on hold for two years starting 17 May 2015), and 22.5% / personal income tax brackets for unlisted.
The credit and deduction rate declared by the Central Bank of Egypt on the 01 January 2016	9.75%

Assumption one:

We assumed in this example that the loan is provided by a resident entity, that the interest is within the thin capitalization ratio and that the interest rate is not more than 2 times the credit and deduction rate declared by the Central Bank of Egypt.

Revenue	200	Paid up capital:	
COGS	50	Number of shares	500
Equity:	1,000	Value of share	2
Loan:	500	Total value of shares	1000
Interest rate:	10%		
Interest expense	50		

Effect on revenue in case of debt/equity financing:

Description	Debt	Equity
Revenue	200	200
Less:		
COGS	50	50
Gross profit	150	150
Less:		
Interest expense	50	0
Earnings before tax	100	150
Corporate tax	22.5	33.75
Stamp tax Imposed on the selling of shares transaction.	0	0
Capital gains tax imposed on the gains realized from selling securities, whether listed or not or whether disposed by residents or non-residents.	0	10% for listed shares (on hold for two years starting 17 May 2015), and 22.5% / personal income tax brackets for unlisted.
Stamp tax imposed on loans	1	0

Assumption two:

We assumed in this example that the debt to equity ratio exceeds the thin capitalization ratio (4:1), and that the loan is provided by a local resident.

Revenue	700	Paid up capital:	
COGS	100	Number of shares	500
Equity:	1,000	Value of share	2
Loan:	4,500	Total value of shares	1000
Interest rate:	10%		
Interest expense	450		

Description	Debt	Equity
Revenue	700	700
Less:		
COGS	100	100
Gross profit	600	600
Less:		
Interest expense	450	0
Add:		
Interest adjustment	50	0
Earnings before tax	200	600
Corporate tax	45	135
Stamp tax Imposed on the selling of shares transaction	0	0
Capital gains tax imposed on the gains realized from selling securities, whether listed or not or whether disposed by residents or non-residents.		10% for listed shares (on hold for two years starting 17 May 2015), and 22.5% / personal income tax brackets for unlisted.
Stamp tax imposed on loans	9	0

Interest adjustment explanation:

Equity average:	1000
Loans average:	4500
Debt to Equity ratio:	4.5 to 1
Adjustment:	4.5-4/4.5
Adjustment percentage:	11%

Assumption three:

We assumed in this example that the interest rate is more than 2 times the credit and deduction rate announced by the Central bank of Egypt which is currently 9.75%.

Revenue	700	Paid up capital:	
COGS	100	Number of shares	500
Equity:	1,000	Value of share	2
Loan:	500	Total value of shares	1000
Interest rate:	20%		
Interest expense	100		

Interest adjustment explanation:

The credit and deduction rate declared by the Central Bank of Egypt is 9.75%, the interest rate used in the calculation of interest cannot exceed the double of the interest rate declared by the Central Bank of Egypt which is 19.5% (9.75%*2).The Interest rate in this example is 20%, so accordingly the interest adjustment is 0.5% (20% - 19.5%).

Description	Debt	Equity
Revenue	700	700
Less:		
COGS	100	100
Gross profit	600	600
Less:		
Interest expense	100	0
Add:		
Interest adjustment	2.5	0
Earnings before tax	502.5	600
Corporate tax	113.06	135
Stamp tax Imposed on the selling of shares transaction	0	0
Stamp tax imposed on loans	1	0

Assumption 4:

We assumed in this example that the loan is provided by a non-resident entity, please note that the Withholding tax will be borne by the loan provider.

Revenue	700	Paid up capital:	
COGS	100	Number of shares	500
Equity:	1,000	Value of share	2
Loan:	500	Total value of shares	1000
Interest rate:	15%		
Interest expense	75		

Description	Debt	Equity
Revenue	700	700
Less:		
COGS	100	100
Gross profit	600	600
Less:		
Interest expense	75	0
Earnings before tax	525	600
Corporate tax	118.12	135
Stamp tax Imposed on the selling of shares transactions	0	0
Capital gains tax imposed on the gains realized from selling securities, whether listed or not or whether disposed by residents or non-residents.		10% for listed shares (on hold for two starting 17 May 2015), and 22.5% / personal income tax brackets for unlisted.
Withholding tax imposed on the interest payments (borne by the provider of the loan)	15	0

Note:
In case a double tax treaty exists between Egypt and the non-resident's country, the Withholding tax imposed on interest payments may be reduced.

Germany

The following article provides an overview of possible forms of financing in Germany.

After a short presentation of general economic aspects as well as the financial environment, related to the selection of the financing, the decisive criteria for the qualification of a financial instrument as equity or as a liability are addressed. The focus is then on the presentation of the tax consequences associated with the selected form of financing, but partly on the legal consequences as well. Finally, on basis of an example calculation the German tax burden resulting from equity financing is compared with that resulting from debt financing.

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Financing environment in Germany

In Germany, debt is an important factor in connection with the financing of companies. As a general rule, debt outweighs equity. Considering all German companies, the equity ratio has continuously increased from 2008 (appr. 22%) through 2014 (appr. 29%).[1]

It is interesting on the one hand that the equity ratio of larger companies – especially the listed companies – is substantially higher than that of smaller companies. On the other hand, the equity ratio also strongly depends on the industry. While in 2013 the average equity ratio in the chemistry and synthetics industry exceeded 34%, the equity ration in the transportation and logistics industry did not even reach 18%.[2] In contrast, considering the low inflation and interest rates of the last years, indication is given that the financing requirements of companies are not significantly influenced by economic measures of inflation or the interest rate level but instead develop more from a business point of view.

Thus, it is also relevant that in Germany – derived from basic constitutional rights –the principle of financing freedom exists. Based on this, a person is principally free to finance an investment with equity or debt. This principle is especially relevant in the context of intra-group financing flows and leads to the fact that debt financing per se is not inappropriate for tax purposes. Of course, various limitations exist regarding financing for tax purposes (in particular the so-called "interest barrier" – see below).

Definition of equity versus debt

In connection with the financing of a company, equity and debt can be distinguished based on the legal status of the investor. Furthermore, there are hybrid financing forms which exhibit elements of both equity and debt.

Legal classification of financing instruments

Under commercial law and company law the classification of financing instruments is dependent upon the liability criterion. Forms of financing which – from the creditor's point of view –are available as recoverable assets in the case of a loss, are normally classified as equity.[3] In contrast, financing instruments that are independent of results are usually classified as debt.[4] Hybrid financing instruments (also so-called quasi-equity), such as jouissance rights (Genussrechte) or shareholder loans, can be treated as equity or debt, depending on their arrangement.[5]

Classification of financing instruments for tax purposes

The starting point for the tax classification of financing instruments as equity or debt is principally the classification under

1 Source: Creditreform market analysis as of November 2015

2 Source: Creditreform market analysis as of November 2015

3 See Fischer/Lohbeck, IStR 2012, 678, 679.

4 See Michalski, Kommentar zum GmbHG, 2. Auflage, Band I, Systematische Darstellung 5, C II Rn. 92ff.

5 See Michalski (Footnote 2), C II Rn. 98f.

commercial law and company law. There can be deviations especially in two cases:[6]

- On the one hand, a legal relationship under the law of obligations due to special agreements can lead to the creation of a so-called partnership between the lender and borrower. This is the case if borrower carries on a trade and the lender carries out entrepreneurial initiative and bares the risk related to the commercial activity.[7] Entrepreneurial initiative means that the lender develops control rights which are at least at a level of control that a limited partner has in a German limited partnership (KG). Entrepreneurial risk means that the lender carries a risk beyond the pure risk of granting a loan; for example, this would be the case if the lender also – at least on a limited basis – participates in income and losses of the borrower as well as in the hidden reserves of the business assets of the borrower.

- On the other hand, in the case of the issuance of a so-called jouissance right, German tax law provides for a differentiated treatment of the legal relationship (Art. 8 (3) Sent. 1 German Corporation Tax Act – KStG). According to this, for tax purposes a relationship similar to equity is assumed if the holder of the jouissance right participates in the income and the liquidation proceeds of the capital company.[8]

Equity financing

In connection with equity financing, the company obtains new capital through an increase in the existing contributions from outside or through a self-financing by converting retained earnings.

Contribution of equity

Legal aspects

With respect to the transfer of equity there are in principle no legal restrictions. In the case of capital companies, however, the procurement of nominal capital is subject to formal requirements (i.e., certification by a notary and entry in the commercial register) and capital maintenance rules. In the case of a GmbH, the minimum capital amounts to EUR 25,000 and for a stock corporation (AG) to EUR 50,000. A contribution exceeding these amounts into free capital reserves is possible at any time without the issuance of new shares.

If, in connection with the raising of cash capital, a capital company, for example, repays loans to its shareholders or purchases assets from its shareholders, the principles of disguised contributions in kind or investments in kind must be observed. This means that the share capital is considered to be insufficient to the extent that the disguised contribution made in kind is not recoverable, i.e., does not reach the nominal amount of the cash contribution. The result is that the shareholders are obligated to make another contribution in the amount of the difference, and the general managers of the company are liable as joint debtors in addition to the shareholders. As a consequence, in connection with the formation of or increase in capital of a capital company, caution should be taken that no transactions are triggered that could qualify as a disguised non-cash contribution or capital increase.

In the case of partnerships, in principle no rules exist regarding the raising of capital or capital increases due to the fact that at least one partner has personal liability. However, to the extent that limited partners of a limited partnership have not actually paid up their contribution, these individuals have unlimited liability pursuant to Sec. 171 of the German Commercial Code (HGB). The raising and use of capital is overall only mandatorily regulated to a limited extent. For example, contrary to tax law[9], equity can also be raised through the performance of services or transfer of right of use.

[6] Also in the Outbound case not further investigated here, the above-mentioned authority with respect to the foreign accounting basically does not apply; see Fischer/Lohbeck, IStR 2012, 678, 679. In the case of a cross-border dimension, the Bundesfinanzhof [federal fiscal court] has developed basic principles for the tax-related differentiation between equity and debt in connection with the investment in a foreign capital company for purposes of Art. 1 of the Foreign Transaction Tax Law; see BFH judgment of May 30, 1990, I R 97/88, BStBl. II 1990, 875; more or less confirmed by BFH, decision of November 29, 2000, I R 85/99, BStBl. II 2002, 720.The German tax authorities regularly apply principles set out in the case law; Sec. 1 AEAStG May 14, 2004; decree of October 17, 2002, IV B 4-S 1341 -14/02.

[7] See H 15.8 (1) EStH.

[8] For more detailed information see BFH v. 14.6.2005, VIII R 73/03, BStBl. II 2005, 861.

[9] Assets that cannot be recognized in the financial statements cannot be contributed according to the resolution of the Grand Senate of the BFH of August 28, 1987, BStBl. II 1988, 348.

Tax-related aspects

For tax purposes, first open contributions and hidden contributions[10] must be distinguished. The latter exists if a domestic company provides a monetary and bookable advantage for a contribution and the company does not receive a corresponding consideration and also if such a contribution would not have been carried out by a non-shareholder. Open contributions are all contributions that are in connection with the formation or capital increase of a company; they generally require a connection with the issuance of shares in a capital company or the justification/strengthening of the status of the partner in a partnership. The distinction between an open and hidden contribution is relevant for the application of various German tax rules.[11]

Under these rules the open contribution of capital into the equity of a company is carried out basically without tax consequences:

- With respect to contributions into capital reserves, the acquisition cost of the investment is increased for the contributing company. At the level of the company there is an increase in the equity (respectively the capital reserve) as well as in the tax-specific contribution account in the amount of the contribution made to the capital reserve.

- Contributions of capital into partnerships which qualify as partnerships for tax purposes basically increase the capital account of the contributing partner. This capital account represents – taking into consideration any adjustments from so-called supplementary and special-purpose balance sheets – the acquisition cost of the partner (so-called capital mirroring approach).

Hidden contributions in principal also have no tax effect; increases in business assets resulting from contributions are to be neutralized for tax purposes at the level of the company that received the contribution[12]. This only applies, however, to the extent that the profit of the contributing shareholder has not decreased (so-called correspondence principle).[13]

Stamp taxes or similar taxes are not assessed in Germany. The last of such taxes that was comparable to these, the so-called exchange tax, was eliminated from January 1, 1992 pursuant to the Financial Markets Promotion Act of February 22, 1990.

Payments out of equity

Legal aspects

With respect to capital companies, payments out of equity are principally possible in the form of distributions. This requires a formal resolution of the shareholders; however, management/the management board can submit an appropriate proposal. A distribution is only possible if a corresponding adequate retained profit is available; this can be created through the release of non-restricted capital reserves (§ 272 (2) No. 4 HGB). For a distribution, there doesn't necessarily have to be a reference to a year-end balance sheet; advance distributions of the expected retained profits are conceivable. If these are ultimately not adequate for the distribution, a reimbursement claim arises against the shareholders.

According to the legal provisions for the maintenance of the nominal share capital pursuant to Art. 30 of the Law on Limited Liability Companies (GmbHG) respectively Art. 57 of the Stock Corporation Act (AktG), other disbursements from equity are principally not allowed for a GmbH or an AG/KGaA. These rules pertaining to capital maintenance aim to achieve creditor protection. However, there are exceptions to the disbursement prohibition pursuant to Art. 30 (1) Sent. 2 and 3 GmbHG, respectively Art. 57 (1) Sent 2 to 4 AktG. According to these rules, repayments to the shareholders from equity are allowed even if not covered by disributable profits, if they are a) made in connection with the existence of a

10 See R 40 KStR.

11 See for example § 6 Abs. 6 EStG.

12 § 4 (1) Sent. 1 EStG (where applicable, in conjunction with § 8 (1) Sent. 1 KStG)

13 § 8 (3) Sent. 4 KStG.

control or profit transfer agreement or b) counter guaranteed with a fully valuable consideration claim or claim of restitution against the shareholder.

The repurchase of treasury shares by the GmbH or AG also represents a form of repayment of equity to the shareholders. The repurchase of treasury shares by the company basically requires a resolution, respectively the approval, of the general shareholder meeting. Depending upon the situation, the repurchase of shares can be connected to a withdrawal of the affected shares. From an accounting perspective, the repurchase of shares requires the ability of the company to establish a reserve in the amount of the acquisition cost for the share repurchase. The instrument of the purchase of treasury shares can be utilized in many constellations, for example in connection with larger changes at the shareholder level, in order to make it easier for individual investors to withdraw from the company through the collection of the shares. Please note thatthe repurchase of treasury shares is subject to the fulfillment of several conditions which vary depending on the legal form of the entity (particularly Art. 71 AktG and Art. 33 GmbHG).

In connection with partnerships, there are basically no corresponding restrictions. Here, a disbursement from capital is essentially possible without restriction; however, for limited partners, under certain circumstances, there is personal and direct liability up to the amount of the guaranteed liability pursuant to Sec. 172 HGB as entered in the commercial register.

Tax-related aspects

Payments out of equity are not tax deductible.[14] German tax law also grants no deemed interest deduction on equity.[15]

As a matter of principle, dividends paid by a German capital company are generally subject to a German withholding tax in the amount of 26,375 per cent including solidarity surcharge.

For capital companies receiving a dividend, the dividend is generally 95 per cent tax free, provided the receiving company held at least a participation of 10% in the nominal capital of the payor at the beginning of the calendar year in which the dividend is received.[16]

Notwithstanding the above, to the extent dividends are funded from the tax-specific contribution account of a company, they are to be offset against the acquisition cost, without tax effect, both by the distributing company and the recipient; accordingly, no withholding tax is due. If the distribution from the tax-specific contribution account is in excess of the acquisition cost, a capital gain results (normally 95 per cent tax free).[17]

With respect to the question of when a distribution from the tax-specific contribution account occurs, an assumed application is applied: first, it is assumed that the so-called neutral asset is distributed, i.e. the amount by which the tax-specific equity account exceeds the nominal capital and the separately determined and assesed tax-specific contribution account. To the extent that this neutral asset is distributed, the tax-specific contribution account is deemed to be used. If this is fully depleted, it is assumed in turn that a distribution is made from the neutral asset, also if the equity for tax purposes is negative or will become negative. Decisive in each case is the last determined tax-basis equity and the tax-specific contribution account prior to the distribution.

With respect to partnerships, profits are first recorded to the capital account of the partner. Distributions then qualify as withdrawals, which reduce the capital account accordingly. No withholding tax is due on this. In the case of withdrawals that are in excess of the profit (“excess withdrawals”), special rules are to be observed. Also in the case of limited-liability owners (for example, limited-liability partners of a KG), there are additional rules to be observed if the withdrawal leads to a negative capital account or increases the negative account.[18]

[14] Different for example from Brazil with the so-called “Interest on Net Equity” regime.

[15] Different for example from Belgium or recently Italy.

[16] Exceptions to this are especially named in § 8b (7) and (8) KStG and exist in particular for financial insti-tutions and financial holdings. Furthermore, for German trade tax purposes the 95% exemption is only applicable if further requirements are met.

[17] See § 8b (2), (3) Sent. 1 KStG.

[18] See especially § 15a EStG.

Reduction of equity

Legal aspects

In the case of capital companies, capital reductions are utilized in practice mostly to eliminate an existing adverse balance in the commercial financial statements and are suitable only to a limited extent for the repayment of nominal capital of the company in the form of successive profit distributions from uncommitted funds that become available. The pre-conditions for and effects of a capital reduction depend on the nature of the reduction. One distinguishes between an ordinary and simplified capital reduction.

The repayment of equity according to an ordinary capital reduction is subject to a number of restrictions to protect the creditors. Equity in principle can only be made available in connection with an ordinary capital reduction when the nominal capital remaining after the reduction is covered by assets, i.e., there is no adverse balance. The remaining nominal capital must at least equal the statutory minimum capital. A condition for an ordinary capital reduction is a notarized resolution of the shareholders which – unless otherwise governed by the articles of incorporation – represents a three-fourth's majority. For every GmbH the reduction resolution is to be published in the electronic Federal Gazette and is to be first entered in the commercial register at least one year after the announcement; for stock companies not only the capital reduction but also its implementation is to be entered in the commercial register. For GmbHs, during the one-year blocking period, creditors of the company can make a claim against the company for collateral security or settlement of their receivables. The application, respectively the disbursement, to the shareholders of the equity becoming free as a result of the reduction, is only possible after the expiration of the blocking period. For stock companies, creditors of the company have a period of six months after the capital reduction is published to make a claim against the company for collateral security or settlement of their receivables. This is not a blocking period.

The fund becoming available from a simplified capital reduction is only allowed to be applied in accordance with Art. 58b GmbHG, respectively Art. § 230 AktG for loss compensation and in the case of a stock corporation for the formation of a capital reserve in a limited amount. In particular, a repayment of such funds to the shareholders is not permitted. In connection with corporate restructurings, the simplified capital reduction is often connected to a simultaneous cash capital increase, so that fresh capital can be injected at the same time that the losses arise on the balance sheet.

Tax-related aspects

In connection with a capital reduction of a capital company it is necessary to distinguish the following two scenarios.

- If there is only a reduction in share capital which does not originate from a conversion of capital reserves or revenue reserves, the distribution is initially without tax consequences (offset with the acquisition cost of the shareholder, no withholding tax). On the other hand, to the extent that capital reserves or share capital arising from the conversion of reserves are distributed, the order of appropriation described above is applicable.

- Capital reductions of a partnership basically reduce – initially without tax effect – the capital account of the respective partner and thereby his acquisition cost in the same amount. Apart from that, the above comments regarding reductions apply correspondingly.

Additional considerations - tax-related aspects

Disproportionate contributions of capital can establish hidden profit distributions. Moreover, disproportionate contributions of capital can meet the conditions for a gift tax.[19] In the case of distributions of non-cash assets of capital companies or partnerships, the so-called partial value

[19] See § 7 (8) ErbStG.

is applied. The application of the partial value has the consequence that hidden reserves in the distributed goods and values become visible and are subjected to taxation. In many cases the partial value equals the fair market value. Still the partial value also considers the use of the asset for the specific business of the seller on the basis of a going concern prognosis.

Debt financing

Issuance of debt

Legal aspects
In contrast to equity, debt fundamentally establishes an obligation for repayment to the creditor. In connection with the issuance of debt it primarily needs to be ensured that at the level of the company no over-indebtedness is incurred under insolvency law or commercial law.

In connection with the granting of shareholder payments which initially qualified as debt, the rules regarding equity substitution needed to be observed, before the law was changed; under these old rules, the issuance of a shareholder loan, in particular in times of crisis of the company, led to the prohibition of repayment. After the German Act to Modernize the Law on Private Limited Companies and Combat Abuses (MoMiG) went into effect on November 1, 2008, the repatriation of such shareholder loan is allowed also in times of crisis. Pursuant to Art. 135 of the German Statute on Insolvency (InsO) any repayments made by the company within one year prior to the filing of insolvency of the company can be contested; the same applies to any security granted by the company for any shareholder loan within ten years prior to the filing of insolvency of the company.

Tax-related aspects
Stamp taxes or similar taxes are not levied in Germany; in particular there is no tax on the conclusion of loan contracts.

Also in other respects there are basically no limitations for tax purposes of issuing debt.[20] However, if a partner of a partnership grants a loan to the partnership, it is treated in a second stage of profit determination as so-called separate business asset similar to equity.[21] This has consequences for the effective deductibility of the payments on this debt for German tax purposes.

Payments on debt

Legal aspects
In connection with the payment of interest on shareholder loans which qualify as debt, the principles already described above regarding contestability of such payments must be considered.[22]

Tax-related aspects
Withholding tax
In principle, Germany does not levy withholding tax (capital gains tax) on interest payments to domestic and foreign lenders.

However, there are exceptions to this principle. For example, a capital gains tax is levied if the borrower is a domestic credit institution, if the interest pertains to a loan that is dependent on profits or if it relates to interest on loans and receivables that are entered in a public debt register or a foreign register. The respective withholding tax can be reduced (where applicable, to 0 per cent) by meeting certain requirements according to the European Interest and Royalties Directive or in connection with a double tax treaty. For this, a timely application prior to the payment is necessary; alternatively a subsequent refund upon application is possible.

Deductibility
As business expenses or income-related expenses, interest payments on debt in principle reduce the tax assessment base as long as they are business related. Such a business relationship, for example, can also be given with respect to debt-financed

[20] In particular, the Thin-Cap-Rule of § 8a KStG in the old version was eliminated by UntStRefG.

[21] This conclusion can also result if the debt is transferred through an intermediated company. In order to insure the deductibility of interest in the case of a partnership, a careful planning review and planning of the financing should accordingly be carried out.

[22] See E I. 1. above

share purchases within a group or debt-financed dividend distributions.

For trade tax purposes, debt financing costs are to be partially added to the assessment basis and as a result are generally not fully deductible.[23] Furthermore, the so-called net principle is to be considered. This means that if earnings components of the trade tax assessment basis are to be reduced, this also applies to the directly-related financing costs; therefore, for trade tax purposes such costs are not fully deductible.

Exceptions exist to the principle of the general deductibility of debt financing costs, however, in the form of the arm's length principle and in the form of the interest barrier, which are described below.

Arm's length principle

If loans do not carry interest rates that are in compliance with the arm's length principle, this can lead to a hidden dividend distribution, respectively this can entail a correction of the income.

Interest barrier

In connection with the 2008 Business Tax Reform Act, the previous rules for shareholder debt financing pursuant to Art. 8a of the Corporation Tax Act (KStG) were replaced by the so-called interest barrier (Art. 4h of the Income Tax Act (EStG)) and in the meantime have been partially modified.

The interest barrier, which is of a highly complex design, provides for a limitation of the deductibility of interest expenses of an operation. Interest expenses are expenses from the temporary transfer of (monetary) capital, thus, among others, all interest expenses that result from loans made by shareholders, related parties and third parties, loans with fixed, variable or income-dependent interest rates and/or loans with shorter or longer terms.

The term "operation" is not defined by law. In principle, however, every capital company and commercial partnership qualifies as an operation in terms of the interest barrier.[24] Controlling companies and consolidated tax group companies are considered as one operation for purposes of the interest barrier.[25]

The interest barrier contains 3 levels:

1. Interest expenses are deductible under the interest barrier if the operation in the related business year generates interest income in at least the same amount.

2. To the extent that the interest expense in excess of the interest income (net interest expense) does not exceed 30 per cent of the taxable income before interest, taxes and depreciation and amortization (taxable EBITDA), the interest expenses are deductible.

3. If the interest expense is in excess of the limit described above, it is not deductible in the related assessment period, and it increases the taxable income; the non-deductible interest expense, however, as an "interest carryforward", can be deducted in a later assessment period – within the limitations mentioned above pursuant to Art. 4h EstG.[26]

In certain cases the interest barrier is not applicable, with the result that all interest expenses of an operation are tax deductible. In particular, the interest barrier is not applicable if:

- the net interest expense of an operation is less than EUR 3 million,
- the operation does not belong to or belongs only proportionately to a consolidated group, or
- the equity ratio (relationship of equity to the balance sheet total) of the operation is not below 2 per cent of the equity ratio of the consolidated group (so-called ratio comparison).

The exceptions 2 and 3 are not applicable due to a reverse exception if a detrimental shareholder debt financing exists, the rules for which are not further presented here.

23 See § 8 No. 1 GewStG.

24 According to, among others, Köhler, DStR 2007, 597; Hahne, DStR 2007, 1947, 1949; Wagner/Fischer, BB 2007, 1811.

25 § 15 Sent. 1 No. 3 Sent. 2 KStG.

26 Hahne, DStR 2007, 1947, 1948.

[27] See especially § 3c EStG.

[28] Vgl. insbesondere § 4 Abs. 4a EStG.

[29] Vgl. insbesondere § 8b Abs. 3 S. 4 ff. KStG.

[30] Siehe oben Ziffer E I. 1.

[31] See especially § 5 (2a) EStG. With respect to the transfer of such liabilities, Germany introduced new legis-lation in 2015 which is not further presented here.

Loans in the case of partnerships
As discussed above, a loan issued by a partner to its partnership generally represents a special business asset (Sonderbetriebsvermögen). As a result of this classification, the interest payments on the loan are added back to second level of income determination of the income generated by the partnership. Furthermore, the payments then represent withdrawals of the partner.

Additional limitations of deductibility
The statutory rules in connection with the deductibility of operating expenses, respectively income-related expenses, in connection with debt are diverse under German tax law. For example, the following (partial) limitations on deductibility exist:

- limitation of deductibility if the operating expenses are in connection with (partially) tax free income,[27]
- limitation of deductibility in connection with over-withdrawals of partnerships, and[28]
- limitation of deductibility in connection with impairment to the lower realizable value of certain shareholder loans.[29]

Reduction of debt

Legal aspects
The repayment of shareholder loans classified as equity is subject to the principles already described above regarding the contestability of such payments.[30]

Tax-related aspects
The repayment of debt, as redemption, in principle has no tax effect. Solely in the case of differences between receivable and according payable (for example, in the form of write-downs made to the realizable value) there are significant tax implications.

Additional considerations - legal aspects

In connection with debt financing, there are often further specific special issues that result from the observance of the insolvency law. In the event that over-indebtedness exists for a company under insolvency law from the issuance of debt, in practice a (partial) waiver of receivables with or without a compensation agreement, respectively a subordination, could come into question.

The subordination serves pursuant to Art. 39 (2) of the Insolvency Statute (InsO) to avoid over-indebtedness under insolvency law of the company and exists if, pursuant to Art. 19 (2) InsO it is agreed, that the creditor with his receivable accepts a lower position than the receivables designated in Art. 39 (1) No. 1 to 5 InsO of other creditors. In contrast to a subordination, a waiver of a receivable results in a cancelation of the receivable. However, if in connection with an improvement of economic situation of the borrower such a receivable is revived, the receivable waiver can be agreed to by a so-called compensation agreement.

Furthermore, in connection with the granting of loans, the other conditions, such as provisions regarding repayment and interest, are of particular importance.

Additional considerations - tax-related aspects

From a tax point of view, there is still a requirement to recognize the liability in the case of both a simple and also a qualified subordination.

If loans provide for conditions, it should be carefully analyzed what the conditions relate to (for example, the arising of the liability, the arising of the obligation to repay). The German tax law contains a special rule in this respect. Thus, liabilities in particular that are only to be redeemed if future revenues or income are achieved are first to be recognized when the revenues or income are achieved.[31]

[32] See especially § 6 (1) No. 3 EStG.

In contrast, in the case of a waiver of a receivable, the liability is derecognized by the borrower with profit or loss effect. However, regarding shareholder relationships, a hidden contribution exists in the amount of the recoverable value of the receivable (see above regarding the effects). On the part of the creditor, the expense resulting from the derecognition of the receivable is generally not tax deductible.

The German tax law provides a special rule with respect to the tax base for interest-free loans.[32] This specifies that liabilities from interest-free loans are to be recognized on a discounted basis and thereby basically establishes a taxable income amount which results in successive expenses in the subsequent years.

Example calculation and overview

Assumptions	m EUR	
Earnings before taxes	40	
Net interest expense	60	
Depreciations/amortizations	80	
EBITDA	**180**	
Corporate tax rate (standard)	15%	of corporate tax base
Solidarity surcharge (standard)	5,50%	of corporate tax amount
Trade tax (applying trade factor of 400%)	14%	of trade tax base

Computation of taxable income	Equity m EUR	Debt m EUR
Corporate tax		
EBITDA	180	180
Depreciations/amortizations	-80	-80
Net interest expense	n/a	-60
Adjustments due to interest capping rule	n/a	6
Corporate tax base	**100**	**46**
Corporate tax	15,000	6,900
Solidarity surcharge	0,825	0,380
Trade tax		
Corporate tax base	100	46
Add-back (simplified)		13,5
Trade tax base	**100**	**59,5**
Trade tax	14,000	8,330
Summary of taxes		
Corporate tax	15,000	6,900
Solidarity surcharge	0,825	0,380
Trade tax	14,000	8,330
Withholding tax on interest	n/a	n/a
Total	**29,825**	**15,610**

In particular due to the fact that – in general – no withholding taxes are levied on interest payments, a debt financing of German operations is usually advantageous from a pure German tax perspective. The overall tax efficiency then depends on the taxation of the interest income at the level of the creditor/shareholder.

Italy

The following article provides an overview of the main distinctions between equity and debt financing from an Italian legal and tax point of view. The consequences deriving from the two forms of financing have been considered from the point of view of the Italian company/borrower; the taxation associated to the outbound payments deriving from the financing (i.e. dividend and/ or interest) have also been commented. At the end of the article, the Italian tax consequences deriving from the equity and debt financing are compared and explained with an example.

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Financing environment in Italy

In principle, Italian companies are free to finance the investments either via debt financing or via equity or through a mixture of both. There are several variables that may drive the final decision including the tax consequences associated to each alternative.

The vast majority of Italian enterprises make systematic use of third party debt financing. Most of these resources are lent by banking institutions. In fact, analysis evidenced that the financial model of most Italian companies is greatly banks dependent. This is particularly true for small/medium size companies.
Analysts put in evidence that the way forward to strengthen the financial model of Italian companies is to encourage a greater capitalization and to replace banks debt with a greater use of other forms of financial instruments.

Some relatively recent law provisions have gone in this direction, namely (i) the Notional Interest Deduction (NID) provision, (ii) allowing more companies to issue financial instruments (bond and subordinate participative loan) and (iii) a less restrictive taxation associated to those types of loan financing.

Definition of terms "equity" and "debt"

Legal perspective

From a purely legal perspective, the distinction between "equity" and "debt" can be found in the fact that the contributing party - upon contribution of equity - becomes a shareholder (with all associated rights and obligations), whilst the lending party – upon granting of financial means to the borrowing company – only acquires the role of creditor, but is not in principle vested with rights usually reserved to a shareholder.

According to the 2003 reform of Italian company law (i.e. Legislative Decree 6/2013), Italian companies are now entitled to issue a wide range of financial instruments that impacts such a traditional distinction.

From a broader perspective, therefore, the significant innovation introduced by the reform was the creation of an entire category of financial instruments which stand between shares and bonds.

A key consideration regarding hybrid instruments – such as those under Article 2411(3) and Article 2346(6) Italian Civil Code (ICC) – is the fact that although the subscriber can exercise economic rights (which means that the relevant holder is granted with a remuneration for having subscribed relevant hybrid instruments) and also has limited administrative powers [such as: (i) an option right in case of issuance of new hybrid instruments and (ii) the right to vote on specific matters, being expressly excluded a right to vote in the general shareholders' meeting], the instruments never involve a share in the equity of the company. In fact, central to their identification is that the new hybrid instruments never give a subscriber the status of shareholder in the issuer.

Moreover, non-listed companies (other than banks and micro enterprises) have been recently entitled to issue subordinate participative bonds (Law decree N.83/2012).

Tax perspective

The classification of financial instruments as debt or equity for tax purposes is provided by art 44 of the Income Tax Code (ITC), which provides for a definition of the securities that are to be considered "similar to shares" and for a definition of securities that are to be considered "similar to bonds".

Securities similar to shares

Article 44(2)(a) of the ITC defines as "similar to shares" the securities and financial instruments issued by corporations, other business entities and all nonresident entities, whose remuneration is entirely made up by a participation to the economic results of the issuer, of other companies in the same group, or of the single deal relating to which the securities and financial instruments were issued. Participation in the capital or equity, as well as securities and financial instruments mentioned in the preceding sentence, issued by non-resident entities are considered similar to shares on condition that the related remuneration is fully nondeductible for the non-resident issuer in determining the taxable income in the foreign country of residence.

Securities similar to bonds

On the other hand, article 44(2)(c)(2) of the ITC defines as "similar to bonds" mass securities containing the unconditional obligation to pay, at maturity, a sum corresponding to not less than the nominal value indicated in them, with or without the payment of a periodic remuneration, which do not confer upon the holder any direct or indirect management rights relating to the issuer or the deal relating to which the security was issued, and do not give any control over the management itself.

In short, the definition of securities similar to bonds is defined by a double negative requirement:

- the absence of contractual risk of loss (as the principal must be always repaid); and
- the absence of control powers.

Borderline areas

The system is not a black-or-white one. As a result, there can be (a) situations in which a security may qualify as similar to both shares and bonds and (b) situations in which a security qualifies as similar to neither shares nor bonds.

Under the first scenario, a security could be built with both (i) the requirements to be considered "similar to shares" (remuneration entirely linked to the economic results of the company) and (ii) those to be considered "similar to bonds" (no risk of loss and no control powers). In such a case, the assimilation to a share prevails.

Under the second scenario, there may be securities which pass neither the test to be defined as (i) "similar to shares" nor that to be defined as (ii) "similar to bonds". Until 2016, this implied that the holder could not treat the remuneration according to the dividend exemption regime and the issuer could not deduct the portion of the hybrid security linked to the economic result of the company. Following a recent amendment, the holder is now allowed to apply the dividend exemption regime, inasmuch as the remuneration of the hybrid security is not deductible in the hands of the issuer. An example of these hybrid securities could be reverse convertibles and mandatory convertible bonds.

Equity Financing

Contribution of equity

Stamp duty or similar taxes

No material tax is due on capital increase: only 200 € registration tax applies to equity contributions.

Legal constraints (e.g., limits to transfer cash inbound, timing, formal requirements, etc.)

In general terms, a company can be equity financed either through new capital injections or through conversion of existing equity reserves, including those composed of retained earnings. Capital can be increased also by means of contribution in kind of assets.

Under Article 2342 and Article 2464 of the ICC, contribution into equity has to be done in cash if the incorporation deed of the company does not provide differently. The minimum capital amount requested by the ICC is respectively Euro 50,000 for a Joint Stock Company (Società per Azioni) and Euro 10,000 for a Limited Liability Company (Società a Responsabilità Limitata), even though it is also possible to incorporate a Società a Responsabilità Limitata with a corporate capital lower than Euro 10,000, being it understood that in such case the company shall comply with certain requirements provided for by the law. Increase of the share capital has usually to be resolved by either the extraordinary shareholders'/quotaholders' meeting, to be held before the Notary Public and whose minutes shall be then filed with the competent Register of Companies. Within certain limits, also the board of directors can be delegated with the power to implement a previously resolved increase of the corporate capital.

Other forms of financing

Apart from capital increase, the grant from the shareholders/quotaholders is one of the most commonly-used means through which a company may increase its financial capability. Unlike loans, grants do not bear interest and are not usually reimbursed as long as the company exists.

Grants can be essentially divided into 3 main categories, depending on the specific reasons for which the same are made:

i. non-repayable grants (versamenti a fondo perduto);

ii. grants on capital account (versamenti in conto capitale);

iii. grants for future capital increase (versamenti in conto futuro aumento di capitale).

Non repayable grants (versamenti a fondo perduto) and grants on capital account (versamenti in conto capitale) are made on a voluntary basis by one or more shareholders (not necessarily in proportion to their respective shareholding and without altering the percentage of shareholding of the granting party) with the specific purpose of increasing the financial capability of the company.

Grants for future capital increase (versamenti in conto futuro aumento di capitale) are explicitly destined to increase the corporate capital within the agreed time period. Should this condition not be met, then the company has the obligation to reimburse to the lending shareholders the grants.

For tax purposes, the cash contribution into new capital is considered as increasing the base cost of the shareholders' participation.

Payments on equity

Withholding taxes

General remarks

This paragraph addresses the taxation of payments on equity, distinguishing if the recipient is individual or corporate and – in the latter case – if it is resident or not resident in Italy.

The notion of payments on equity is not limited to dividends distributed as such.

As a general rule, capital reserves distributed as such are not taxable as dividends: they reduce the base cost of the shares and only once such base cost is zeroed also for tax purposes, is the excess taxable (as dividend outside business income, or as a capital gain within a business income framework). However, there is a presumption under which, irrespective of the shareholders' meeting resolution, any profit reserves (available for distribution) are deemed to be distributed before capital reserves.

Capital distributions work likewise: ordinarily they are not taxable as dividends, but reduce the base cost (also for tax purposes) of the shares; however, to the extent profit reserves were previously imputed to capital, these take precedence in any distribution, which is correspondingly taxable as dividend.

Liquidation and redemption proceeds are always taxable (generally as dividend outside business income, or as a capital gain or dividend within a business income framework, depending from the nature of the items distributed): the taxable base is the amount exceeding the tax base cost of the participation. When a WHT is provided for, the taxpayer must provide the WHT agent with the base cost for tax purposes: otherwise this latter may apply the WHT on the gross amount.

In the event of a distribution in kind, capital gains tax may be triggered for the company paying the dividend, for the difference between the fair market value of the goods distributed and their base cost for tax purposes.

Dividend taxation for resident individual shareholders

The dividends derived by individual shareholders are subject to the individual progressive income tax (43% top rate plus 3% surcharge) and the relevant tax treatment depends on whether or not the relevant participation is held in a business capacity. In essence:

- Dividends received by individual shareholders in a business capacity are partially (50.28%) exempt from tax; the remaining portion (49.72%) is included in the taxable income subject to the progressive rates of personal income tax (IRPEF); assuming an individual top marginal rate of 43%, this means an effective tax rate of 21-22%.

- The taxation of individual shareholders not holding the participation in a business capacity depends on whether or not some qualification thresholds are exceeded. A participation is considered qualifying if exceeding 2% of voting rights in the ordinary shareholders' meeting or 5% of capital in a listed company; for unlisted companies, the percentages are 20% of voting rights in the ordinary shareholders' meeting or 25% of capital. A participation is considered non-qualifying if not exceeding either of the above thresholds.

  - Dividends received by individual shareholders (no business) from a qualifying participation are taxed like those received in a business capacity.
  - Dividends received by individual shareholders (no business) from a non-qualifying participation are subject to a final withholding tax at a rate of 26%; there is no tax return filing requirement.

In both cases, dividends derived from participations in tax haven companies (other than those from a non-qualifying participation in a listed company, which are still taxable at 26%) are fully included in the taxable income for individual income tax purposes and taxable at progressive rates unless a ruling is granted, accepting that the participation does not result in sheltering the profits in a tax haven.

Dividend taxation for resident corporate shareholders

Dividends derived by resident companies from other resident companies are exempt from the 27.5% corporate income tax (*IRES*) for 95% of their amount; effective tax rate is 27,5% * 5% = 1,375% as long as some requirements are met. According to the 2016 Budget Law, the corporate tax rate will be decreased to 24% from 2017, thus the effective tax rate will be 24% * 5% = 1,2%.

Dividends derived by resident companies from non-resident companies are subject to the same tax treatment, provided that (i) the dividends are not deductible on the distributing company's side and (ii) the distributing company is not resident in a tax haven.

Dividends derived – directly or indirectly – from participations in tax haven companies are fully taxable at the 27,5% (24% from 2017) corporate income tax rate. However, this does not apply if a ruling is granted, accepting that the participation does not result in sheltering the profits in a tax haven.

A special tax regime applies to shares and similar financial instruments held by companies preparing their financial statements according to the IAS or the IFRS and accounting for the shares as "held for trading". In this case, dividends are fully taxed and realized and unrealized gains and losses resulting from the mark-to-market valuation of the shares are fully relevant for IRES purposes.

Dividends received by commercial and manufacturing enterprises are not subject to local trade tax (IRAP). Different rules apply to banks and financial companies.

Nonresidents: domestic law
26% dividend WHT applies to dividends paid to all nonresidents (irrespective of whether or not they exceed the qualification threshold).

As an alternative to other reductions (i.e. treaty or EU regimes), a refund of foreign taxes (if any) is granted to the nonresident shareholder, up to 11/26 of the WHT (i.e. up to a maximum of 11%).

Nonresidents: primary EU regime, the 1.375% rate
A special rate is provided for companies in the EU and white-listed EEA Countries (i.e. Norway and Iceland): these companies are entitled to a 1.375% dividend WHT rate. The 2016 Budget Law lowers this rate to 1,2%, taking effect from 2017.

The requirements are pretty much the same as those to the Parent-Subsidiary Directive regime, but there is (i) no minimum participation threshold and (ii) no minimum holding period. There is no specific anti-abuse rule, but circular letters held that the European Court of Justice "wholly artificial arrangement" standard applies.

Nonresidents: secondary EU regime, the Parent-Subsidiary Directive
Dividends paid to an EU company may benefit from the EU Parent–Subsidiary Directive: they are not subject to any WHT in Italy if the EU parent company receiving the dividends from its Italian subsidiary (both having one of the legal forms listed by the Parent–Subsidiary Directive) has held, without interruption, for at least one year, a participation representing at least 10 per cent of the capital of the subsidiary (provided that the residence country does not allow for any special regime exempting the subsidiary from corporate tax).

There used to be a specific anti-abuse rule, which reversed the burden of proof: the directive could apply also if the EU parent (of the Italian subsidiary) was controlled, directly or indirectly, from a non-EU company, as long as the taxpayer proved to the tax administration that the structure was not merely a way to benefit from the directive with no economic substance whatsoever.

In order to cope with the common de minimis general anti-abuse rule in the revised PSD, the above-mentioned specific anti-abuse rule was repealed and reference is now made to the Italian GAAR (general anti-avoidance rule). As a result of this recent amendment, the burden of proof should now be with the Tax Authority, rather than reversed on the taxpayer.

Nonresidents: double tax treaties
When the EU Parent-Subsidiary Directive's requirements are not met, and for payments destined to entities resident in non-EU countries, the network of 80+ Double Tax Conventions(DTCs) which Italy has in force comes into play. Where the income is classified as dividend income, the WHT levied may vary from 5% to 15% depending from the applicable DTC.

The application of the minimum WHT rate provided for in the treaties is generally subject to the condition that the recipient is the beneficial owner of the income.

(Fictitious) deductions on equity (INE, NID, similar considerations)

From tax year 2011, resident companies and Italian branches of non-resident companies are entitled to benefit from Notional Interest Deduction ("NID"), i.e. a deduction from their corporate income tax base computed as a percentage of "new equity" generated after 2010. The deduction is equal to the notional yield of qualifying equity increase (net of qualifying decrease) which must be realized in comparison to the equity resulting from the balance sheet as of 31 December 2010. The qualifying increase must derive from cash contributions or from undistributed profits destined to reserves (except for the sum set aside as non-available reserves).

The notional yield rate was fixed at 3% for FY 2011 though FY 2013; the rate was: (i) 4% for the 2014 fiscal year, (ii) 4,5% for the 2015 fiscal year and (iii) 4,75% for the 2016 fiscal year. From 2017 onwards, a Ministry of Finance decree will establish the notional yield rate on a yearly basis, based on the remuneration of Government bonds plus a premium risk. Companies listed on an EU - or EEA - regulated stock exchange market after June 25, 2014 may increase their new equity qualifying for NID by 40% in the first three tax years after first being so listed.

In the relevant tax year the contribution in cash is computed from the date on which it is made.

The amount of notional yield exceeding the net taxable income of the relevant fiscal year may be carried forward and used to offset the net taxable income of a following fiscal year or to be offset against IRAP liabilities according to certain mechanics.

The regulation includes an anti-avoidance provision that reduces the new equity after transactions that may create an undue duplication (or multiplication) of qualifying equity. In this context, there are specific transactions, listed by NID Law, which entail an a priori reduction in the new equity.

Anti avoidance instructions have been provided for also by the Revenue Agency; essentially the guidelines require to apply a "look through" approach in case of capital contribution coming from nonresident shareholders to see if there are either ultimate Italian resident contributor(s) that could benefit from the NID (thus creating a duplication of the benefit) or contributors resident in black listed countries. In such cases the capital contribution would affect the benefit associated to the NID allowance.

Though no longer mandatory, a tax ruling can be filed in order to disregard this anti-avoidance provision.

Legal constraints (e.g., limits to transfer of cash outbound, timing, formal requirements, etc.)

From a legal perspective, payments out of equity can be represented by either the distribution of profits or by the redemption of prior contributions made by shareholders / quotaholders. The reimbursement of contributions is examined under following Paragraph 3 (Reduction of Equity).

The distribution of profits (or of dividends according to an alternative terminology) has to be resolved by the shareholders' / quotaholders' meeting (upon proposal of the board of directors). Distribution of the annual results is ordinarily resolved when approving the yearly financial statements.

Dividends cannot be paid unless from profits effectively attained and resulting from the duly approved financial statements and, moreover, in the event that a loss affecting the corporate capital occurred, dividends may not be distributed until the corporate capital is restored or reduced accordingly.

Distribution of interim dividends is allowed to those companies whose financial statements shall – pursuant to law – be audited (and have obtained a positive assessment by the auditor(s)) and whose by-laws permits the payment of interim dividends. If dividend is not cashed by a shareholder / quotaholder, the corresponding credit right is subject to a 5-year statute of limitation.

Reduction of equity

Stamp duty or similar taxes

A 200 € fixed amount registration tax applies to reductions of the statutory equity paid in cash.

Withholding taxes

General remarks
As a general rule, capital reserves distributed as such are not taxable as dividends: they reduce the base cost of the shares and only once such base cost is zeroed, is the excess taxable (as dividend outside business income, or as a capital gain within a business income framework). However, there is a presumption under which, irrespective of the shareholders' meeting resolution, any profit reserves (available for distribution) are deemed to be distributed before capital reserves.

Capital distributions work likewise: ordinarily they are not taxable as dividends, but reduce the base cost of the shares; however, to the extent profit reserves were previously imputed to capital, these take precedence in any distribution, which is correspondingly taxable as dividend.

Liquidation and redemption proceeds are always taxable (generally as dividend outside business income, or as a capital gain or dividend within a business income framework depending from the nature of the items distributed): the taxable base is the amount exceeding the base cost of the participation. When a WHT is provided for, the taxpayer must provide the WHT agent with the base cost: otherwise this latter may apply the WHT on the gross amount.

In the event of a distribution in kind, capital gains tax may be triggered for the company reducing the equity, for the difference between the fair market value of the goods distributed and their base cost.

For dividends taxation, reference is made to the "payments on equity" paragraph.

In the following, an outline is provided for the taxation of capital gains.

Capital gains taxation for resident individual shareholders
Capital gains derived by individual shareholders are subject to the progressive individual income tax (43% top rate plus 3% surcharge) and the tax treatment of capital gains depends on whether or not the relevant participation is held in a business capacity.

- Provided the "participation exemption" requirements are met (see below for corporations), capital gains derived by individual shareholders in a business capacity are partially (50,28%) exempt from tax with the remaining portion (49.72%) included in the taxable income subject to the progressive rates of IRPEF; assuming a top marginal rate of 43%, this is tantamount to an effective tax rate of 21-22%.

- The taxation of individual shareholders not holding the participation in a business capacity depends on whether or not qualification thresholds are exceeded. A participation is considered qualifying if exceeding 2% of voting rights in the ordinary shareholders' meeting or 5% of capital in a listed company; for unlisted companies, the percentages are 20% of voting rights in the ordinary shareholders' meeting or 25% of capital. A participation is considered non-qualifying if not exceeding either of the above thresholds.

- Capital gains derived by individual shareholders (no business) from a qualifying participation are taxed like those received in a business capacity.
- Capital gains derived by individual shareholders (no business) from a non- qualifying participation are subject to a 26% substitute tax; this substitute tax can be administered (i) by way of tax return, or (ii) by intermediaries administering the securities, or (iii) by intermediaries managing the portfolio.

In both cases, capital gains on participations in companies resident in tax haven countries (other than those deriving from the disposal of a non- qualifying participation in a listed company) are fully included in the taxable income for individual income tax purposes and taxable at progressive rates unless a ruling is granted accepting that the participation does not result in sheltering the profits in a tax haven.

Capital gains taxation for resident corporate shareholders
Capital gains on shares are 95% exempt from the 27.5% corporate income tax, leading to a 1.375% effective tax rate (1,2% from 2017 when the corporate income tax rate will be set at 24%), provided that (so called "participation exemption" requirements):

- the participation is held for at least 12 months (actually, first day of the 12th month period before the date of alienation);
- the participation is classified as a financial fixed asset in the first balance sheet after acquisition;
- the subsidiary is not resident in a tax haven and
- the subsidiary is engaged in active business preceding alienation (real estate management does not fulfill this requirement).

Although capital gains are taxable for 5%, capital losses are fully (100%) non-deductible.

Capital gains derived by commercial and manufacturing enterprises are not subject to local tax IRAP. Different rules apply to banks and financial companies.

Nonresidents: domestic law
Nonresidents are taxable in Italy on capital gains derived from the sale of companies resident in Italy. Their taxation depends on whether or not qualification thresholds are exceeded and it is equal to a 13,67% effective tax rate (i.e. the corporate income tax rate of 27,5% applied to the taxable portion of the capital gain equal to 49,72) in case of capital gains deriving from the disposal of a qualifying participation and to a 26% tax rate in case of the disposal of a not-qualifying participation.

Nonresidents are not taxable in Italy on capital gains derived from the sale of a non-qualifying participation in a listed Italian company. White-listed nonresidents are not taxable in Italy on capital gains derived from the sale of a non-qualifying participation in any Italian company (whether listed or not). The "white list" is a list of Countries providing a suitable exchange of information with the Italian Tax Authorities. The current white list can be found at this link: http://www.agenziaentrate.gov.it/wps/content/Nsilib/Nsi/Documentazione/Fiscalita+internazionale/White+list+e+Autocertificazione/Elenco

Nonresidents: Double Tax Conventions
Most Double Tax Conventions concluded by Italy provide that capital gains on shares are only taxable in the State of residence of the seller.

However, some treaties contain a "real estate company provision". Under this provision, the State where real estate is situated retains its taxing rights, even when such real estate is held by a company, whose shares are later sold.

Moreover, a few treaties contain a "substantial shareholding provision". Under this provision, a capital gain is taxable also in the State where the company sold is resident, whenever the seller exceeded a certain participation threshold.

Legal constraints (e.g., limits to transfer of cash outbound, timing, formal requirements, etc.)

From an Italian corporate law perspective, the reduction of the corporate capital can either be "real" or "nominal", depending as to whether or not the reduction is undertaken by means of returning capital to the shareholders/quotaholders (in proportion to their respective contributions).

Capital reductions require a shareholders' resolution before the Notary Public, which amends the By-Laws. As a general rule, corporate capital cannot be reduced below the legal minimum. The discipline applicable to the "real" reduction of corporate capital is rather strict, as this reduction implies a return of capital to the shareholders / quotaholders (or a release from the obligation to make the payment still due); as such it may be detrimental of both minority shareholders and creditors of the company. For this reason and before being effective, creditors have a 90-day period to challenge the capital decrease before Courts. The "nominal" reduction of the capital might happen in case of operating losses incurred by the company. The discipline is slightly different,

[1] Without seeking completeness, it is worth noting that such limits can be derogated when debentures in excess are destined to professional investors or when debentures are secured by a first degree mortgage on real estate property owned by the issuing company.

depending on whether losses have affected minimum required corporate capital (need to restore the corporate capital above the minimum, or to resolve the conversion of the company) or not (in this case, losses can be carried forward to the next financial year. If by then losses are not reduced, then corporate capital shall be reduced accordingly).

Debt Financing

Granting of debt

Stamp duty or similar taxes

Financing transactions (e.g. loans) may fall within the scope of VAT, although exempted. If not subject to VAT (e.g. because the lender is not a VAT subject) they are subject to registration tax at 3%, unless they are executed by exchange of correspondence, which is one of the means to conclude a legal contract, requiring less formalities (e.g. registration). In case guarantees are provided, these may trigger additional registration taxes, as well as mortgage / cadastral taxes if real estate is involved.

However, medium/long term loans (defined as exceeding 18 months) granted from banks, may benefit of the application of an optional substitute tax generally levied at 0.25% rate of the total amount of the loan requested, instead of the levying of stamp duty, government license tax and registration, mortgage and cadastral taxes.

Legal constraints (e.g., limits to transfer of cash inbound, timing, formal requirements, etc.)

Amongst the multiple forms of debt financing, we can list the following.

Shareholder Loans

In this case it's worth to notice that there is a specific regime (Articles 2497quindquies and 2467 ICC) under which the reimbursement of the loan made by a shareholder / quotaholder is subordinated to the payment of other creditors of the borrower, and if the reimbursement took place in the year preceding the declaration of bankruptcy, it must be returned. Such discipline is specifically set for S.r.l.; common opinion is that the same shall apply mutatis mutandis to S.p.A also.

Third party Loans

The so called ordinary banking loan is by far the most commonly used third party form of medium and long-term financing granted by financial institutions. It can be secured by either pledges or mortgages over the assets of the borrowing party, or by personal guarantees. If the loan is secured by a mortgage, usually the mortgage value is much higher to secure also the reimbursement of interest in addition to principal.

Debentures / Bonds (Obbligazioni) and other forms of financial instruments

The resolution to issue debentures is usually taken by the directors before the notary public.

Under Article 2412 ICC, debentures (whether bearer or registered debentures) can be issued for an amount not exceeding, in total, twice the amount of the corporate capital, the legal reserve and other available reserves resulting from the last approved financial statements. Such compliance shall be certified by the statutory auditors[1]. Under the Law no. 134 of August 7, 2012, the above limitation doesn't apply to bonds to be listed in a regulated market or in a multilateral trading system, or if the bonds give the right to acquire or subscribe shares. These rules also apply to all those financial instruments, however named, whose return is linked to the economic results of the issuing company.

Debentures / Bonds convertible into shares (Obbligazioni convertibili in azioni)

Convertible debentures are ruled by Article 2420-bis, ICC and allowed to companies having the corporate capital fully paid in. The issuance of convertible debentures/ bonds is reserved to the extraordinary shareholders' meeting, which shall resolve about terms and conditions for the conversion as well as about the increase of the corporate capital requested to serve the conversion. Prior to the conversion of the bonds into shares the company is prohibited from resolving upon a reduction of the corporate capital, a merger or a de-merger or an amendment to the By-laws altering the rules regarding distribution of profits; such limitations have been set forth in order to protect the rights of the holders of convertible debentures from transactions that may modify the value of their rights deriving from the conversion as well as their position as future shareholders. The limitations can be avoided by granting the holders of convertible debentures with the right to anticipate the relevant conversion. Following the reform, also S.r.l. are now permitted to issue debentures/bonds, if so permitted by the By-Laws, provided that these debts instruments shall be underwritten only by supervised professional investors.

Payments on debt

Withholding taxes

Italian companies are subject to corporate income tax at a 27.5% rate (as seen above, will become 24% from 2017) on interest income. Non-financial companies are not subject to local tax (IRAP) on interest income. Banks, financial and insurance companies are subject to local tax on interest income also. Any withholding tax on interest payments to Italian companies is an advance creditable against the corporate income tax liability.

Italian-source interest paid to a non-resident is generally subject to a 26% withholding tax: interest is considered as sourced in Italy whenever paid by an Italian resident. The 26% withholding tax is usually operated and paid by the borrower, in its capacity as the person paying the interest; no WHT applies to interest due on medium and long-term financing granted by EU banks, insurance companies and white-listed institutional investors, provided that no regulatory constraints are breached. A reduced 12.5% rate applies to Government bonds and certain other public debt. As a rule, interest withholding tax applies on a cash basis (upon interest payment). Since an interest deduction is granted on an accrual basis, timing mismatches could ensue in certain circumstances. In order to avoid those, interest on bonds is subject to a withholding tax on an accrual basis (even if the interest is not paid).

A special regime applies to Government bonds, listed bonds, bonds issued by banks and listed companies and to unlisted bonds subscribed by qualified investors. Rather than a withholding tax operated by the interest payer, a substitute tax applies, except for Italian corporate residents, operated by the custodian banks. Non-residents are exempt from this substitute tax, only if they are resident in “white list” Countries (i.e. Countries providing a suitable exchange of information with the Italian Tax Authorities).

Interest paid to an EU corporate entity are WHT-free under the EU Interest and Royalties Directive, provided that (a) the EU company owns directly at least 25 per cent of the voting rights of the Italian company, or vice versa, or (b) a third EU company owns directly at least 25 per cent of the voting rights of both companies (a one-year minimum holding period applies). To benefit from the exemption, among other conditions, the recipient must qualify as the “beneficial owner” of the interest; moreover the recipient must be subject to one of the taxes listed in the Annex to the EU Interest and Royalty Directive and the interest must be fully subject to one of the taxes listed in the Annex to the EU Interest and Royalty Directive in the hands of the recipient.

When the directive requirements are not met, and for payments destined to entities resident in non-EU countries, the network of 80+ Double Tax Conventions (DTCs) which Italy has in force comes into play. Where the income is classified as interest for tax treaty purposes, the maximum WHT rate applicable may vary from 10% to 15% (and the DTC with Argentina 20 per cent) on a case-by-case basis. Few DTCs provide for no WHT.

Deductibility

As a basic rule, Italian companies may deduct interest expenses from the corporate income tax base at a 27.5% rate (24% from the 2017 fiscal year). Non-financial companies may not deduct interest expenses from the local trade tax IRAP. Banks, financial and insurance companies as well as holding companies may deduct accrued interest expenses for both corporate income tax and local trade tax purposes: insurance companies may only deduct 96% interest expenses, while banks and financial companies may deduct 100% from 2017 (until 2016, they also had the 96% cap).

Transfer pricing rules

Interest expenses incurred by Italian resident companies on loans borrowed from non-resident related parties must be set at arm’s length (Article 110(7) of ITC) The arm’s length interest rate is determined on the basis of that which would be agreed upon for a comparable loan entered into between unrelated parties.

EBITDA rule

Italy has adopted an EBITDA earnings stripping rule under which interest expenses (net of interest income) are deductible up to 30 per cent of the EBITDA produced by the company in the same fiscal year.

The system applies to most categories of corporate income taxpayers, except few business categories, but not to partnerships, for which a different system has been crafted. Subjective exclusions are provided, for instance, for banks, insurance and other financial institutions (insurance companies have a flat 4% non-deductible interest expenses, banks have no limitation from 2017, while until 2016 they also had the 4% non-deductible).

The adjusted EBITDA is represented by the difference between the value of production and production costs – increased not only by the annual amount of depreciation/ amortization, but also by the annual amount of capital/financial lease expense – without accounting for financing costs, passive income (e.g. dividends, interest), capital gains and losses, taxes; as an exception, dividends cashed from foreign subsidiaries are taken into account. The amount of (adjusted) financing costs exceeding 30% of the EBITDA is not deductible from the taxable income of the relevant fiscal year. Unrelieved financing costs may be carried forward to a subsequent fiscal year, without any time limitation. In each of the following fiscal years the same EBITDA threshold will apply and so relief will only be granted to an overall amount of financing costs (including those carried forward from previous fiscal years) not exceeding 30% of the EBITDA.

Also excess EBITDA capacity (i.e. the difference between 30 percent of the EBITDA and the financing costs deducted from taxable income) is available for carry-forward to increase EBITDA capacity in a following fiscal year. Excess financing costs are transferred following a merger or a division: some of the anti-avoidance regulations applicable to the transfer of tax losses under mergers or divisions also apply to excess financing costs carried forward.

Excess EBITDA capacity of a company may be offset against post-consolidation excess financing costs of another company (in case of group relief).

Participative subordinated bonds (hybrid securities)
As an exception to general tax rules, the floating return of participative subordinated bonds is deductible from the taxable income of the issuer, according to the ordinary 30% of EBITDA rule, if the following conditions are met:

1. the rate of return is not exclusively a floating rate (there is a fixed component);
2. the issue includes a subordination clause;
3. the issue stipulates the impossibility to reduce the equity, except for dividends;
4. the bonds have been purchased by qualified investors;
5. the qualified investors do not detain, also through fiduciary companies or through third parties, more than 2% of the capital or of the net equity of the issuer;
6. the beneficial owner of the income is resident in Italy or in a State providing an adequate information exchange.
7. the issue has an initial duration of at least 36 months.
8. the issuer is not listed and it is neither a bank nor a micro-enterprise (i.e., an enterprise with less than 10 employees and a turnover below EUR 2 million).

In substance, the provision allows the issuer to deduct from its taxable income also the return linked to the profit of the company.

Legal constraints (e.g., limits to transfer of cash outbound, timing, formal requirements, etc.)
When debt arises out of a loan facility arrangement, the borrowing company shall reimburse the loaned facility in accordance with reimbursement terms. As said before, unless differently agreed between the lending party and the borrower, the loan is deemed to be an interest-bearing loan. Parties are anyhow free to decide that no interest will accrue on the loan amount.

Reduction of debt

Stamp duty or similar taxes
As already mentioned, medium/long term loans (more than 18 months) granted from banks may benefit from the optional application of a substitute tax generally levied at a 0.25% rate of the total amount of the loan requested, instead of the levying of stamp duty, government license tax and registration, mortgage and cadastral taxes.

Reduction of debt through the waiver of the receivable by the lender would represent an extraordinary taxable income for the borrower; however, should the waiver be carried out by a shareholder of the borrower, it would be considered taxable income only for the part exceeding its tax base (the cost for acquiring the credit).

Calculation and Matrix for General Decision

Generally, the decision to finance an Italian subsidiary with debt or equity should be taken on a case by case basis, considering the 30% EBITDA interest deduction limitation and the notional interest deduction (NID) incentive. See the following example:

Assumptions	Equity m EUR	Debt m EUR
Equity	2.000	-
Debt	-	2.000
Interest rate	3,50%	3,50%
EBITDA	190	190
Net interest expenses	-	70
Depreciations / amortizations	80	80
Earning before taxes	110	40
Corporate tax rate standard	27,50%	27,50%
Nominal interest deducation on capital increase	4,75%	4,75%
Interest cap set at 30% of the EBITDA	57	57

Italian entity tax computation	Equity m EUR	Debt m EUR
EBITDA	190	190
Depreciations / amortizations	80	80
Net interest expense	-	70
Adjustments due to interest capping rule	**-**	**13**
Nominal interest deduction	95	
Corporate tax base	15	53
Corporate income tax at 27, 50%	4,13	14,58
Net Profit After Tax	105,88	25,43

WHT tax calculation	Equity m EUR	Debt m EUR
OECD Model WHT on dividend		
WHT Rate	5%	5%
WHT	5,29	1,27
OECH Model WHT on interset		
WHT Rate	10%	10%
WHT	-	7
Total WHT	**5,29**	**8,27**

Parent Company Taxation assuming interest is taxed at statutory rate and dividend is fully exempt	Equity m EUR	Debt m EUR
Interest income taxation		
Hypotetical parent company statutory rate	20%	20%
Tax on interest income	-	14
Dividend income taxation		
Hypotetical parent company dividend tax rate	0%	0%
Tax on dividend income	-	-
Creditable WHT (OECD Model ordinary credit method)		
Dividend exempted, no credit	-	-
Interest taxed at statutory rate, full credit	-	7
Total Parent Company Taxation	-	7,00
Total Tax: Italian Entity + WHT + Parent Company	9,42	29,85
Net Cash Flow	100,58	80,15

Malaysia

The following article provides an overview of possible forms of financing in Malaysia.

Firstly, we will discuss the financial environment in Malaysia. The focus is on the requirements under the Companies Act 1965 ("the Act") and outline the tax consequences associated with the forms of financing namely, equity and debt. This article will also discuss briefly redeemable preference shares ("RPS") which is a hybrid between debt and equity. Finally, the tax consequences associated with Islamic financing in Malaysia will be addressed.

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Financing environment in Malaysia

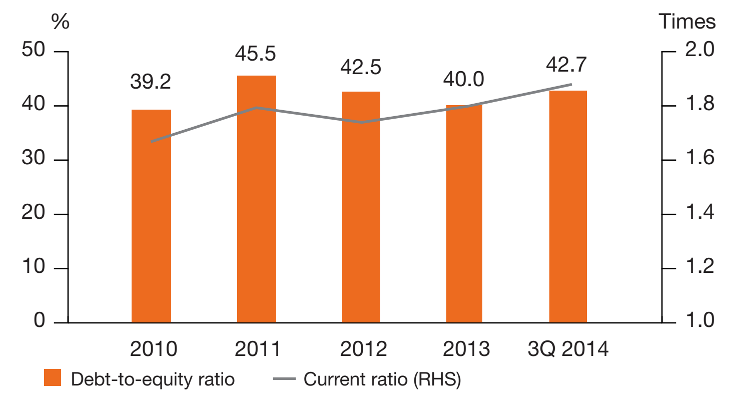
The Malaysian capital market grew across all segments in 2015, with its size expanding 2.1% to RM2.82 trillion, equivalent to 2.5 times the size of the domestic economy.

Malaysia continues to have the largest debt securities market in Southeast Asia, at 104.4% of GDP (2014).

The equity market also performed well in 2014. Overall capitalisation of the Malaysian equity market expanded to RM1.7 trillion, representing an increase of 2.6 per cent from 2013.

Over the recent years, Malaysian corporate funding is more towards equity financing as shown in the table below:

Business Sector: Leverage and Liquidity Indicators



Source: Securities Commission and Bank Negara Malaysia

Definition of equity versus debt

Classification of financing instruments

A financial liability is a contractual obligation to deliver cash or another financial asset or to exchange financial instruments with another entity under conditions that are potentially unfavourable. In contrast, equity is any contract that evidences a residual interest in the entity's assets after deducting all of its liabilities.

A company in Malaysia can be financed by way of equity, debt or RPS which is a hybrid financing form which exhibits elements of both equity and debt.

Under accounting principles, RPS may be treated as debt or equity depending on the features of the RPS as governed under FRS 132.

From a Malaysian tax perspective, RPS is treated as equity in the company. As such, the payment of dividends on RPS is treated in the same way as payment of dividends for ordinary shares.

Equity financing

Contribution of equity

Legal aspects
As from 30 June 2009, the government has liberalised the Foreign Investment Committee ("FIC") guidelines. The FIC guidelines covering the acquisition of equity stakes, mergers and takeovers have been repealed and as such, no equity conditions are imposed on such transactions. Notwithstanding this deregulation, the national interest in terms of strategic sectors will continue to be safeguarded through sector regulators. Companies in specific sectors will continue to be subject to equity conditions as imposed by their respective sector regulator such as the Energy Commission, National Water Services Commission, Malaysian Communications and Multimedia Commission, Ministry of Domestic Trade, Cooperative and Consumerism and others.

Companies Act 1965 ("the Act")
Malaysian companies limited by shares can be private (Sdn Bhd) or public (Bhd). There are two levels of capital, namely authorised capital, being the maximum amount of shares a company may issue and paid up capital, being the actual capital subscribed by shareholders and contribution to the Company. Authorised capital attracts capital duty. In both cases, the minimum authorised and issued capital are RM2 respectively.

For both the private and public companies above, the requirement of issued and paid up capital depends on the working capital needs of a company or the guidelines / licence / incentive that may be applicable to a company. For example, if a company intends to apply for the Principal Hub Incentive, the minimum capital requirement is RM2,500,000.

Public companies seeking for listing on Bursa Malaysia are required to fulfil both quantitative and qualitative criteria.

With respect to the transfer of equity, there are in principle no legal restrictions, save for any restrictions provided in the company's Articles of Association.

In the case of partnerships, in principle no rules exist regarding the raising of capital or capital increases due to the fact that the partners are personally liable to the debts of the partnership. For limited liability partnership ("LLP"), the amount of capital contribution by each partner shall be stated in the LLP agreement.

Tax-related aspects
The issuance of capital via equity does not give rise to income tax consequences.

Payments out of equity

Legal aspects
Companies limited by shares are allowed to make payments out of equity in the form of distributions. The most common form of distribution is by way of dividends. Dividends must be declared out of profits (Section 365 of the Act) and may be an interim or final dividend.

In the case of interim dividend, the Board's recommendation and approval are sufficient. However for a final dividend, the Board recommends the dividend amount for approval by shareholders at the general meeting.

Another common form of distribution is a bonus issue whereby shares are issued to existing shareholders in proportion to their shareholdings. A bonus issue does not involve cash, but merely book entries to capitalize profits or revenue reserves for additional shares in the company. A bonus issue requires approvals from both the Board and shareholders.

The repurchase of its own shares by a public listed company also represents a form of repayment of equity to the shareholders. However, certain conditions need to be met before the repurchase of shares by the company.

Tax-related aspects
Payments out of equity are not tax deductible as it is paid out of profit after tax. There is also no dividend distribution tax in Malaysia. Shareholders are also exempted from income tax on the dividends paid or credited to them.

The thin capitalisation rules have been introduced under the Anti-Avoidance Provisions relating to Transfer Pricing. Currently there are no "safe harbour" rules specified in the legislation.

The implementation of Thin Capitalisation rules have been deferred to post 31 December 2017.

Reduction of equity

Legal aspects
Capital reduction is a reduction of the issued share capital and if it is authorized by the Articles of Association of a company, it may be carried out with approval of a three-fourth's majority of members and sanctioned by the Court.

For a capital reduction, the underlying principle is to preserve and protect the interests of creditors and members of different classes of shares (if applicable) as the assets available for distribution in the event of winding up will be reduced.

Tax-related aspects
There are no tax consequences in connection with a capital reduction.

Additional considerations - redemption of RPS

RPS can only be redeemed out of:

- proceeds of a fresh issue of shares made for purposes of the redemption; or
- out of profits otherwise available for distribution as dividends.

RPS can only be redeemed if it is fully paid up and the redemption is not regarded as a reduction of share capital of the company. Any premium payable on redemption shall be provided for out of profits or share premium account before the shares are redeemed.

Where the RPS are redeemed out of profits available for distribution, a non-distributable 'capital redemption reserve' must be created equal to the nominal amount of shares redeemed.

The capital redemption reserve may be applied for the issue of fully paid bonus shares. The company is required to notify the Registrar of Companies within 14 days of redemption of the RPS.

Debt financing

Issuance of debt

Stamp duty

Stamp duty is chargeable on instruments executed in Malaysia and not on transactions. Loan agreements executed in Malaysia attract stamp duty at the following rates:-

Instrument	Stamp duty rate
RM loan	0.5 per cent
Foreign currency loan	Maximum of RM500
Loan without security for any sum repayment on demand or in single bullet repayment	0.1 per cent

Thin capitalization

The thin capitalisation rules have been introduced under the Anti-Avoidance Provisions relating to Transfer Pricing. Currently there are no "safe harbour" rules specified in the legislation.

The implementation of Thin Capitalisation rules have been deferred to post 31 December 2015.

Payments on debt

Tax-related aspects

Withholding tax

Payment of interest from the Malaysian company to a non-resident lender is subject to Malaysian WHT at the rate of 15 per cent. This rate may be reduced under specific Double Tax Agreements ("DTA").

Deductibility

The general deduction provisions under Section 33(1) of the Income Tax Act 1967 provides that expenses are deductible only if they are incurred in the production of income chargeable to Malaysian tax.

Interest expense is deductible under Section 33(1)(a) if it was incurred on money borrowed and:

- used in the production of gross income (for example, as working capital); or
- laid out on assets used or held for the production of gross income (for example, acquiring fixed assets to be used in generating income).

Where a borrowing is used partly for business purposes and partly non-business purposes, only the interest on the portion used for the business is allowed for deduction against gross business income. The proportion of interest applicable to the non-business operations would be allowed against gross income from the relevant non-business sources. However, interest expense attributable to dividend income (which is tax exempt) does not qualify for deduction and is to be disregarded.

All qualifying interest deduction is to be claimed against the income of the year in which the interest was payable. However, the claim can only be made when the interest is due to be paid.

Transfer pricing

The interest charged on shareholders' loan must be at arm's length. Under the new transfer pricing guidelines, actual transfer pricing documentation is required to be prepared and the Malaysian tax authorities are empowered to disregard or vary non-arm's length transactions between related companies and make adjustments . There must be commercial substance and the charging of expenses should not lead to profit extraction or tax avoidance.

Reduction of debt

Tax-related aspects

The repayment of the principal amount does not have any tax effect on the payer. However, the waiver of a loan may be taxable in the hands of the borrower if the loan is revenue in kind.

Generally, the interest portion waived is taxable to the borrower if a deduction has previously been taken on the interest expense.

Additional considerations - Islamic financing

Apart from the conventional debt financing, Islamic financing is also popular in Malaysia. The Malaysian Islamic financial sector is seen as one of the most progressive and attractive in the world given the numerous incentives planned and the further liberation granted over the years. Islamic finance players in Malaysia comprise institutions such as Islamic banks, Takaful operators, Islamic unit trusts, and Islamic fund management companies.

Tax-related aspects

The Malaysian taxation system caters for Islamic Finance by providing tax neutrality to Islamic transactions.

Under Syariah principles, the concept of "interest" is prohibited. The Malaysian tax legislation provides that all gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Syariah would be treated as interest for tax purposes. Therefore, the taxability or deductibility of "profits" under Islamic finance would be similar to the treatment of "interest" in a conventional financing arrangement. All tax rules relating to "interest", such as interest withholding tax and tax exemptions will equally apply on the "profits". This ensures that Islamic financing is accorded the same tax treatment as conventional financing.

In addition, underlying disposal of the assets/properties required for Islamic transactions will be disregarded for income tax purposes. Therefore, there is no additional tax impact on the sale and leaseback required in Islamic transactions.

Cross border transactions involving non-resident borrowers would be treated in the same manner as conventional borrowings from non-resident borrowers. Islamic "profits" would be seen as interest for Malaysian tax purposes. Generally, due to tax incentives provided to the Bond market and financial services, there is usually no withholding tax when profits or "interest" is paid to non-residents on Malaysian issued Sukuks (bonds) or if paid by a licensed bank in Malaysia.

Switzerland

The funding of an enterprise with either equity or debt is often driven by operational needs of the enterprise. It is an important factor for such enterprise as the form of funding typically has an impact on whether and how investors – who may have specific yield expectations – will take influence on the enterprise's business decisions.

The main forms of business organisation for a Swiss enterprise are governed by the Swiss Civil Code of Obligations ("CO"). In Switzerland, the most common form of organisation is the company limited by shares ("Aktiengesellschaft", "AG"), followed by the limited liability company ("GmbH"), which is over time gaining importance.[1] Both types, the AG and GmbH, are corporate bodies, i.e. entities with their own legal personality and liability to corporate taxes.[2] This is also true for the cooperative ("Genossenschaft"), which however is not a very common legal form and hence not widely used in the Swiss economy.

Other business organisations, such as the simple partnership ("einfache Gesellschaft") or the general/limited partnership ("Kollektivgesellschaft" or "Kommanditgesellschaft") do not provide for their own corporate body.[3] Compared to the AG and GmbH, they are of limited economical significance, as the Swiss forms of simple, general and legal partnerships do always require at least one individual person that is unlimited liable with his personal wealth for any claims raised against the partnership.

As a consequence of the above explained business relevance of the different legal forms, the following considerations will in particular emphasise on the Swiss tax implications of different financing options for Swiss corporates (i.e. mainly on AGs and only where of special interest also on GmbHs).

At the end, a model computation/comparison will demonstrate the positive tax effect of debt financing.

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1 Daniel Schafer, The debt-equity conundrum, Swiss Branch Reporter on the 2012 Boston Congress of the International Fiscal Association, Volume 97b, 715 et seq., in particular 718.

2 Schafer, 718.

3 Schafer, 718.

General investment environment in Switzerland

Switzerland offers a favourable investment and tax environment. It is a peaceful, prosperous and modern market economy with low unemployment, a highly skilled labour force, and – last but not least – it is known for moderate corporate tax rates.

Furthermore, Switzerland provides for an extensive treaty network. The communication with the Cantonal and Swiss Federal Tax Authorities is well established and in particular advance tax rulings can be obtained in a fairly short time frame, providing for the necessary advance certainty on how the applicable tax laws have to be applied on a particular case at hand.

Since the late 90s, Switzerland has continually attempted to strengthen its position in international tax competition, namely by the implementation of the Corporate Tax Reform I ("CTR I") and the Corporate Tax Reform II ("CTR II"). Besides tax reliefs for domestic small and medium-sized enterprises as well as for Swiss resident investors, the CTR II also resulted in considerable tax benefits for multinational groups. This applies namely for the extension of the investment deduction (participation relief, see below section D.II.2.b) and the introduction of the so called capital contribution principle (see below section D.II.2.c). In addition, foreign companies are usually recognised for Swiss tax purposes if they are managed and controlled outside of Switzerland and are not set up purely for the reason of avoiding Swiss taxes. Switzerland is currently in the process to draft its third corporate tax reform package ("CTR III"), which will provide for an attractive OECD conform tax framework. It is further worth noting that the latest draft law package of CTR III includes a notional interest deduction regime (see below section D.II.2.b), in particular footnote 37).

By means of a thorough planning it is generally possible to avoid Swiss withholding tax ("Swiss WHT") and Swiss stamp duty consequences related to the issuance of capital.

Definition of equity versus debt

Legal classification of financing instruments

As is generally known, a company may partly be financed by equity and by debt. Although the diversity is not as strong as in other jurisdictions, Swiss corporate law provides for a valuable amount of financing instruments for businesses.[4]

Switzerland's accounting, legal and fiscal framework adheres to a clear distinction between debt and equity.[5] Shares (whether ordinary or preferred), participation certificates and dividend rights certificates all classify as equity.[6]

All other forms of financing instruments usually qualify as debt under Swiss corporate law.[7] This is also true for hybrid forms of financing, which as such are not known in Swiss corporate (tax) law.[8]

It is further notable that the highest Swiss court rendered in 2014 a decision based on which the company's freely distributable equity was treated as blocked in relation to (up- and cross-stream) intra-group loans that were granted at non at arm's length's conditions and were at the same time not secured.[9]

Classification of financing instruments for tax purposes

As a matter of principle, the qualification of a financing instrument under Swiss tax law generally follows the qualification of the respective instrument under Swiss corporate law.[10] For tax purposes, the main consequence of the qualification of a financing instrument as a debt instrument is the tax deductibility of interest payments.

The principle that the tax qualification of an instrument should be based on Swiss corporate law usually even applies if an equity instrument is subject to strong elements of a debt instrument, which for example, may be the case with respect to preferred shares. As a result, the formal form prevails over the economical form of such instrument.[11]

There are however very few cases where for tax purposes, a debt instrument and consequently also the payments made on the debt instrument are re-qualified as equity instrument, as are shown in the following examples:

- There are tax driven thin capitalisation rules which limit the debt to equity ratio and the interest rate paid on the debt instruments. In case a debt instrument violates these rules, the part in excess of the thin capitalisation rules is re-qualified as equity and dividends respectively. However these rules only apply to intercompany debt. See in this respect below sections E.I.2.c) and E.II.2.c).
- In very rare cases, the tax administration may come to the conclusion that the application of a financing instrument would result in a pure tax avoidance structure and therefore may re-qualify the instrument into equity and the respective interest into a dividend distribution.

4 E.g. (as per their significance) ordinary shares, regular loans, subordinated loans (including mezzanine loans), preference shares and shares with privileged voting rights, participation certificates and dividend rights certificates, participating loans, bonds, convertible bonds/bonds with warrants; cf. Scha-fer, 718.

5 Article 959 and 959a CO.

6 Basle Commentary to the CO Part II 2012 (BSK OR II), Markus Neuhaus/Jörg Blättler, art. 663a CO N 63 et seq.; articles 656 CO et seq.; Schafer, 715.

7 Thomas Meister, Hybride Finanzierungsinstrumente und -vehikel im grenzüberschreitenden Verhältnis, ASA 70, 97 et seq., 114; see also BSK OR II, Markus Neuhaus/Jörg Blättler, art. 663a CO N 13/13a.

8 Schafer, 718. Quasi-hybrid funding structures have been used by domestic and foreign private equity companies (in the form of mere contractual arrangements between the relevant parties). Moreover, in the past years, Swiss banks started to offer different financial products with a quasi-hybrid model (exclusively) to financial/institutional clients.

9 Decision of the Swiss Supreme Court of 16 October 2014 (4A_138/2014), BGE 140 III 533.

10 Schafer, 715.

11 Meister, ASA 70, 114; Schafer, 715.

Hybrid instruments are generally not seen in domestic relationships as the Swiss corporate and tax treatment of a financing instrument is harmonised between the two parties to the instrument.[12]

Contrary to domestic relationships, financing of a Swiss company from abroad may result in definition conflicts with the effect that such an instrument could be treated as debt with corresponding tax deductible interest payments in Switzerland and equity in the funding country that might benefit from a participation exemption.

In future, such international definition conflicts for tax purposes should no longer exist or at least be limited as a result of the Actions on Base Erosion and Profit Shifting by the OECD (Organisation for Economic Co-operation and Development).

In more detail, the report released on 5 October 2015 in relation to Action No. 2 "Neutralising the Effects of Hybrid Mismatch Arrangements" should in future prevent tax payers from using tax driven hybrid financings.

It is however worth noting that the BEPS report does not have an immediate effect to the Swiss domestic tax system.

Equity financing

Based on Swiss corporate and accounting law, equity usually consists of nominal capital, free and general reserves and retained earnings. There are two forms of equity financing: The company is provided with new capital (i) through an increase in the existing contributions from outside or (ii) by the way of self-financing.

Contribution of equity

Legal aspects
For capital companies, the incorporation and an increase in nominal capital is subject to formal requirements (e.g. certification by a notary and entry in the commercial register) and capital maintenance rules. In the case of a GmbH, the minimum capital amounts to CHF 20'000[13] and for a stock corporation (AG) to CHF 100'000.[14]

A contribution exceeding these amounts into the reserves (so called "surplus") is either admissible when issuing new shares or at any time else (i.e. without the issuance of new shares).

Tax-related aspects
Capital contributions into a Swiss AG are generally subject to the Swiss stamp duty of 1% on the issuance of capital.[15] Exceptions may apply upon the foundation or a formal capital increase for the first CHF 1 million of capital[16] or under certain circumstances for a company subject to a recapitalisation[17] or a reorganisation[18]. In addition, an existing non-resident company may generally relocate to Switzerland without incurring Swiss issuance stamp duty. However, if the company was formed abroad and relocated to Switzerland exclusively or mainly in order to avoid Swiss stamp taxes, the issuance stamp tax may apply. Last but not least, according to a court decision of 2009, indirect capital contributions (e.g. granted by the grandparent company to the additionally paid-in capital only, i.e. without issuance of any new shares) are not subject to the Swiss stamp duty of 1% on the issuance of capital.[19] A potential abolition of the stamp tax on the issuance of capital is – still with uncertain outcome – in discussion in the Swiss Parliament.

Capital contributions (e.g. premiums, additionally paid-in capital and contributions into the reserves of a company without increasing the nominal share capital) of the shareholder(s) which were accumulated after 31 December 1996 and meet some further requirements (e.g. specific and timely recordings in the Swiss statutory books and vis-à-vis the tax authority) are deemed 'qualifying capital contribution reserves' for tax purposes. If the specific criteria are met, the capital contribution principle allows

12 Meister, ASA 70, 114; Schafer, 718.

13 Art. 773 CO.

14 Art. 621 CO. The participation rights without nominal capital (the so called „Genussscheine") are only available to related parties (art. 657 para. 1 CO). Generally, participation rights (with/without nominal value) are rarely used by (public) companies and therefore are of minor interest for the following considerations.

15 Art. 5 and 8 of the (Swiss) Stamp Duty Act (SDA).

16 Art. 6 para. 1 letter h SDA.

17 Art. 6 para. 1 letter k and art. 12 SDA.

18 Art. 6 para. 1 letter j SDA.

19 Decision of the Swiss Administrative Court dated 15 April 2009 (A 1592/2006).

the withholding tax-free repayment of the (qualifying) capital contribution reserves (see below section D.II.2.c).

Usually, convertible bonds will become subject to the Swiss stamp duty of 1% on the issuance of capital at the time of their conversion into equity. However, due to a recent amendment, the conversion of Contingent Convertible Bonds (so called CoCo-bonds/"Pflicht¬wandelanleihen") into equity will not trigger Swiss issuance stamp duty on the newly created equity anymore.[20] This relief applies to CoCos according to the Swiss Banking Act only. Other convertible bonds will still trigger Swiss issuance stamp duty if converted into equity.

There are three levels of corporate taxation in Switzerland. There is the Swiss federal income (but not capital) tax based on the Swiss Federal Tax Act. In addition, each of the 26 cantons has its own Cantonal Tax Act, whereupon a cantonal and communal income and capital tax is levied. With the exception of the applicable cantonal and communal tax rates, the Cantonal Tax Acts are widely harmonized. The equity of a Swiss company is subject to annual cantonal and communal capital tax. The applicable capital tax rates vary from canton to canton, respectively from community to community and amount to a range of bet-ween 0.0010% and 0.525% for an ordinarily taxed[21] company[22]. At a federal level, no capital tax is levied.

Payments out of equity

Legal aspects

Capital companies may principally pay out their equity in the form of distributions. Such resolution has to be adopted by the shareholders. Usually, the management/ management board submits an appropriate proposal towards the shareholders.

A distribution is only feasible if freely disposable reserves are available.[23] According to art. 675 para. 2 CO, dividends may only be paid from the disposable profit and from reserves formed for this purpose. Usually, a distribution is based on the previous year-end balance sheet and the retained profit documented therein. An advance distribution of freely disposable reserves is feasible based on a special confirmation/report of the auditor and an extraordinary shareholders' meeting.[24] It should however be noted that current year profits can only be distributed based on a formal year end-closing balance.

In order to maintain the nominal share capital and the minimally required amount of legal reserves[25], other regular disbursements from equity are principally not allowed for Swiss capital companies. It is yet notable that larger Swiss companies may regularly repay part of their nominal capital instead of paying out a dividend.[26]

The acquisition of treasury shares takes place either with the intention to cancel such shares or to hold them in treasury. De facto, the former case also represents a form of repayment of equity to the shareholders as it leads to a reduction of the company's assets. From a corporate law perspective, the repurchase of treasury shares is only admissible, if freely disposable equity is available and the nominal value of the treasury shares amounts at maximum to 10% of the aggregate nominal capital.[27] In special cases, the threshold is 20%, whereas the additional 10% have to be sold or cancelled within two years.[28] The instrument of the purchase of treasury shares can be utilized in many constellations, for example in connection with employee incentive programmes, with larger changes at the shareholder level or as defence measure against tender offers. Until 31 December 2012, treasury shares were to be documented in the assets whilst a special reserve for treasury shares was required on the liabilities side of the balance sheet. As of 1 January 2013, a Swiss accounting revision entered into force, whereupon it is not admissible anymore to report the treasury shares on the asset side of the balance sheet. Rather, the treasury shares are to be documented as a negative item of the equity section. The new accounting law provided for a transition period of two years which has in the meantime lapsed.

[20] Art. 6 para. 1 letter l SDA.

[21] 0.001% cantonal/communal capital tax is also the lowest end for companies subject to a tax privileged status. In this respect and regarding the potential future limitation of tax privileged companies see below footnote 37.

[22] Effective tax rates of the year 2015. The Cantons are allowed to foresee in their tax acts that corporate income tax is creditable against a corporation's capital tax. As of 1 January 2016, the following Cantons have implemented such credit system: Argovie, Appenzell Innerrhoden, Bern, Basel-Land, Geneva, Glarus, Neuchâtel, St. Gallen, Solothurn, Schwyz, Thurgau, and Vaud.

[23] Art. 671 CO. According to art. 671 CO, 5% of the annual profit must be allocated to the general reserve until it equals 20% of the paid-up share capital. Further, if a dividend distribution amounts of more than 5% of the nominal value, another 10% of the profit has to be allocated to the general reserve (this second rule is not applicable for holding companies). To the extent that the general reserve does not exceed an amount equal to 50% of the share capital, the general reserve may only be used for very specific purposes, e.g. for covering losses. Special rules apply for holding companies.

[24] Forstmoser/Zindel/Meyer Bahar, Zulässigkeit der Interimsdividende im schweizerischen Recht, SJZ 2009, pages 205 et seq., 206. No report/confirmation of the auditor is required, if the extraordinary distribution takes place within 6 months of the last close of business.

[25] Art. 671 CO. See also footnote 23 above.

[26] See in this respect below section D.III.2.b).

[27] Art. 659 para. 1 CO.

[28] Art. 659 para 2 CO.

Tax-related aspects

Overview

As a general rule, payments out of equity are not tax deductible. As a consequence, Swiss tax law does typically not grant the right to a deemed interest deduction on equity. An exception applies up to date for Swiss Finance branches (see below cf. E.II.2.e).

Dividend distributions deriving from retained earnings

A dividend distributed by a Swiss company and deriving from retained earnings is principally subject to Swiss withholding tax of 35%. The distributing Swiss company has to declare the Swiss withholding tax towards the Swiss Federal Tax Administration within 30 days from the date of the shareholders' meeting (the declaration has typically to be made with the so called form 103)[29] and has to pay the Swiss withholding tax to the Swiss Federal Tax Administration within 30 days after the dividend became due.[30] In case of a delayed payment of the Swiss withholding tax, late payment interest applies and the regular 3-years-period in order to claim for refund of the Swiss withholding tax may elapse.

Swiss domestic beneficiaries which meet certain standard conditions are usually entitled to full recovery of the Swiss withholding tax. Among domestic group companies it is possible to notify instead of paying the Swiss withholding tax, provided that the beneficiary of the dividend distribution owns at least 20% in the share capital of the payer of the dividend distribution.[31] If the notification procedure applies, the distributing company has not only to file form 103 (see above) but has also to notify the dividend distribution within 30 days of the maturity date of the dividend (so called form 106).[32] The Swiss Supreme Court decided in 2011 that the deadline of 30 days is to be met mandatorily as otherwise, the advantages of the notification procedures are forfeited and late payment interest may apply.[33]

International beneficiaries within a group may be entitled to full or partial recovery of Swiss withholding tax, either based on an applicable double tax treaty or – for beneficiaries that are tax residents in the EU – based on article 15 of the Agreement on the Taxation of Savings Income between the European Union and Switzerland ("Savings Agreement").[34] Under the double tax treaties, the (partial) refund of the Swiss withholding tax regularly requires a minimum ownership in share capital and typically a mini¬mum holding period. Similarly, under article 15 of the Savings Agreement the refund of the Swiss withholding tax regularly requires a minimum holding period of two years and a minimum ownership of 25% in the share capital. For foreign dividend recipients, the refund of the Swiss withholding tax may only be feasible if certain anti-abuse provisions (for example thin-cap rules, substance requirements, etc.) are met.

Similar to distributions from a Swiss subsidiary to its Swiss parent company, a notification procedure may also be applicable in an international context. A precedent for a notification in the international context, is a confirmation by the Swiss Federal Tax Administration that the notification procedure is available (form 823B or 823C). Such confirmation is typically valid for three years. If the notification procedure is in principle available, the distributing company has not only to file form 103 (see above), but has also to notify the dividend distribution within 30 days of the maturity date of the dividend (so called form 108 for international distributions). As already mentioned above, the deadline of 30 days is strictly mandatory also in an international context, as the right to apply for the notification procedure is considered forfeited if the respective deadline is not met.[35]

[29] Art. 4 para. 1 letter b and art. 13 (Swiss) Withholding Tax Act ("WTA"); see also art. 21 para. 1 of the Ordinance to the WTA. Different forms may apply for extraordinary dividend distributions or for legal forms other than the legal form of a company limited by shares.

[30] Art. 12 and art. 16 WTA; see also art. 21 para. 2/3 of the Ordinance to the WTA. If no explicit maturity date of the distribution was defined at the shareholders' meeting, it is assumed that the maturity date is equal to the date of the shareholders' meeting.

[31] Art. 20 WTA in connection with art. 26a of the Ordinance to the WTA.

[32] Art. 20 WTA in connection with art. 26a para. 2 of the Ordinance to the WTA.

[33] Decision of the Swiss Supreme Court dated 19 January 2011, decision number 2C_756/2010.

[34] On 1 July 2005, the Swiss-EU Savings Agreement entered into force, providing – among other measures – for rules similar to those laid down in the EU Parent-Subsidiary Directive (2003/123/EC) and the EU Interest and Royalty Payments Directive (2003/49/EC). Thereafter, cross-border dividends, interest and royalty payments between EU and Swiss companies are, under certain conditions, no longer subject to withholding tax.

[35] See also footnote 33 above.

[36] Art. 69 (Swiss) Federal Tax Act ("FTA"); art. 28 para. 1 of the (Swiss) Federal Tax Harmonization Act ("FTHA").

[37] The various cantonal tax acts do foresee specific tax privileges as for example the "holding privilege" or the "mixed privilege". A qualifying "holding company" is generally exempt from cantonal/communal corporate income tax (with the exception of income from Swiss real estate). Consequently, a holding company is in principle only subject to an effective income tax rate of 7.83% (i.e. effective federal corporate rate) prior to participation relief for qualifying dividends and capital gains. Further, usually a reduced capital tax rate at the cantonal/communal level applies. Companies that only carry out administrative functions in Switzerland (but no real commercial activities) may be eligible for the "mixed company" tax status (note that different names exist in different cantons for the "mixed company" tax status, e.g. "domicile company" tax status). The conditions to qualify as a mixed company vary from canton to canton. For mixed companies, only a modest fraction – this in accordance with the importance of the administrative functions in Switzerland – of foreign sourced income (typically some 10% to 20%) is subject to Swiss corporate income tax. Income from qualifying participations (including dividends, capital gains, and re-evaluation gains) is usually tax exempt, whereas all income from Swiss sources is taxed at ordinary rates. A mixed company may usually benefit from an effective tax rate in the range of 8% to 12%. Further, reduced capital tax rates are usually applicable.
It is mentioned at the end of section D.II.2.b), that as a result of discussions of Switzerland with the EU and the OECD, the above mentioned tax privileges shall in a few years be replaced by other tax relief schemes. In this context, Switzerland is currently in the process to draft its third corporate tax reform package ("CTR III"), which will provide for an attractive OECD conform tax framework. It is further worth noting that the latest draft law package of CTR III includes a notional interest deduction regime. As the draft bill is still debated in the Swiss Parliament, the timing is not yet clear. One can however expect that CTR III will not be implemented before 1 January 2018.

In general, dividend distributions are taxable income at the level of the Swiss beneficiary. But there are also certain mechanisms to reduce the taxation of dividend income from qualified participations. At corporate level, dividends qualifying for participation relief are those from participations representing at least 10% of the share capital or 10% of profits and reserves of another company or those having a market value of at least CHF 1 million.[36] It is notable that there is neither a minimum holding period nor a requirement that the dividend paying subsidiary is liable to income tax in its jurisdiction of residence. Participation relief is not an outright tax exemption, but rather a tax abatement mechanism. It is a percentage deduction from the corporate income tax which is equal to net participation income divided by taxable income. It is commonly also referred to as 'participation deduction' or 'participation exemption'. For Swiss tax resident individuals, holding their shares as private assets, there also exists a relief for dividend income deriving from qualified participations.

The income taxation at the level of a Swiss recipient company depends on how such income is treated in its statutory books. As mentioned beforehand, the tax relief for dividend income from qualified participations may further apply. For Swiss recipient companies subject to the privileged tax status of a 'holding company' or a 'mixed company', the dividend income would usually be exempt from cantonal/communal corporate income taxation[37] and only be subject to Swiss federal income tax of 7.83% (effective tax rate), whereas the above mentioned participation deduction applies for dividends from qualified investments.

Note that as a result of discussions of Switzerland with the EU and the OECD, the tax privileges as mentioned in the paragraph above shall in a few years be replaced by other measures (discussions ongoing in connection with CTR III, see also footnote 37).

At the level of Swiss individual shareholders (holding their shares as private assets), dividend income deriving from retained earnings is subject to income tax; as mentioned above, a relief may apply for qualified interest in such company.

Dividend distributions deriving from capital contribution reserves

In relation with the Corporate Tax Reform II, the capital contribution principle was introduced in Switzerland in 2011.

Based on the applicable legal provisions, capital contribution reserves that were accumulated after 31 December 1996 and meet some further requirements (e.g. specific and timely recordings in the Swiss statutory books and vis-à-vis the tax authority) are deemed 'qualifying capital contribution reserves'. The capital contribution principle generally applies for premiums, additionally paid-in capital and contributions into the reserves of a company without increasing the nominal share capital. Treasury shares may also be allocated to the capital contribution reserves.

If the specific criteria are met, the capital contribution principle allows the withholding tax-free repayment of the (qualifying) capital contribution reserves.[38] Care has been taken that the shareholders' meeting adopting the distribution positively makes reference to the distribution of capital contribution reserves (instead of retained earnings). Note that the Swiss distribution company usually needs to record the distribution out of capital contribution reserves within 30 days of the shareholders' meeting with form 170.

The income taxation at the level of a Swiss recipient company depends on how such income is treated in its statutory books (i.e. as substance dividend usually leading to a depreciation of the value in the subsidiary or as a "regular" dividend on which the relief for dividend income from qualified participations may apply) and on its tax status.[39] Further, the tax relief for dividend income from qualified participations may apply. At the level of Swiss individual shareholders (holding their shares as private assets), dividend income deriving from capital contribution reserves is fully exempt from income tax.[40]

Capital reduction

Legal aspects

At the level of Swiss capital companies, the nominal capital may be reduced for different reasons, for example for investors' reasons, to eliminate an existing adverse balance sheet, for the purpose of reducing share capital by repurchasing own shares for cancellation and for various other reasons.

An ordinary capital reduction is subject to a number of restrictions to protect the creditors.[41] In particular, the nominal capital remaining after the reduction has to be covered by assets, i.e., there is no adverse balance after the capital reduction. A condition for an ordinary capital reduction is a notarised resolution of the shareholders.

Tax-related aspects

Overview

As a matter of principle, a mere reduction in share capital does usually not trigger any tax consequences except for reducing the applicable municipal/cantonal capital tax.

"Distribution" of nominal capital

In Switzerland, larger companies, usually quoted at the stock exchange, frequently use capital reductions as an instrument in order to distribute funds without Swiss tax implications to Swiss tax resident shareholders (similar to a dividend, but principally without Swiss tax implications).

In more detail, such a "distribution", which is technically a repayment of capital, does not trigger any Swiss withholding tax at the level of the Swiss source company. Further, at the level of Swiss individual investors (holding their shares as private assets), income deriving from capital reductions is fully exempt from individual income tax. The income taxation at the level of a Swiss recipient company depends on how such income is treated in its statutory books and on its tax status.[42]

Further, some companies aim at minimizing their equity in order to enhance the rate of return.

Repurchase of own shares for cancellation

As outlined above, Swiss corporate law allows a limited (re-)purchase of own shares if they shall be held in treasury (see also above, section D.II.1). These limitations do not apply if own shares are repurchased for cancellation.

In case a company repurchases own shares for cancellation, Swiss withholding tax is due, on the difference between the sum of nominal value and attributable qualifying capital contribution reserves and the purchase price of the shares. The same applies, if the restrictions or time limits of Swiss corporate law (see above, section D.II.1) are violated for shares that were originally repurchased to hold them in treasury, as the violation of these restrictions/time limitations does have the effect that these shares are deemed cancelled.[43] In this context, it is worth noting that Swiss tax law foresees an ordinary maximum holding period of six years for the usually admissible threshold of treasury shares of 10% of the aggregate nominal value as stipulated under Swiss corporate law.[44] Otherwise, the company that acquired its own shares is liable for Swiss withholding tax as if it had repurchased these shares for cancellation.[45] An extension of time may apply, if the company holds own shares for equity plans or for convertible bonds.

[39] Cantonal Tax Acts do foresee specific tax privileges as for example the "holding privilege" or the "mixed privilege" for cantonal and communal taxes. See in more detail footnote 37 above. As a result of discussions of Switzerland with the EU and the OECD, such tax privileges may in a few years be replaced by other tax relief schemes.

[40] See for Swiss federal tax art. 20 para. 3 FTA and for cantonal/communal tax art. 7b FTHA.

[41] See art. 732 et seq. CO.

[42] Cantonal Tax Acts do foresee specific tax privileges as for example the "holding privilege" or the "mixed privilege" for cantonal and communal taxes. See in more detail footnote 37 above. As a result of discussions of Switzerland with the EU and the OECD, such tax privileges may in a few years be replaced by other tax relief schemes.

[43] Art. 4a WTA.

[44] Art. 4a para. 2 WTA.

[45] Art. 4a WTA.

[46] The former art. 5a SDA – stipulating generally a stamp duty on the issuance of bonds – was cancelled effective 1 March 2012.

[47] Art. 6 para. 1 letter l SDA.

Furthermore, an exemption from above described Swiss withholding tax implications may apply in case of a deemed cancellation of such shares if the treasury shares in question respectively their value were beforehand allocated to the reserves from capital contributions and all relevant criteria are met (see above, section D.II.2.c).

Additional tax-related aspects

Disproportionate contributions of capital can trigger deemed profit distributions and trigger various other tax implications and should therefore be analysed in detail and ruled in advance.

Debt financing

Issuance of debt

Legal aspects

Other than equity, debt fundamentally establishes an obligation for repayment to the creditor. Care has to be taken that the issuance of debt does not create any over-indebtedness under commercial (or insolvency) law at the level of the company.

Under Swiss corporate law, specific minimal-equity-rules apply for Swiss banks and insurances.

Tax-related aspects

Overview

In Switzerland, interest is generally treated as ordinary business expense and is consequently as such tax deductible. There are certain limitations, such as for example arm's length rules for interest rates and thin capitalisation rules.

Taxes on the issuance of bonds

On 1 March 2012, the amendment of the Swiss Banking Act (so called 'too big to fail rules') was enacted. This Act included the abolition of Swiss issuance stamp tax on the issuance of Swiss bonds and money market instruments. Accordingly, the issuance of Swiss bonds and money market instruments is no longer subject to Swiss issuance stamp tax.[46]

As already mentioned above, the conversion of contingent convertible bonds (CoCos) into equity will not trigger Swiss issuance stamp tax on the newly created equity.[47] This relief applies to CoCos according to the Swiss Banking Act only; other convertible bonds will still trigger Swiss issuance stamp tax if converted into equity.

Swiss thin cap rules

Swiss thin capitalisation rules are, in general, only applicable for related parties. The respective circular letter number 6, "Hidden Equity", issued by the Swiss Federal Tax Administration on 6 June 1997 provides for debt-to-equity ratios as safe harbour rules. In general, an asset test is required, based on which at least 30% of the weighted assets should be equity-financed. As an exception thereof, the debt-to-equity ratio is generally fixed at 6:1 for finance companies (safe harbour). It is further worth noting that a company which is not in line with the safe harbour rules can always provide evidence that the applied debt-to-equity ratios are nevertheless arm's length ratios. There are no limitations on debt-financing of Swiss corporations by independent third parties (e.g. banks).

In case of a thin capitalisation, the related party debts may be treated as taxable equity. Interest paid on loans that exceed the relevant debt-to-equity ratios are not tax deductible; further, such interest may be deemed as a hidden distribution and hence be subject to Swiss withholding tax.

In addition, interest paid to affiliated companies is subject to periodically fixed ceilings. The tax deduction of interest in excess of the permitted safe harbour rate may be disallowed and also treated as a hidden distribution subject to Swiss withholding tax (see section E.II.2.c).

On 5 October 2015, the OECD released the report to BEPS Action 4 "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments". Switzerland will thoroughly observe the OECD and international environment in order to assess whether in future, adaptions to the currently existing Swiss thin cap rules (e.g. EBITDA fixed ratio rules) may become necessary.

Interest payments on debt

Legal aspects

Swiss corporate law stipulates that in commercial transactions, interest on loans is due, even if not expressly agreed.[48] Where the interest rate is not specifically stipulated, it is presumed to be the ordinary rate for loans of the same type at the same time and place that the loan was received.[49]

Tax-related aspects

Withholding tax/Stamp duty

Overview

In principle, the granting of credit facilities to a non-bank Swiss borrower does not trigger Swiss stamp duty, and interest payments by a Swiss non-bank borrower are not subject to Swiss withholding tax.

Exceptions are to be considered, in case a credit facility qualifies as a collective funding scheme. A collective funding scheme would be assumed in case of a bond (so called Anleihensobligation), a medium-term note (so called Kassenobligation) under the 10/20 (non-banks) lender rule (see below) or an interest bearing debt/deposit under the 100 (non-banks) lender rule (see below) for purposes of Swiss withholding tax.

The Swiss withholding tax exemption on interest of contingent convertible bonds (CoCos) is restricted to interest on bonds issued by respective bank institutions in the period between 2013 and 2016. A draft bill in order to extend the exemption is currently pending.[50] These bonds must, furthermore, fulfil specific criteria in order to benefit from the Swiss withholding tax exemption.[51] This temporary exemption is to be seen in connection with ongoing political discussions in order to replace the Swiss withholding tax system by a "paying agent system" (in German "Zahlstellenprinzip"), aimed at facilitating the issuance of bonds on the Swiss capital market.

10/20 lender rule

Overview

A bond for Swiss withholding tax purposes is given if a Swiss borrower is granted a credit facility from more than 10 non-bank lenders at identical conditions against the issuance of certificates (the written credit agreement is already considered a certificate) and the entire credit exceeds the amount of CHF 500'000.

A medium-term note for Swiss WHT purposes is given, if a Swiss borrower is granted a credit facility from more than 20 non-bank lenders at varying conditions against the issuance of certificates (note that the written credit agreement is already considered a certificate) and the entire credit exceeds the amount of CHF 500'000.

Based on a regulation which came into force on 1 August 2010, loans between related companies[52] are no longer considered as bonds or medium-term notes under the 10/20 rule. According to the new standards, interest payments on liabilities to group (affiliated) companies, regardless of their terms, their number or their amount, are no longer subject to withholding tax.[53] As a consequence, interest on inter-company debt does not carry withholding tax. Note however, that for tax evasion reasons, these rules are not available where a domestic (Swiss) company provides a guarantee for a non-domestic group company raising funds by means of issuing foreign bonds.

Consequences of the 10/20 Rule

Interest payments by a Swiss borrower under a credit facility that qualifies as a bond or a medium-term note are subject to Swiss withholding tax levied at a rate of 35%.

48 Art. 313 para. 2 CO.

49 Art. 314 para. 2 CO.

50 BBl 2016, 2097 et seq.

51 Art. 5 para. 1 letter g WTA.

52 Group companies in the context of the law are companies whose financial statements are fully consolidated in the group accounts according to recognised accounting standards.

53 Art. 14a of the Ordinance to the WTA. The stamp duty on the issuance of bonds was abolished effective 1 March 2012, see above footnote 46.

Swiss resident lenders are in principle entitled to a full refund of the Swiss withholding tax, if they are the beneficiaries of and have duly declared the interest payments as income. Other lenders are entitled to a refund of the Swiss withholding tax depending on the applicable double tax treaty, if any. No refund is granted to residents of countries with which Switzerland has not concluded a double tax treaty.

In the past, in addition to the Swiss withholding tax on the interest payments, the granting of such a credit facility would have been subject to Swiss stamp duty. However, the stamp duty on the issuance of bonds was abolished effective 1 March 2012.[54]

Due to the limited application of the 10/20 rule to non-related parties, its relevance has significantly dropped. There might nevertheless be cases where these principles have to be observed (e.g. capital-intensive real estate acquisition with several third-party investors).

Qualification as bank

Interest paid on any kind of debt or deposits are subject to Swiss interest withholding tax if a Swiss borrower is granted credit facilities from more than 100 non-bank creditors and the entire credit exceeds the amount of CHF 5'000'000.[55]

The relevance of this test dropped when the threshold of 100 (instead of 10) was introduced in 2011.

Taxation at source for loans secured by mortgage

The (Swiss) Federal Tax Act as well as some of the Cantonal Tax Acts (e.g. the Tax Act of the Canton of Zurich) stipulate that an income taxation at source is levied on the interest to be paid to a foreign lender, if the respective loan is secured by mortgage. Some double tax treaties foresee an elimination or mitigation of these rules.

Deductibility

In general, interest paid by a corporation to a third party is qualified as deductible business expense. Interest paid to related parties (affiliated company or shareholder) has to meet the arm's length test and is subject to limitations (regarding thin capitalisation see section E.I.2.c) above.

With respect to related parties, the Swiss Federal Tax Administration annually publishes safe harbour interest rates to be used on loans denominated in Swiss francs on the one hand and in foreign currencies on the other hand. Related companies may deviate from these safe harbour rates to the extent that they can prove that the used rates are at arm's length. The burden of proof is however high. The cantons usually follow for cantonal and communal taxes these federal guidelines.

[54] See above footnote 46.

[55] Circular letter number 34 "Kundenguthaben" (customer credit balance) of the Swiss Federal Tax Administration dated 26 July 2011.

The safe harbour rules for loans denominated in Swiss francs applicable as of 1 January 2016 are as follows (rates are reviewed and possibly adjusted on an annual basis):

For loans granted to related parties		Minimum interest rate (%)
Financed from equity		¼
Financed from debt (actual costs plus at least):		
On amounts up to CHF 10 million		½
On amounts of more than CHF 10 million		¼
But in all cases at least		¼
Type of loan	**Home construction/ agriculture**	**Industry and business**
Real estate loans:	1	1½
A loan up to the amount generally acceptable for mortgages (i.e. of the market value of the real estate)		
Rest, whereby the following maximum interest rates for debt are applicable:	1¾	2¼
Land, villas, residences, vacation houses, business premises up to 70% of the market value		
Other real estate up to 80% of the market value		
Operational loans up to CHF 1 million:		
Granted to trading and production companies	-	3
Granted to holding and asset management companies	-	2½
Operational loans of more than CHF 1 million:		
Granted to trading and production companies		1
Granted to holding and asset management companies		¾

In addition, special practice rules apply for short-term (usually < 1 year) cash pool deposits and drawings.

The tax deduction of interest in excess of the permitted safe harbour rate may be disallowed and treated as a deemed dividend distribution subject to Swiss withholding tax.

For calculating the amount of the maximum interest permissible from a Swiss tax perspective, any potentially existing hidden equity (under Swiss thin capitalisation rules, see above section E.I.2.c) has to be considered.

Arm's length principle
The Swiss tax law adheres to the arm's length principle. Consequently, a tax commissioner may question a not at arm's length interest rate which may lead to a correction of the taxable income and a related deemed dividend distribution.

Finance branch
Overview
A qualifying Swiss Finance branch may apply for a tax ruling covering the tax treatment of the branch dotation capital. Typically, the foreign head office would provide funds to the Swiss branch for financing group companies. Consequently, the Swiss branch would receive dotation capital that is treated like dotation capital of a Bank with branches within Switzerland. With other words 10/11th of the dotation capital would qualify as interest bearing debt providing for a tax accepted interest deduction.[56]

Due to the interest deduction on such dotation capital qualifying as debt and the status of a mixed company for cantonal and communal tax purposes[57], a Swiss Finance branch can benefit from an effective income tax rate that may be as low as 2 % - 4 %. The branch's dotation capital treated as equity (1/11 of the total branch assets) is considered taxable capital.

56 See in this context also the circular letter dated 9 October 1991 of the Swiss Federal Tax Administration with respect to a Dutch financing company with a Swiss Finance branch. This circular letter is currently still the main base for the Swiss Finance branch practice.

57 See above footnote 35.

Often, mixed companies are subject to a reduced cantonal capital tax rate.

Usually, the taxable income at the head office country (e.g. Luxembourg) is low and limited to income directly allocable to the head office. This obviously requires that the head office country applies the exemption method for branch income (either unilaterally or based on the applicable double taxation treaty with Switzerland).

General requirements
A Swiss branch may qualify as "Swiss Finance Branch" if the following conditions are fulfilled:

- Finance branch must have assets in its balance sheet of at least CHF 100 million
- ¾ of the average balance sheet must be investments in financial activities (e.g. loans) and ¾ of the gross income must be derived from such sources
- Qualifying financial services usually include: granting loans, cash management, factoring, leasing, netting, re-invoicing, centralising of group-wide currency risks etc.
- Loans and advances to Swiss affiliates may not exceed 10% of the total balance sheet
- The Swiss branch must maintain its own branch accounts and records, financial state-ments can be kept in foreign currencies, but must be converted to Swiss Francs for the determination of taxable profit and capital

Ongoing developments
As a result of discussions of Switzerland with the EU and the OECD, the Swiss Finance branch concept as well as the cantonal mixed tax privilege may in a few years be replaced by other measures.[58]

[58] See in more detail, in particular regarding the mixed companies, above footnote 37.

Reduction of debt

Legal aspects
The reduction of debt is usually not subject to specific legal provisions.

Tax-related aspects
In principal, the repayment of debt does not have tax implications.

Example

Debt financing of Swiss operations is from a Swiss tax perspective often advantageous, as at arm's length interest payments are generally tax deductible. Furthermore, debt is usually not considered as taxable equity with respect to the cantonal and communal capital tax. See in this respect in particular sections E.II.2.c) and E.I.2.c) above.

The following example compares equity and debt financing. The computation is based on an ordinarily taxed company with its tax residency in the City of Zurich. Note that as outlined above (at the end of section D.I.2), the overall effective Swiss tax burden may vary from canton to canton and from community to community. Furthermore, the cantonal/communal effective tax rate may be lower in case a cantonal/communal tax privilege applies (currently subject to discussions between Switzerland and the EU/OECD, see footnote 37).

Assumptions	Equity financing m CHF	Debt financing m CHF
Income		
Earnings before taxes	165	143
+ Net interest expense	0	22
+ Depreciations / amortizations	15	15
EBITDA	180	180
Funding		
Equity	10’000	7’000
Debt (intercompany / third parties)	0	3’000
Total	10’000	10’000
Corporate income tax rates 2016 [1]	statutory [2]	effective [2]
for Zurich cantonal / communal tax purposes	18.32%	14.45%
for direct federal tax purposes (in ZH)	8.50%	6.70%
Total	26.82%	21.15%
Corporate capital tax rate 2016 [1], [3]	statutory	
Total for Zurich cantonal / communal tax purposes	0.1718%	

Computation / comparison of total tax liability	Equity financing m CHF	Debt financing m CHF
Corporate income tax		
EBITDA	180	180
Depreciations / amortizations	-15	-15
Net interest expense	n/a	-22
Corporate income tax base (earnings before taxes)	**165**	**143**
Corporate income tax (effective tax rate)	34.90	30.24
Corporate capital tax		
Equity	10’000	7’000
Debt (intercompany / third parties)	0	3’000
Corporate capital tax base	**10’000**	**7’000**
Corporate capital tax	17.18	12.03
Summary of taxes		
Corporate income tax	34.90	30.24
Corporate cantonal / communal capital tax	17.18	12.03
Total	**52.08**	**42.27**

[1] For the above model calculation, the tax rates of the City of Zurich / Canton of Zurich (ZH) were chosen. Please note that the cantonal and commumal income and capital tax rate may vary from canton and also from commune to commune depending on the place of the residency of the company

[2] Please note that in Switzerland, taxes are tax deductible. The statutory tax rate applies to earnings after taxes, where as the effective tax rates report the effective tax rate before taxes.

[3] Please note that annual capital tax is levied on cantonal / communal level only. In several cantons (but not in the Canton of Zurich), income tax can be credited against capital tax.

The Netherlands

Funding of a Dutch company with either equity or debt is a decision often based on business reasons, as the form of funding typically coincides with the influence of the investors in such company. Legal aspects and tax consequences are however of equal importance when deciding the way of financing a company.

This article provides an overview of the financing possibilities in the Netherlands. In the first section, we will elaborate on the general economic aspects as well as the financial environment in the Netherlands. In the subsequent section, the definitions of equity and debt according to Dutch law are examined, whereby both legal and tax aspects are taken into account. Section D and section E consider the specific consequences of each form of financing. The final section of this article provides a comparative calculation of a Dutch company funded with equity versus a company funded with debt.

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Financing environment in the Netherlands

The Netherlands, situated in north-west Europe, functions as strategic gateway to Europe and the Middle East. Approximately 160 million people live within a 300 mile radius of Amsterdam, the capital city of the Netherlands, with a population density three times higher than New York or Tokyo. The Dutch economy is stable and open, with low inflation, relatively low deficits and high labour participation. As such, the Netherlands have a prominent role in world economy: it is the world's 5th largest exporter of goods, the world's 6th largest recipient of foreign investment and the 6th largest foreign investor abroad.

The stable Dutch economy is supported by its superior infrastructure: Europe's largest port (third largest port worldwide) is located in Rotterdam and Amsterdam Airport Schiphol, with its optimal logistics infrastructure, continual supply-chain innovation and the added value of highly qualified team of experts, finds itself firmly in the top five of European Cargo airports.

The above, in combination with the world-class ICT infrastructure, highly developed R&D facilities and highly educated, multilingual workforce whose productivity exceeds that of most other European countries results in the fact that the Netherlands are currently regarded as third out of 138 countries in the Enabling Trade Index and eight-best business climate in the world by the World Economic Forum.

From a tax point of view, the Netherlands is regarded an attractive location for holding, financing and principal activities. The Dutch tax authorities are known for their open and pragmatic approach, while the Netherlands also have an extensive tax treaty network, an established ruling practice, special tax features such as Innovation Box regime (resulting in an effective tax rate of 5 per cent on income from qualifying IP) and a moderate corporate income tax rate of 25 per cent (FY 2014).

The Dutch Agency for Statistics examined the way Dutch companies are financed over the last decades. This study demonstrated that Dutch companies are generally financed in a robust way, whereby debt slightly outweighs the amount of equity in a Dutch company. This conclusion applied both to small companies as well larger companies. Please refer to the table below, that reflects the solvency of Dutch companies in the past three decades.

[2] HR 27 January 1988, BNB 1988, 217 / HR 25 November 2011, V-N 2011, 63.10.

[2] HR 8 September 2006, 42 015, BNB 2007/104.

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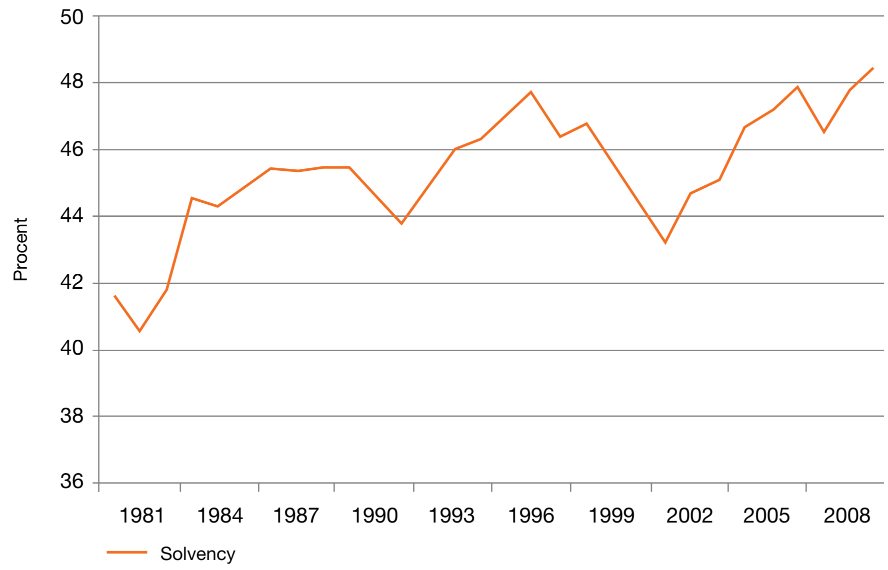

Definition of equity versus debt

Legal classification of financing instruments

Under Dutch civil law (7A:1793 DCC) the main characteristic of a financial instrument qualifying as debt, is whether the debtor has an obligation for repayment. In principle financing instruments qualifying as debt are due to be repaid independent of results, and in case of insolvency of the debtor the creditor has preference over the providers of equity. The Dutch Supreme Court has however identified a few situations of "fake transactions", in which there is no realistic intention or possibility to meet the repayment obligation. In these cases the alleged loan was classified as equity contribution.[1]

Classification of financing instruments for tax purposes

In principle, a Dutch taxpayer is unrestricted in the way it finances its enterprise: this can be either equity or debt.

The starting point for determining whether an instrument qualifies as debt or as equity is the qualification of such instrument for civil law purposes. In the "Caspian Sea" case, the Dutch Supreme Court judged that the essential characteristic of debt is the repayment obligation of the debtor.[2] This means that if the recipient of the funds is not obliged to repay the amount, the financing is, in principle, not considered debt.

There are however three exceptions which result in the requalification of debt to equity. These apply in case of a 'sham transaction', certain hybrid financing loans and 'loss financing loans'. If any of the above exceptions apply, the relevant financing arrangement qualifies as equity for Dutch purposes. Interest paid on a requalified financial instrument qualifies a dividend distribution for Dutch tax purposes and is treated accordingly.

In its February 2014 rulings, the Dutch Supreme Court made clear that in order to determine whether an instrument should be treated as debt (instead of equity) for Dutch corporate income tax purposes, the qualification of such instrument in another jurisdiction is not relevant for the

[3] HR 15 December 1999, BNB 2000/126.

(civil law) qualification of such instrument in the Netherlands. As a result, financial instruments qualifying as equity in a foreign jurisdiction may very well qualify as debt for Dutch tax purposes and vice versa. This used to be important, as the Dutch participation used to apply to all income derived from active subsidiaries, even to payments received on hybrid finance instruments that were deductible in a foreign jurisdiction. Under the new Dutch participation exemption rules applicable as per January 1, 2016, payments that are deductible in the payor's jurisdiction are no longer tax exempt under the Dutch participation exemption.

Based on a decision of the Dutch Supreme Court on 15 December 1999,[3] in exceptional cases a transaction may be qualified for Dutch tax purposes on a stand-alone basis, despite its qualification for Dutch civil law purposes. This exception only applies if the Dutch tax consequences of the civil law qualification of the transaction leads to unacceptable economic results, and this outcome is not in line with the 'rationale' of Dutch tax law.

Equity financing

Contribution of equity

Legal aspects

In the Netherlands enterprises can be organized in various ways, such as a one-person enterprise (eenmanszaak), partnerships with partners bearing full or limited liability (maatschap, VOF, CV) and private or public capital companies (B.V., N.V.).

Contributions to equity can be paid in cash or in kind. In case of capital companies these contributions can be made to formal capital (shares) or informal capital (share premium). Contributions to formal capital are subject to formal requirements (i.e. issue of shares instrumented by public deed signed by a notary and entry in the commercial register) and capital maintenance rules. In case of a private company (B.V.) the minimum capital amounts to the nominal value of at least one share, which is determined in the Articles of Association (can be lower than EUR 0,01). For public companies the minimum capital amounts to EUR 45,000 and needs to be validated by a bank statement (cash contribution) or an auditor statement (contribution in kind). Contributions exceeding the nominal value of the issued shares are registered as share premium (agio).

In case of partnerships, the law does not provide specific regulations on raising capital or capital increases. The Partnership Agreement can however contain all kinds of stipulations regarding capitalization. The partnership becomes the beneficiary of a contribution, but cannot hold legal title, which remains with the partner(s). Despite of the fact that the partnership does not hold legal title to the equity, the equity is separated from the other possessions of the partners, and can be subject to recourse by the partnerships creditors, with preference over private creditors of the partners.

Tax-related aspects

Capital contributions (both formal and informal capital contributions) do not have adverse Dutch corporate income tax consequences, as a capital contribution is not regarded as a taxable event.

In addition, the Netherlands do not levy a stamp duty.

Payments out of equity

Legal aspects

With respect to capital companies, payments out of equity are principally possible in the form of distributions. In general this requires a formal resolution of the shareholders; however, the Articles of Association can delegate this authority to another corporate body (2:216 par. 1 DCC). There is a distinction between repayment of formal share capital (repurchase of shares, cancellation

[4] Reinout De Boer and Frederik Boulogne, "Country Report: the Netherlands" *Taxation of Intercompany Dividends under Tax Treaties and EU Law*, Publisher: Amsterdam: IBFD, Editors: G. Maisto, pp.771-867.

of shares or capital reduction), which are subject to specific formal legal requirements, and distribution out of freely distributable reserves (e.g. retained earnings or share premium). For the purpose of this chapter we will use the term "Distributions" covering all abovementioned distributions.

For private companies Dutch law introduced rules creating a liability for the managing directors and/or the counterparty of the B.V. for Distributions if the position of the B.V.'s creditors is harmed. A resolution of the shareholders to make a Distribution is subject to approval by the management board, based on two criteria: a "balance test" and a "liquidity test".

The balance test is to identify reserves which need to be maintained, based on legislation or Articles of Association (mandatory reserves). These reserves may not be distributed.

The liquidity test is to establish whether the B.V. will remain able to fulfil its due and payable debts after the contemplated Distribution. If the B.V. fails this test, the management board must refuse approval.

If after a Distribution the B.V. is unable to continue payment of its debts, and the managing directors knew or should reasonably have foreseen this at the moment of the Distribution, each individual managing director will be held jointly and severally liable. The liability will be to compensate the B.V. for the shortfall resulting from the Distribution plus interest as of the date of the Distribution.

For public companies a more formal criterion applies. According to the legal provisions for the maintenance of the nominal share capital pursuant to 2:105 DCC a public company can only make distributions to the extent that its equity exceeds the issued and paid up share capital plus the reserves which mandatory need to be maintained, based on legislation or Articles of Association (mandatory reserves). For distribution of interim dividend a recent balance sheet is required. In practice, although the liquidity test is not applicable to the public company, the management board of the public company should make a similar judgment to whether distribution is justified, considering the financial health of the company.

In case of partnerships, there are basically no corresponding restrictions. Here, a disbursement from capital is essentially possible without restriction, unless otherwise agreed in the partnership agreement.

Tax-related aspects

Payments out of equity are not tax deductible at the level of the Dutch company making the payments. In addition, Dutch tax law does not grant deemed interest deductions on equity. For Dutch tax purposes, it is relevant whether or not the payment out of equity qualifies as dividend distribution. Capital reductions that do not qualify as dividend distribution for Dutch dividend withholding tax purposes will be considered in *Reduction of equity*.

To the extent that a Dutch company with a capital divided into shares distributes profits to its shareholder(s), Dutch dividend withholding tax may be levied at a rate of 15 per cent. A taxable profit distribution can be described as follows:

[T]he term "profit distribution" can be defined as a shift of assets [vermogensverschuiving] by the company to its shareholder, as a consequence of which an amount of money or other item of value, covered by profit [reserves] that is [are] part of its assets, is withdrawn from the assets of the company for the benefit of the shareholder.[4]

The above definition covers both formal and deemed dividend distributions by a Dutch company.

At the level of the (Dutch) shareholder receiving the dividends, such distributions are considered part of the (taxable) profit. Two important exceptions apply to this main principle: i) the dividend is paid out of profit reserves that were already present at the time of the acquisition of the shareholding and ii) the dividend is exempt at the level of the shareholder under the Dutch participation exemption.

Partial repayments of paid-in capital, if and to the extent that there are existing and anticipated profit reserves ('zuivere winsten'), also qualify as a taxable dividend. An exception may apply if the general meeting of shareholders has resolved in advance to make the repayment and also decided that the nominal value of the shares involved has been reduced by a corresponding amount by way of an amendment of the articles of association of the company.

Profit distributions made by Dutch cooperatives are in principle not subject to Dutch dividend withholding tax (subject to certain anti-abuse provisions).

Reduction of equity

Legal aspects

In the Netherlands the term capital reduction is in practice used for the decrease of formal share capital of capital companies, which can be executed by reducing the number of issued shares (either (i) through repurchase of shares, followed by cancellation, or (ii) through direct cancellation of shares or (iii) through a devaluation share capital by lowering the nominal value per share). The pre-conditions for and effects of a capital reduction depend on the nature of the reduction. For private companies repurchase of shares is resolved by the management board. The Articles of Association can limit the authority to repurchase shares. Cancellation of shares and decrease of nominal value are shareholder resolutions, subject to management board approval (see *Payments out of equity*).

For public companies specific rules for creditor protection apply. The resolution to decrease share capital must be filed at the commercial register and published in a nationally distributed newspaper. The publication triggers a two month creditor opposition period, in which creditors have the opportunity to object and ask for additional security for their claims.

Tax-related aspects

To the extent that the capital reduction does not relate to existing and anticipated profit re-serves, capital can be repaid tax-neutral (i.e., no dividend withholding tax will be levied).

To the extent that there are existing and anticipated profit reserves, we refer to our comments in *Payments out of equity*.

Debt financing

Issuance of debt

Legal aspects

As described under *Definition of equity versus debt - Legal classification of financing instruments*, for a financial instrument to qualify as debt, it is essential that the debtor has an obligation for repayment. In other words, debt fundamentally establishes an obligation for repayment to the creditor. With regards to this debt financing it is the responsibility of the management board to ensure that no over-indebtedness is incurred, hazarding the financial health and the solvability position of the company.

In the event of granting of shareholder payments/loans which qualify as debt, the management board must be on its guard to treat all creditors equally. Especially if the company's financial position is weak, it is essential to treat all creditors the same way (paritas creditorum). If shareholders are paid to the disadvantage of other creditors, both the shareholder and the management board run the risk of being charged with claims for unlawful acts, and in that respect of being exposed to personal liability.

(Legal) actions by the management board within one year previous of a bankruptcy of the company may be examined to determine whether they deliberately harmed the position of creditors (Pauliana) and may in that event be judged as being null and void.

Tax-related aspects

Issuance of debt should occur at arm's length terms and conditions. If this is the case, such issuance is not subject to Dutch tax.

Exceptions may apply with respect to the issuance of certain debt instruments such as zero coupon bonds. If such bonds are issued for value less than its nominal value, the difference between such value and the nominal value is subject to Dutch corporate income tax.

Payments on debt

Legal aspects

In relation to the payment of interest on shareholder loans which qualify as debt, the principles already described above regarding contestability of such payments must be considered. With each payment the management board must judge the solvability of the company and determine whether it does not advantage one creditor over another, and whether it is still is in a position in which it is able to pay other creditors as well.

Tax-related aspects

On an instrument that qualifies as debt for Dutch tax purposes, an at arm's length interest expense is in principle deductible for Dutch corporate income tax purposes.

The terms and conditions of the debt instrument meet the arm's length criteria. Regardless the actual interest expenses, in principle interest expenses are deductible at the arm's length rate. If there is a difference between arm's length and actual interest expenses, an informal capital contribution or a deemed dividend is recognized. Dividend withholding tax may have to be considered in the latter case. An

[5] HR 25 November 2011, 08/05323, BNB 2012/37.

exception is laid down in article 10b Dutch Corporate Income Tax Act 1969 ("CITA"), which states that interest is non-deductible if a loan has a term of 10 years or longer and no interest has to be paid with respect to this loan or the interest is 30 per cent lower than the interest that would have been paid if the loan had been concluded between non-related parties. Further, deductibility of interest on loans that would not have been granted by unrelated parties may be restricted, such based on case law.[5]

Dutch tax law provides some other provisions that may have an impact on the deductibility of interest expenses on debt. In the overview below, these provisions are considered.

Tainted transactions
The anti-base erosion rule of article 10a CITA needs to be considered if one of the following tainted transactions take place:

a. Dutch tax payer borrows from an affiliated company and such loan can be directly or indirectly linked to

1. a dividend distribution by that Dutch taxpayer or an affiliated Dutch taxpayer;

2. a capital contribution by that Dutch taxpayer or an affiliated Dutch taxpayer; or

3. an acquisition of shares in an affiliated company by that Dutch taxpayer or an affiliated Dutch taxpayer.

In such case, interest expenses (including foreign currency exchange results) relating to this debt instrument may not be tax deductible if the corresponding interest income is not sufficiently taxed and both the transaction and the financing thereof are not based on sound business reasons.

Excessive' participation debt rule
With the abolishment of the thin-capitalisation rules, the Dutch legislator introduced article 13l CITA, a provision that limits the deduction of so-called "excessive participation interest".

This mathematical rule may limit the deductibility of interest expenses relating to "participation debt". Participation debt can be defined as an amount by which the cost price of the non-qualifying participations exceeds the equity for Dutch corporate income tax purposes.

A participation is considered as non-qualifying if the Dutch participation exemption applies and the participation investment is not a so-called expansion investment. The exclusion of expansion investments is meant to avoid interest deduction restrictions for operational expansion investments by Dutch tax payers. Thus, interest expenses on debt financed expansions of the group's operational activities (e.g., manufacturing, R&D, distribution and sales activities) through acquisitions of or capital investments in subsidiaries remain deductible.

The expansion investment exception, however, does not apply if the expansion related interest expenses is deducted elsewhere within the group ('double dip') or if the participation financing is predominantly tax driven. This might occur when, for example, the taxpayer cannot demonstrate a management link between the Dutch taxpayer and the participation.

Up to EUR 750,000 (threshold), excessive participation interest expenses do not fall under this limitation.

Limitation of interest deduction with respect to debt-funded acquisitions
Restrictions apply to set off interest expenses on debt related to the acquisition of a Dutch target company, against the taxable profits of that target company, within a Dutch tax consolidated group (i.e., a Dutch fiscal unity).

Up to EUR 1,000,000 (threshold), interest expenses relating to the above-mentioned debt-funded acquisition do not fall under this limitation. Further, acquisition debt is only regarded as excessive if and to the extent that debt exceeds 60 per cent of the acquisition price. During the subsequent seven years the percentage is reduced by

5 per cent per year. After seven years the part of the acquisition debt that exceeds 25 per cent of the acquisition price remains as excessive.

Reduction of debt

Legal aspects
Reduction of the debt position can be achieved:

- By repayment of debt. When repaying a shareholder loan to shareholders, paritas creditorum should be considered (see *Debt financing - Issuance of debt, Legal aspects*).

- By converting debt into equity. A shareholders can resolve to contribute the receivable it holds on the company to shares (or share premium), which improves the solvability of the company.

- By waiver of the debt by the creditor.

Tax-related aspects
The reduction of debt in principle does not result in Dutch corporate income tax purposes.

If debt is waived by the creditor based on business motives, such waiver may in principle result in profit at the level of the debtor. However, Dutch tax law provides for an exemption if such debt should be regarded as 'uncollectable' at the level of the creditor.

If debt is waived by the creditor based on shareholder motives, such waiver is regarded as informal capital contribution in the debtor. As such, no profits should arise at the level of the debtor.

Turkey

In general, the enterprises require external/internal funding in order to be able to maintain the operations, to fund new acquisitions or investments. Depending on the circumstances bank loans, or more complex financing instruments (i.e. mezzanine funding) as well as intra-group financing and equity financing.

This article intends to elaborate Turkish tax and legal implications of equity or debt financing and to focus on the main differences between these two different funding instruments for Turkish corporates.

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Financing environment in Turkey

Turkey is located at a close proximity to Europe (between two and three hours' flight to major European destinations). Turkey benefits from its location as a bridge between Europe and Asia. It also acts as an energy corridor connecting Asia to Europe.

Turkey entered into a customs union with the EU in 1996 and has been an EU accession candidate since 2005. This has resulted in the expansion of trade relations with Europe, which now accounts for approximately 40 per cent of Turkey's trade.

Turkey offers an accessible, skilled, young and cost-effective workforce, providing the fourth largest labour force amongst EU members and accession countries. It boasts a large population of over 74 m people, of which 47 per cent is under age 30.

The Turkish government provides various tax and non-tax incentives to foreign investors, in line with those provided to domestic companies. These include customs and VAT exemptions on various imported or locally delivered goods, including machinery and equipment, as well as priority regions offering incentives such as free land and energy support. Investors are also able to benefit from R&D support and market research with the aim of encouraging exports and increasing the competitiveness of firms in international markets.

The Turkish government has also introduced flexible exchange rate policies and liberal import regulations in order to promote and sustain foreign investment.

The Turkish legal framework offers a level playing field to foreign investors and domestic companies. Foreign ownership is unrestricted, with no pre-entry screening requirements, except for certain regulated sectors.

As legal entity forms, Joint Stock Companies ("JSC"), Limited Liability Companies ("LLC") and Limited Partnerships divided into shares are defined as capital companies under the Turkish Commercial Code.[1] In general, JSCs and LLCs are most common legal forms that are used by the investors in Turkish business environment.

Definition of equity versus debt

Legal aspects

Turkish companies can be financed either by equity or debt. The equity can be contributed by the shareholders into the companies in the form of (i) cash, receivable, security and participation shares, (ii) intangible rights, (iii) movable/immovable properties and other rights which are transferrable and have economic value. Accordingly, the equity contribution can be classified as a cash contribution and in-kind contribution which can be provided through (i) the internal resources of the company (i.e. previous year's profits, share

[1] Turkish Commercial Code numbered 6102 dated 2011, Article 124.

premiums, etc.) or (ii) external financing by the shareholders or third parties. All such economic values are qualified as equity once they are registered as a capital/ share premium. In contrast to equity, debt fundamentally establishes an obligation for repayment to the lender.

Tax-related aspects

In principle, equity financing and debt financing have different tax implications in Turkey. Equity financing (mainly registered capital and share premium) does not allow companies to claim any interest expense (or foreign exchange loss) deduction for corporate tax purposes.

All other financing instruments which do not fall under equity are qualified as a debt for tax purposes. The key consideration for the financing instrument is deductibility of financing expenses (i.e. interest, foreign exchange losses/gains).

Depending on who is the lender (or guarantor) of the financing arrangement there may be restrictions as follows:

- Thin capitalisation rules limit the debt to equity ratio for intercompany borrowings. As explained in a detailed way under the section *Thin capitalization*), the portion of the debt which exceeds 3 times the total equity is deemed as a thin capital and corresponding interest payments are not deductible for corporate tax purposes.

- As per recent changes within the legislation, the deductibility of financial expenses on external borrowings (related/unrelated) is also limited up to the 10 per cent of the total financial expenses. (Please see *Limitation on interest deductibility*). Although the legislation is introduced by the Government, it is not currently applicable since the details have not been announced yet.

Hybrid instruments are neither well recognized in Turkish tax and legal legislation nor have been tested in the eyes of tax authority. However, there have been previous cases where long term loan agreements having arm's length interest were implanted in the market.

Equity financing

Based on the Turkish corporate law, the equity can be contributed by the shareholders into the companies in the form of (i) cash, receivable, security and participation shares, (ii) intangible rights, (iii) movable and immovable properties and other rights which are transferrable and have economic value.[2] Accordingly, the equity contribution can be classified as a cash and in-kind contribution which can be provided through (i) the internal resources of the company (i.e. previous year's profits, share premiums, etc.) or (ii) external financing by the shareholders.

Contribution of equity

Legal aspects

The increase in nominal capital is subject to legal procedures and should be registered before the Trade Registry. The minimum capital requirement for JSC is TRY50,000, whereas it is TRY10,000 in case of a LLC.[3]

According to the legislation, it is mandatory that at least 25 per cent of the nominal capital that is committed by the shareholders in the form of cash should be paid before the registration of the new capital. The remaining capital (if any) should be paid within 24 months following the registration. In case of having a share premium at the capital contribution, the share premium amount should be fully paid up before the registration.[4] In addition to this, the amounts that are transferred by the shareholders to the accounts of the company as a capital contribution are blocked by the banks and cannot be used for other purposes until the registration of the capital.[5]

Tax-related aspects

A capital contribution is not a taxable

[2] Turkish Commercial Code numbered 6102, Article 127.

[3] Turkish Commercial Code numbered 6102, Article 332 and Article 580.

[4] Turkish Commercial Code numbered 6102, Article 344.

[5] Turkish Commercial Code numbered 6102, Article 345.

in Turkey. It is possible to contribute a share premium to the equity at the capital contribution or increase for the increasing value over face value of the shares issued. Under Turkish Corporate Tax Law, share premium is treated as a profit received by the company which is fully exempted for joint stock companies.[6]

Under the Law on the Protection of Competition, the capital amount contributed at the establishment of new JSC/LLC, or the increased capital amount to an existing JSC / LLC are subject to the contribution fund at the rate of 0.04 per cent.[7]

Notional interest deduction
According to a recent legislative change notional interest deduction for cash capital increases will be possible for Turkish companies excluding bank, financial institutions, insurance companies and public economic enterprises[8]. In accordance with this new incentive,

- 50% of the interest (Council of Ministers has authority to change the deduction ratio with certain limitations) to be calculated over increased cash capital amount that is paid after 1 July 2015 will be regarded as allowance from corporate tax base,

- notional interest deduction will be calculated by taking into consideration the "annual weighted average interest rate applied to Turkish denominated commercial loans provided by banks" which is announced annually by the Central Bank of Turkey for the year when the deduction is availed.

- if the portion of the deduction that is not utilized in a given fiscal year as a result of insufficient corporate tax base, it can be carried forward to the subsequent year.

The details of the new legislation has been announced by Ministry of Finance via a Communique which makes respective changes on the General Communique numbered 1 on Corporate Income Tax Code. Accordingly;
The interest rate will be based on the announcement of Turkish Republic Central Bank's on the average weight interest rates applied to the commercial bank credits (denominated in Turkish Lira) in the respective year in which the capital increase takes place. The interest rate will be calculated as of (i)the month covering the registration date of the capital increase for the capital paid before the registration, and (ii)the month covering the transfer date for the capital paid after the registration (no interest deduction is available for unpaid capital increases).

The companies eligible for this incentive can use the interest deduction as of 4th advance corporate tax period of the year in which the capital increase has been registered. The deduction cannot be taken into account for first three advance corporate tax returns during the year.

Payments out of equity

Legal aspects
Under the Turkish Commercial Code, each shareholder of a capital company has the right to receive dividend from the yearly net profit at the ratio of their participation. The dividend can only be distributed from the current year's profit or freely disposable reserves (i.e. previous year's profits).[10]

It is mandatory to allocate 5 per cent of the annual profit as a general first legal reserve for capital companies up to 20 per cent of paid in capital. Furthermore, following the payment of dividend to the shareholders up to 5 per cent of paid in capital, 10 per cent of the total distributed profit is allocated as a second legal reserve.. The legislation explicitly specify the utilization area of the legal reserves set aside up to 50 per cent of the paid in capital.[11] Although it is not explicitly stated within the legislation, in practice general understanding is that the exceeding portion of 50 per cent of paid in capital (if any) is deemed as freely disposable reserves. In addition to the requirements set out under the Turkish Commercial Code, a dividend distribution

[6] Turkish Corporate Tax Law numbered 5520 dated 2006, Article 5.

[7] Law on the Protection of Competition numbered 4054 dated 1994, Article 39.

[8] Law numbered 6637 dated 2015, Article 8.

[9] Communique numbered 9 dated 4 March 2016.

[10] Turkish Commercial Code numbered 6102, Article 507/508.

[11] Turkish Commercial Code numbered 6102, Article 519.

should be in line with the principles of the articles of association of the company, where the general assembly of shareholders meeting resolution should be adopted for the distribution both for JSCs and LLCs.

As a general rule, the distributable profit amount is determined based on the year-end balance sheet. However, with new regulations introduced recently, capital companies can distribute interim dividends on a quarterly basis with some limitations.[12]

Tax-related aspects

Dividends out of equity are not tax deductible in Turkey. In principle, the dividend distribution is subject to a withholding tax at a rate of 15 per cent. The dividend distributed between Turkish resident entities is exempt from withholding tax, where the profit repatriated to a Turkish individual or non-resident entity is subject to a 15 per cent withholding tax. The withholding tax amount is declared and paid by the company on behalf of the recipient via the withholding tax declaration of the related month when the dividend is distributed.[13]

Among the double tax treaty network of Turkey, the withholding tax rate is reduced to 10 per cent (i.e. the Netherlands, Luxembourg) or 5 per cent (i.e. Germany, Switzerland, Spain) which is generally subject to a minimum ownership ratio of 25 per cent in the share capital.

The dividend income received by a Turkish company from a Turkish resident company is fully exempt from corporate tax. For Turkish individuals, 50% of dividends received from a Turkish company is exempt from income tax, while the other half is subject to income tax at the rate of 35 per cent (effectively 17.5 per cent ignoring the progressive rates).[14] Turkish resident individuals can credit the withholding tax (15 per cent) paid by the company against their calculated income tax (which ends up an effective cash out tax payment at roughly 2.5 per cent at individual level).[15]

Reduction of equity

Legal aspects

Capital reduction is defined under Article 473 et seq. of the Turkish Commercial Code and requires a set of procedures to be completed from a legal perspective. In principle it may take 2-3 months to complete as there is a waiting period of 2 months for creditors to claim and secure their receivables from the company (therefore the key issue is to get consent of creditors in capital increase processes). However, there is an exception to this rule as stipulated under Article 474 of the Turkish Commercial Code which foresees a possibility for board of directors to waive from making an announcement for the creditors and getting their consent under a certain condition (i.e. previous year losses). In other words, according to the said Article, the board may decide on not getting the consent of the creditors if the capital decrease is to be made due to the previous year losses.

[12] Communique on Interim Dividend Distribution published in Official Gazette dated 9 August 2012 and numbered 28379. Although the details have not been announced clearly, the interim dividend cannot exceed 50 per cent of the below calculation:
(+) Interim Period Profit
(-) Taxes, funds, levies and provisions
(-) Legal reserves to be allocated as per the relevant laws
(-) any amount to be allocated for owners of preferred shares, usufruct shares and other parties that have right in the profit of the company, if any
(-) interim dividends distributed in previous interim periods of the relevant fiscal year

[13] Turkish Corporate Tax Law numbered 5520, Article 15 and 30 and Turkish Income Tax Law numbered 193, Article 94.

[14] Turkish Corporate Tax Law numbered 5520, Article 5 and Turkish Income Tax Law numbered 193, Article 22.

[15] Turkish Income Tax Law numbered 193 dated 1960, Article 121.

With reference to the principle of protection of creditor's rights, after the capital reduction, the Company cannot be in a technical insolvency position as per article 376 of the Turkish Commercial Code.[16] To this end, in case of a technical insolvency position following the capital reduction, such reduction resolution of the company cannot be registered at the relevant Trade Registry Office in Turkey.

Tax-related aspects
In principle, a capital repayment made to the shareholders from the paid in capital of the company is not taxable in Turkey, as long as the components of the capital have previously been paid in cash. On the other hand, if there is some portion of the capital arising from previous conversions of internal reserves into the capital (i.e. retained earnings, inflation adjustment, other funds and reserves), the reduced capital would be deemed as a dividend distribution being subject to withholding taxation at 15 per cent (to be reduced further down to 5 per cent depending on the double tax treaty, for Turkish receivers the rate is 0%) as described above. Furthermore, in case of having non-cash items within the share capital, repayment may, in addition, be subject to corporate tax at 20 per cent as well as the dividend taxation.

Debt financing

Issuance of debt

Legal aspects
In contrast to equity, debt fundamentally establishes an obligation for repayment to the creditor. From a commercial law perspective, there is no restriction on the loans provided by the shareholder. However, since the Turkish commercial law aims to protect third parties (i.e. creditors), in order to ensure the repayments of debts, technical insolvency positions are regulated under Article 376 of the Turkish Commercial Code which brings equity/capital ratio conditions for the companies.

Debt financing is possible in Turkey without a specific format. Loans to be granted from abroad for Turkish residents must be arranged through banks according to the foreign exchange rules in Turkey.[17]

Tax-related aspects
There is no requirement for registering the loan agreement to the Tax Authorities. However, the intermediary bank which is facilitating the cash transfer requests the loan agreement from the local entity.

According to the Turkish Tax Legislation loan agreements signed in Turkey or abroad are subject to stamp tax once the clauses are somehow benefitted in Turkey at the rate of 0.948 per cent on the highest figure stated on the agreement in year 2016.[18] Maximum payable stamp tax cannot exceed TL1.797k. Note that the signing parties are jointly and severally responsible for payment of stamp tax in the eyes of the authority.

On the other hand, the financing documents signed by Turkish companies regarding loans provided by resident or non-resident banks or financial institutions are exempt from stamp tax under stamp tax exemption list no.2/IV/23. The underlying purpose of this exemption is to avail Turkish companies having less borrowing costs. Accordingly, if such documents bring additional liabilities to the Turkish company on top of usual liabilities on a regular borrowing, i.e. any cross guarantees for group companies, stamp tax may apply on such document as well.

Payments on debt

Legal aspects
In case of debt financing, the most essential concept is the interest rate.

According to the Commercial Code, the interest rate related to the commercial transactions can be freely specified by the transaction parties.[19] There is no exchange control for intercompany lending in Turkey.

[16] Pursuant to Article 376/1 of the New TCC, if it is ascertained from the last annual balance sheet that half of the sum of the capital and legal reserves of the company has been lost, the Managers must immediately resolve on holding a general assembly meeting. At such meeting, the Managers shall clearly explain and inform the general assembly regarding the financial downfall of the company, the reasons that have caused the losses and present the necessary reformative precautions that should be taken by the company. The Managers shall be liable if they fail to inform the general assembly on the reasons for the financial status and present reformative precautions. In case the downfall of the company can be realized from the interim balance sheet, the Managers shall not wait for the preparation of the annual balance sheet and shall immediately call the general assembly for a meeting.
Pursuant to Article 376/2 of the New TCC, if it is ascertained from the last annual balance sheet that two thirds of the sum of the capital and legal reserves of the company has been lost, the Managers must immediately resolve on holding a general assembly meeting. At such meeting, the general assembly must resolve on either (i) recovering the lost capital of the company or (ii) decreasing the capital of the company to one third of the original level. If the general assembly does not resolve on one of the foregoing, the company shall be dissolved. If the general assembly resolves on recovering the lost capital unanimously, each shareholder shall make the payment in order to recover the lost capital.

[17] Article 17 of Decree on the Protection of Turkish Currency numbered 32

[18] The Stamp Tax Law, numbered 488, Article 1- Attached List 1-Section I.

[19] Turkish Commercial Code numbered 6102, Article 8.

[20] Law on Legal Interest and Default Interest, Article 1. (The current applicable rate is 9 per cent per year.)

[21] Banking and Insurance Transaction Tax Code numbered 6802, Article 28.

[22] Value Added Tax Law numbered 3065 dated 1984, Article 24.

[23] Value Added Tax Law numbered 3065, Article 27.

[24] Turkish Corporate Tax Law numbered 5520, Article 13.

[25] Turkish Corporate Tax Law numbered 5520, Article 12.

If an interest rate is not determined in an agreement, the provisions of the Law on Legal Interest and Default Interest numbered 3095 are applicable.

Tax-related aspects

Withholding tax

Under the corporate tax law, there is no withholding tax on interest payments made to a Turkish resident entity. On the other hand, interest payments made to non-resident entities are subject to withholding tax at the rate of 10 per cent. There is no reduced withholding tax rate on interest payments among the double tax treaties concluded by Turkey.

The withholding tax rate is nil on the payments made to non-resident banks and financial institutions.

In addition to above, interests and commissions gained by banks operating in Turkey are subject to Banking and Insurance Transaction Tax (BITT)[21] at a rate of 5 per cent. The responsibility of BITT filing is at Turkish banks. On the other hand, interest payments to foreign banks would not trigger BITT.

Value Added Tax (VAT)

Interest payments on loans are subject to VAT at 18 per cent, if the lender is a non-financial institution.[22] VAT has to be calculated and paid by a Turkish company under the "reverse charge mechanism". This VAT is recoverable with the future sales (subject to VAT) of Turkish company.

Although it has not been explicitly stated within the legislation, the VAT might be applicable on an interest free loan although no interest is accrued as per recent inspections. This is due to a provision within the VAT Law stating that VAT should be completed upon fair values of any delivery of service.[23] Until recently, interest free loans were the basic funding tools in Turkey. However, the tax authority claimed VAT on deemed interest in an inspection performed recently.

VAT is not applicable to interest accruals/ payments to foreign banks or financial institutions. Please refer the above explanations on the definition of the financial institutions.

Deductibility

In principle, interest payments are deductible for corporate tax purposes assuming they are related to the company's operations. On the other hand, interest payments regarding shareholder loans or loans provided by related parties are subject to limitations as follows:

Arm's length principle / transfer pricing

Under the transfer pricing regulations, the conditions of the related party borrowing should be in line with the arm's length principle, i.e. the interest rate and the terms of the agreement should be based on fair commercial terms and comparable to third party agreements. Otherwise, the interest payment corresponding to the portion exceeding the arm's length price, is deemed to have been a disguised dividend distribution which will be subject to a withholding tax at 15 per cent considering the lender is a non-resident company (lower withholding tax might be applicable depending on tax treaty rates subject to conditions).[24]

Thin capitalization rules

According to Turkish legislation, if the ratio of the borrowings from shareholders or from related parties exceeds three times the shareholders' equity of the borrower company at any time within the relevant year, the exceeding portion of the borrowing will be considered as thin capital.

For loans received from related party banks or financial institutions that also provide lending to third parties, the debt equity ratio will be considered as 6:1 instead of 3:1. The equity capital is the equity of the corporation at the beginning of the fiscal year, hence capital increases within the year are not taken into account for that year but for the following years.[25]

Should borrowings be deemed as thin capital, interest and foreign exchange losses incurred in relation to the thin

[26] A provision of the Article 11 of the Turkish Corporate Tax Code has been amended by the Law numbered 6322. The enforcement date is 01.01.2013.

[27] Decree of Council of Ministers numbered 2012/4116.

[28] Turkish Tax Procedural Law numbered 213, Article 324.

capital portion should be non-deductible for corporate tax purposes. Moreover, interest payments will be considered as deemed dividend distributions at the period end, hence subject to a dividend withholding tax at 15 per cent considering the lender is a non-resident company (lower withholding tax might be applicable depending on tax treaty rates subject to conditions).

Limitation on interest deductibility
A new legislation on the deductibility of financial expenses has been introduced very recently.[26] Accordingly, some portion of the financial expenses (i.e. interest, foreign exchange losses) of non-financial companies, associated with the portion of external leverage (third party / related party) exceeding the total equity of the companies cannot be deductible for tax purposes. The Legislation authorizes the Council of Ministers to set the ratio of disallowable financial expenses which cannot exceed 10 per cent of the total financial expenses. This legislation excludes all kind of financing expenses which are capitalized as part of an investment and the debts obtained from financial institutions or banks.

The new legislation is effective from 1 January 2013. However, the rate of the disallowable portion of the financial expenses still has not been announced by the Council of Ministers. Therefore, there is still no limitation for financial expenses on current status.

Other costs on debt financing - Resource Utilisation Support Fund (RUSF)
Foreign sourced loans obtained by Turkish resident individuals or legal entities (except for banks or financial institutions), are subject to RUSF at the rate of,

- 3 per cent on the principal if the average maturity period of the foreign currency denominated loan does not exceed 1 year,
- 1 per cent on the principal if the average maturity period of the foreign currency denominated loan is between 1 and 2 years (including 1 year),
- 0.5 per cent on the principal if the average maturity period of the foreign currency denominated loan is between 2 and 3 years (including 2 years),
- 0 per cent on the principal if the average maturity period of the foreign currency denominated loan is longer than 3 years (including 3 years).

Any foreign sourced TL denominated loans would attract RUSF over interest payments at 3 per cent regardless of maturity.[27]

Reduction of debt

Legal aspects
The reduction of debt is generally not subject to specific legal provisions.

Tax-related aspects
In principle, the repayment of debt does not have tax consequences. If the receivables are waived by the shareholders, the amount would be tracked in a special equity reserve account for three years following the end of the relevant year in which the receivable has been waived. The amount should be reflected in the P&L account being taxable unless any loss offset is done.[28]

Illustrative calculation

Assumptions	Equity financing TRY	Debt financing TRY
Fund amount	**10,000**	**10,000**
Shareholding equity of the entity		
Capital	60,000	50,000
Retained earnings	18,000	18,000
Total	**78,000**	**68,000**
Financing expenses		
Competition fund	4	-
Stamp duty on loan agreement*		95
Gross interest payments**	-	500
WHT on interest (10%)	-	50
Reverse charge VAT on interest (18%)***	-	90
RU SF (between 0% - 3%)****	-	-
Annual financing expenses	**4**	**595**
Profit of the company		
Annual Gross income	8,000	8,000
Annual Financing exprenses	4	595
Income before tax	7,996	7,405
Corporate tax (20%)	1,599	1,481
Profit after tax (= a-b)	**6,397**	**5,924**
Net tax difference		**473**
Legal reserves******		
1st and 2nd legal reserves	628	603
With holding tax		
Dividend with holding tax (15%)*****	865	798
Net dividend to be distributed	**4,903**	**4,523**

Notes

* Assuming that there is only one original copy. One time cost.

** Assuming that the interest rate is %5-yearly basis

*** The reverse charge VAT is not a cash cost for Turkish entity if it is in Vat paying position.

**** Assuming that the maturity of the debt is more than 3 years, and the loan is denominated in foreign currency.

***** The rate (i) is not for Turkish resident companies as receiving company and (ii) can be reduced by double tax treaty provisions (generally down to 5% or 10% if the shareholder is non-resident.

****** Legal reserve requirements have been ignored for the sake of simplicity.

United Kingdom

This article provides an overview of the two main forms of financing a UK company. It includes consideration of the UK company law requirements and highlights the key UK corporation tax and stamp duty issues associated with financing a UK company with equity or debt. This article does not seek to address non-UK matters and does not address any indirect tax matters.

At the time of writing, it is noted that the OECD have published various papers with recommendations for changes to domestic law or double tax treaties as part of the Base Erosion and Profit Shifting ("BEPS") initiative. The UK is in the process of amending or consulting on amending its domestic UK tax legislation, may sign a multilateral instrument in due course and/or re-negotiate treaties to make them BEPS compliant. This article is based on UK legislation announced or enacted as at 30 June 2016, does not provide legal or tax advice and does not consider any possible changes in UK legislation that may arise if the UK leaves the European Union.

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Equity financing

Contribution of equity

Legal aspects

In relation to a private company and an unlisted public company, provided that there are no restrictions on the amount of share capital that a company can have or the requirement for shareholder authorisation either in the company's articles of association or because the company has more than one share class, shares can be allotted by a resolution of the directors of a company.

The allotment and issue of shares may be subject to pre-emption rights. Statutory pre-emption rights require that where shares are issued for cash (and only cash), they must first be offered on the same terms to existing shareholders in the company. Where shares are issued wholly or partly for non-cash consideration this is not relevant. Private companies can remove or disapply this provision by passing a resolution or having a provision excluding this provision in its articles. Companies can also adopt specific contractual pre-emption rights.

Non-cash consideration can be accepted by the board of directors to pay up shares and in the case of a private company, shares can be issued partly paid or nil paid. There are a number of further special rules in relation to public companies that must be adhered to. For example, a public company requires a minimum amount of £50,000 in terms of the value of its nominal share capital with each allotted share being paid up to a quarter of its nominal value and the full amount of any premium.

Listed companies will also need to bear in mind the views expressed by institutional investor's representative bodies and must comply with the relevant listing rules in the UK. These rules require an explanatory circular to be sent to shareholders seeking the relevant shareholder authorisations in relation to the directors' authority to allot and the disapplication of statutory pre-emption rights.

Tax-related aspects

The contribution of equity to a UK company in exchange for the issue of shares should not give rise to any immediate tax consequences. In the case of a parent company subscribing for new shares in a subsidiary, the tax base cost for the parent in the new shares is determined by reference to the number of shares issued and/or the market value of the shares issued. Particular attention is required in the case of an insolvent subsidiary as the full amount actually paid by the parent might not represent good base cost.

The contribution of equity to a company may also take the form of a capital contribution, being a gratuitous payment by one company to another (typically by a parent to its wholly owned subsidiary) for nil consideration, usually to strengthen the subsidiary's balance sheet.

There is a risk that a capital contribution received by a trading company could be taxed as a profit of the trade. Practical steps in respect of documenting the donor's intention for making the capital contribution can mitigate this risk.

A capital contribution without an issue shares is unlikely to carry or create any additional base cost even if the donor already holds share capital of the recipient. The absence of good base cost may not be of significant consequence if the Substantial Shareholdings Exemption ("SSE" – the UK regime for participation exemption on capital gains for companies) is available.

No UK stamp duty should arise on an issue of new shares by a UK company.

Payments out of equity

Legal aspects

The capital maintenance doctrine provides that the share capital of a company forms a fund that should be permanently available to the creditors of a company to satisfy any claims against the company. Paid up share capital must not be returned to shareholders and shareholders liability in relation to capital not fully paid up on shares must not be reduced.

The above principle means that: (i) a company must not generally purchase its own shares; (ii) a public company must not give financial assistance to anybody acquiring its shares; (iii) dividends must not be paid out of share capital; (iv) if a public company suffers a serious loss of capital, a general meeting of the company must be called to discuss the issue; and (v) a subsidiary may not be a member of its own UK incorporated holding company.

Shareholders may obtain cash or other assets from the company by way of distributions made by the company. Generally, the power rests with the directors to recommend a distribution, but a company proposing to make a distribution must satisfy two basic rules: (i) it must have profits available to make a distribution; and (ii) the distribution must be justified by relevant accounts. In addition a public company is only able to pay a dividend provided that both before and after the distribution, the net assets of the company are not less than the aggregate of its share capital and non-distributable reserves (a private company can therefore ignore unrealized losses in assessing its ability to pay a dividend, a public company needs to have realised profits sufficient to cover such losses).

If the articles of a company are silent on the basis of payment then dividends must be divided among shareholders in proportion to the nominal value of their shares. This can be adjusted by provisions in the articles, so that, for example, dividends are paid in relation to the amount paid up on shares. If the default Model Articles are used, or as they were previously known, Table A, the position is that interim cash dividends are approved and paid by the directors alone and that final cash and non-cash dividends are declared by the directors, but approved by an ordinary resolution of the shareholders of a company.

The power to declare a dividend can be reserved to a company's shareholders, but shareholders should not declare a dividend in excess of the directors' recommendation. On the recommendation of the directors, a company can declare a non-cash dividend by way of an ordinary resolution of its shareholders.

Tax-related aspects

UK tax law explicitly provides that no deduction is allowed for UK corporation tax purposes in respect of the payment of a dividend or other distribution by a company. A UK resident company should generally be exempt from UK tax on dividend income from its subsidiaries. There are five different classes of dividend exemption under UK corporation tax law. A detailed discussion of the dividend exemption regime is outside the scope of this article.

Dividends by a UK company can be paid gross irrespective of any double taxation agreement between the UK and the recipient's state, as there is no domestic requirement for withholding tax on dividends in the UK.

Reducing capital: repayment of share capital & capital reduction

Legal aspects

A company may reduce its share capital for several reasons (for example, to create additional distributable reserves or return surplus capital to shareholders).

Private companies limited by shares can reduce their share capital in three principle ways: (i) by a Court approved capital reduction; (ii) by a capital reduction supported by a solvency statement; and (iii) by a buy-back of shares out of distributable reserves, de-minimis cash, proceeds from a fresh issue of shares or share capital. Public companies can use the Court approved route and buy-back shares out of distributable reserves or proceeds from the fresh issue of shares. An unlimited company is free to reduce its capital by a resolution of its shareholders without the need for Court approval or a solvency statement. These entities may also enter into a scheme of arrangement to change their capital structures (such a scheme is a Court approved arrangement between a company and its shareholders and/or creditors).

The Court approved capital reduction will involve agreeing a timetable to issue the claim form, book a date for the directions hearing and for the final hearing. The claim form may need to be advertised but this is not always necessary if creditor protection measures are put into place. The reduction will take effect once the Court order and the forms have been registered with the Registrar of Companies.

The statement of solvency capital reduction process instead of involving the Court has the directors make a solvency statement confirming that the company will be able to pay its debts as when they fall due for a period of a year. A creditor cannot object to a reduction of capital supported by a solvency statement but they are effectively protected by the requirement of the company's directors to take into account all of the company's liabilities.

Directors of companies could face claims for breach of duty if the solvency statement was found to be incorrect and criminal penalties can be imposed if the directors make the statement without reasonable grounds for doing so.

A private company may buy-back its shares out of distributable reserves or capital whereas a public company may only buy-back its shares out of distributable reserves. A company can be restricted from doing so by a prohibition in its articles and a private company needs to be expressly authorised to take advantage of the new de minimis buy-back out of capital provisions which do not need to follow the steps for a buy-back out of capital.

A buy-back needs to take place pursuant to a contract between the company and a shareholder approved by the shareholders of a company by an ordinary resolution. Shares must be fully paid to be bought back and there must be at least one non-redeemable share in issue following the buy-back.

For a private company, a buy-back may be funded by distributable profits, out of the proceeds from a fresh issue of shares, out of capital or with cash up to the value in any financial year of the lower of £15,000 and 5% of its share capital. If a premium is payable on shares to be bought back by a company, it must be paid out of distributable profits. There is an exception to this rule, if the shares to be purchased were issued at a premium, any premium payable on their repurchase may be paid out of the proceeds of a fresh issue of shares, up to an amount equal to the lower of: (i) the aggregate amount of the premiums received by the company on the issue of the shares to be bought back (this can be difficult to establish, especially where the company has been in existence for a long time during which there have been numerous share issues with different premiums paid on the shares at different times); and (ii) the current amount of the company's share premium account (including any sum transferred to that account in respect of premiums on the new shares).

There are additional requirements for a buy-back of shares out of capital. Available profits must be first extinguished before capital can be used to fund the buy-back. A directors' statement must be produced accompanied by an auditor's report. Broadly speaking the statement would set out that, immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts and that the company will be able to continue to carry on business as a going concern throughout the year following the date of the buy-back.

Details of the proposed buy-back must be published in the London Gazette and a national newspaper within a week immediately following the shareholders' resolution. Any member or creditor of the company may, at any time within the five weeks immediately following the date of the resolution, apply to the Court for an order preventing the payment. If such an application is made then notice must be given to the Registrar of Companies. A payment out of capital must be made no earlier than five weeks and no later than seven weeks after the date that the resolution approving the payment out of capital is passed.

A buy-back by a public company follows similar principles to that carried out by a private company out of distributable profits except a public company cannot act by written resolution but must instead hold a general meeting to approve the buy-back. In addition, public companies will need to consider various regulations depending on whether they are listed or not including the Takeover Code, the Listing Rules and the Aim Rules, as well as investor representative guidelines.

A reduction of capital may be combined with a scheme of arrangement. This makes particular sense in connection with a Court approved reduction as the scheme itself necessitates Court approval. There are specific rules for buy-backs in respect of employee share schemes (including the approval by a special resolution of the company supported by a solvency statement for a buy-back out of capital and a general authority to undertake buy-backs).

Tax-related aspects

Repayment of capital and buy-back of shares

There should generally be no UK tax consequence for the UK company effecting the repayment of capital or buying-back its own shares from its shareholder company(ies).

The UK corporate tax consequences for the recipient company can vary as there is an interaction between the UK capital gains rules and the dividend exemption rules as to whether the proceeds are entirely or partially taken into account for capital gains purposes. As a broad principle, if the dividend exemption applies to exempt distributions received by the corporate shareholder and SSE would exempt the disposal of shares, then the final UK corporation tax position should be that the corporate shareholder should be exempt on all the proceeds of the repayment of capital or buy-back of shares.

In certain cases, the recipient company may not qualify for dividend exemption and part of the proceeds would in that case be treated as a taxable dividend with the rest of the proceeds subject to the capital gains rules with a deduction for any base cost and an allowance for inflation as applicable. The portion attributable to capital should of course be exempt if SSE applies.

Capital reduction

There should be no immediate UK tax impact when a UK company undertakes a capital reduction, as the capital reduction process simply serves to reclassify shareholders' funds on the balance sheet between share capital and distributable reserves. The capital reduction is effectively treated as a form of tax-free reorganisation for the parent company.

Tax consequences should only arise when a distribution is subsequently made from the reserves created as a result of the reduction of capital. Where the recipient of such a distribution is a UK tax resident company, the distribution should in principle be treated as an exempt dividend subject to one of the five classes of dividend exemption applying. Consideration should be given to the UK tax implications of a later disposal of the shares.

Debt financing

Issuance of debt

Legal aspects

Debt finance, the raising of money by a company borrowing from a lender with a promise to repay the sum at a later date, is generally available to all companies unless their articles of association restrict such financing. The ability to borrow usually rests in the hands of the directors of the company unless expressly restricted by the company's articles of association.

Debt finance can be divided into two main types of financing: (i) the company issuing debt securities and (ii) the company taking out a bank loan. Debt securities are a promise to repay by the company to the holder of the security. They can take many forms depending on their terms and include instruments such as bonds, term notes and commercial paper. Bank loans also take a variety of forms depending on their terms for example overdraft facilities, revolving facilities and term facilities.

There are no specific legal requirements set down by statute relating to lending and borrowing arrangements. The issuance of debt is therefore based on the common law of contract and the parties involved in the lending and borrowing process are free to determine the terms on which they want to conduct that relationship. There are organisations that attempt to regularize these private arrangements; for example, the London Market Association provides for standard syndicated loan documentation in an attempt to improve liquidity, transparency and efficiency in debt markets.

Tax-related aspects

The issue of a debt instrument by a UK company does not in itself generally present any major UK tax consequences. The key tax issues are typically ensuring that there is a loan relationship for UK tax purpose, the deductibility of the interest expense on the debt instrument, any obligation to withhold income tax on the payment of interest and the corporation tax treatment of any foreign exchange differences. These issues are addressed in more detail below.

No UK stamp taxes should generally arise on the issue of debt by a UK company.

Interest payments on debt

Legal aspects

Interest payments are made in accordance with the contractual agreed arrangements between the parties. The parties are free to agree the amounts of interest, how this is calculated and how it should be paid.

The rate of interest and the manner in which it is charged should be chosen carefully to avoid the common law rules on penalty clauses. The rule against penalties only affects payments triggered by a breach of contract.

If an interest clause is held to be a penalty, it is unenforceable and will not displace any statutory rights to interest. A penalty clause is one that obliges the debtor to pay an excessive amount, which cannot be justified commercially.

Tax-related aspects

Withholding tax

Where any payment of "yearly interest" arising in the UK is made by a company, the company making the payment must deduct withholding tax from the payment (subject to various exemptions) at the basic income tax rate currently set at 20%. The broad principle is that "yearly interest" is interest that arises on a loan that is capable of lasting for more than one year. Accordingly, interest payments in respect of borrowing with a term of less than one year may be made gross, without deducting UK income tax.

Although there is a requirement to withhold UK income tax from payments of yearly interest, there is generally no requirement to withhold tax from payments of discounts. Therefore, where a debt is structured as a zero coupon deep discounted bond, withholding tax would not be due on the discount when the bond is redeemed at maturity.

There are a number of exceptions to the requirement to withhold tax from interest payments. For example, loans to and from UK banks may be made without the deduction of withholding tax, as can interest payments made to a UK resident company or made in respect of a quoted Eurobond and certain Private Placement debts.

Relief from withholding tax may also be available under Double Tax Treaties or the EU Interest & Royalties Directive. Prior to applying any reduced rate of withholding tax under a treaty or the Directive, the recipient of the interest must apply to the UK tax authorities, HM Revenue & Customs ("HMRC"), stating that tax need not be deducted from future payments or to deduct tax at a reduced rate specified under an applicable treaty. There is anti-conduit case law precedence in the UK and many treaties, including the Directive, have some form of anti-conduit provisions. HMRC can therefore deny treaty relief if they consider that loans have been routed via particular territories purely to reduce withholding tax to nil. The reduced rate of withholding cannot be applied until HMRC have accepted the application.

The EU Interest & Royalties Directive only applies where payments are made between 'associated' companies who are both resident in the EU or have a PE in the EU. Two companies are 'associated' for the purposes of the EU Directive if one company directly holds at least 25% of the share capital and/or voting rights of the other or a third company directly controls at least 25% of both the payer and recipient.

Deductibility of interest expense

The availability of a tax deduction for interest in the UK is complex area and the following UK tax provisions should be considered when determining the deductibility of interest expense for UK corporation tax purposes:

- Unallowable purpose;
- Thin capitalisation and transfer pricing;
- Worldwide debt cap and Interest restriction under BEPS Action 4;
- Anti-arbitrage and anti-hybrid;
- Late paid interest; and
- General Anti-Abuse Rule ("GAAR").

Unallowable purpose

The unallowable purpose provisions may restrict tax deductions on UK borrowing where a loan is entered into for an unallowable purpose. An unallowable purpose for a loan relationship includes a purpose which is not amongst the business or other commercial purposes of the company.

A tax avoidance purpose will be an unallowable purpose if it is the main purpose or one of the main purposes for the borrowing. A tax avoidance purpose includes any purpose which consists of securing a UK tax advantage for the borrowing company or any other person. The meaning of tax advantage includes a relief or increased relief from tax, a repayment of tax or increased repayment of tax and the reduction of a charge to tax.

In practice, a UK issuing company should maintain adequate documentation setting out the relevant transactions and the purpose of the relevant loans to support the case for obtaining a tax deduction for the interest.

Thin capitalisation and transfer pricing

In respect of connected party loans, companies can only deduct interest expense up to an "arm's length" maximum amount in calculating the profits subject to UK corporation tax. If the actual interest expense exceeds this maximum, which is established by considering the quantum and terms of debt which the company could and would have borrowed from an independent lender, then the company is "thinly capitalised" and some of the intercompany interest incurred will be disallowed for UK corporation tax purposes. Clearly, the interest rate on the loan would also need to be an arm's length rate and any interest exceeding an arm's length rate would also be disallowed.

When determining the arm's length borrowing capacity of a company, the separate entity principle must be used. However, HMRC acknowledge that, even on a standalone basis, any third party lender would take into consideration the assets and liabilities of the borrower's 51% subsidiaries (UK and foreign). Once this 'borrowing unit' (i.e. the grouping whose assets and liabilities are considered when assessing whether or not a company is thinly capitalised) has been determined for a particular company, the consolidated figures are used to determine the thin cap position.

A company must self-assess that its borrowing is at arm's length so it must make any necessary adjustments in its corporation tax return. UK tax law does not provide a set formula to determine whether the transactions would have taken place absent the group relationship, nor guidance on what would constitute appropriate levels of debt or arm's length terms of that debt. Consequently, there are no statutory rules as to an acceptable debt level for a UK company or safe harbour ratios.

HMRC approaches thin capitalisation by considering what a bank would do and their current approach is to agree leverage and interest cover ratios, generally with reference to Earnings Before Interest Tax Depreciation and Amortisation ("EBITDA"). EBITDA is commonly used as a gearing indicator for financial covenants set in third party lending agreements, and is therefore a common measure used by HMRC in evaluating a company's thin capitalisation position.

The UK has announced that it will introduce new rules from 1 April 2017 to restrict interest deductions in line with the OECD BEPS recommendations under Action 4. This is addressed briefly below.

Worldwide debt cap and Interest cap under BEPS Action 4

The worldwide debt cap rules are aimed at limiting the net amount of interest that is deductible for a UK company by reference to the gross external interest of the consolidated group. The excessive net finance costs (if any) are treated as permanently disallowable for UK corporation tax purposes.

The debt cap is only applicable for groups where a "gateway test" is satisfied. If the gateway test is not met then the debt cap provisions will not apply and there should be no disallowance in respect of UK borrowing or any filing obligations as a result of these rules. The gateway test is satisfied where the net debt of the UK group exceeds 75% of the gross debt of the worldwide group. The UK net debt is the sum of the net debt amounts (an average of the opening and closing amounts for the period) for each UK group company as shown in each UK company's statutory accounts. The worldwide gross debt is an average figure for the group as a whole for that accounting period. Both of these measures are tested with reference to the companies' financial statements prepared under GAAP.

It was recently announced that the UK plans to repeal the worldwide debt cap rules and introduce a new restriction for the corporation tax deductibility of interest expenditure, in response to BEPS Action 4. It is proposed that the rules will apply for accounting periods beginning on or after 1 April 2017 and restrict the amount of interest deductible to 30% of the UK group's taxable EBITDA. The restriction will only take effect where the net UK interest expense is in excess of £2 million. A higher amount of interest deduction may be available if the ratio of net interest to accounting EBITDA on a consolidated basis is higher but the overall tax deduction available for interest in the UK will be subject to an overall restriction by reference to a group's interest cost.

At the time of writing, detailed guidance has not been provided and the mechanics of the EBITDA restriction have not been released.

Anti-arbitrage and anti-hybrid

The UK anti-arbitrage rules counteract perceived tax avoidance achieved through arbitrage between the tax laws of different territories. The legislation potentially applies where an arbitrage scheme using a hybrid entity or hybrid instrument results in either: (i) a double deduction for the same expense (deduction cases); (ii) a UK deduction for the payer where the recipient is not taxed on the receipt (deduction cases); or (iii) amounts being received by a company in a non-taxable form (receipts cases).

In order for these provisions to take effect HMRC is required to issue a notice specifying the effect that HMRC considers the legislation will have. In broad terms, the notice will specify that deductions will be denied and receipts will become taxable to the extent of the arbitrage.

The anti-arbitrage rules apply in respect of deductions (deduction cases) where four conditions are satisfied:

- the company is party to a scheme that involves a hybrid entity, hybrid instrument or hybrid effect;
- a UK tax deduction is due or an amount can be offset against profits in respect of the scheme;
- the main purpose, or one of the main purposes, of the scheme is to obtain a UK tax advantage; and
- the amount of the tax advantage is not minimal (this is typically taken to mean that the tax advantage exceeds £50,000).

A hybrid entity is an entity that is recognised as a taxable person under one tax code, and whose profits or gains are treated as the profits or gains of a different person or persons under the same or another tax code. A common example is a UK "check the box" subsidiary of a US resident company – where an election is made (by the US parent) for the subsidiary to be taxed in the US as if it were a branch of the US company rather than a separate entity. A hybrid instrument would include a loan instrument which is characterised as debt under the laws of one territory but as equity in another territory.
In respect of receipts (receipts cases) there is no need for a scheme in which there is hybrid entity or instrument. Rather, the legislation will apply where:

- a company has entered into a scheme under which it receives a qualifying payment at least part of which it is not liable to tax on;
- that amount may be deducted from or allowed against taxable income of the person making the payment;
- the mismatch of tax treatment (i.e. the arbitrage) is a reasonable expectation of the parties to the scheme; and
- the qualifying payment constitutes a contribution to the capital of the company.

The UK is introducing new anti-hybrid rules which have effect for payments made on or after 1 January 2017. The new rules effectively replace the current anti-arbitrage rules and are being introduced in response to BEPS Action 2.

The new rules seek to address the mismatches between tax jurisdictions achieved through the use of hybrid entities and hybrid financial instruments and companies with exempt or low tax permanent establishments, in particular situations arising whereby:

- an amount is deductible for one party and the other party is not taxed on the corresponding credit (a "deduction/non-inclusion mismatch")
- an amount is deductible more than once (a "double deduction mismatch")

The hybrid mismatches will be counteracted by primary response. If a deduction/non-inclusion mismatch is achieved and the payer entity is resident in the UK, the rules will deny the deduction. If the payer is resident in a foreign jurisdiction and the deduction is not denied in that territory, the credit will be brought into account for the UK payee. The rules will tackle the double deduction mismatch by denying the deduction in the parent if the entity is resident in the UK. If the parent is resident overseas and the deduction is not denied in that jurisdiction, the rules will deny the deduction for the UK payer entity.

One of the key changes of the new rules is that there is no longer a "commercial purpose test". The rules will be applied regardless of whether the hybrid mismatch was intentional or not.

Late paid interest
Corporation tax relief for interest expense is normally given on an accruals basis. Until fairly recently, when the parties to a loan are connected, the late paid interest rules would operate to defer tax relief for the interest expense to the period in which it is paid if the following conditions are met:

- the interest is not paid within 12 months of the end of the period in which it accrued;
- credits for the full amount of interest are not brought into account by the lender under the loan relationship rules; and
- the lender is tax resident in a "non-qualifying territory" or effectively managed in a non-taxing "non-qualifying territory".

A "qualifying territory" is, broadly, one with which the UK has a double taxation agreement which contains a non-discrimination provision. A "non-qualifying territory" is therefore a territory which is not a "qualifying territory". Similar rules operated to delay tax relief for the issuer of discounted securities until the issuer pays the discount on redemption, when the creditor is connected to the issuer.

Legislation was announced in December 2014 which effectively repeals the deferral rules for late paid interest such that interest is now generally deductible on an accruals basis.

General Anti-Abuse Rule ('GAAR')
Following a period of consultation, Finance Act 2013 introduced a GAAR to UK tax law. The purpose of the GAAR is to counteract or deter "abusive" arrangements while ensuring normal business transactions are unaffected. The GAAR should only apply to counteract tax advantages arising from tax arrangements that are abusive. Amongst other taxes, the GAAR applies to corporation tax, income tax (including withholding taxes on interest) and stamp duty.

The term "tax advantage" includes relief or increased relief from tax, repayment or increased repayment of tax and avoidance of an obligation to deduct or account for tax. Tax arrangements are "abusive" if the entering into or carrying out of those arrangements cannot reasonably be regarded as a reasonable course of action in relation to the relevant tax provisions. Situations where the tax result does not follow the economics of a transaction may be an indicator of abusive tax arrangements. Arrangements may not be regarded as abusive if they accord with established practice at the time they were entered into and HMRC is aware of and has not challenged that practice.

There is no advanced clearance procedure and taxpayers must self-assess whether they consider that the GAAR applies.

In practice, the UK GAAR may be seen as having limited application in the area of debt financing as there is already a rule in respect of loans for unallowable purposes.

Reduction of debt

Legal aspects
Repayments are made in accordance with the contractual agreed arrangements between the parties. The parties are free to agree the amounts to be repaid including the calculation of amounts, when these payments should be made and how they should be paid.

Parties are free to waive or release debts subject to certain overriding considerations and restrictions. A debt waiver or release is a non-market value transaction as the waived debt is deemed a gift/contribution to the party who owes the debt. As such a number of legal considerations need to be taken into account by the borrower and the lender.

If the parties are in the same group of companies then thought should be given to the maintenance of capital principles outlined above whereby a company's capital can only be returned to its shareholders in very limited circumstances. For example, should a subsidiary waive its right to money owed to it by its parent then this would be a distribution and would have to fall in line with the rules on the maintenance of share capital and distributions. There would not be the same issue if a holding company were to waive its rights to be repaid by its subsidiary company as this would be considered to be a capital contribution to the subsidiary or a mere gift.

A debt waiver will constitute a transaction at an undervalue should the company waiving the repayment have solvency difficulties. Moreover, regardless of the solvency of the entities involved in the waiver and release, the directors of the respective companies need to consider their duties to act in the best interests of their respective companies.

Tax-related aspects
The repayment of a loan at maturity should generally not give rise to any UK corporation tax consequences in the borrower or the lender. There are situations where the early settlement or the transfer of a loan by a UK company gives rise to an economic profit or loss. The profit would be taxable but the losses may in certain cases not be deductible.

The UK corporation tax treatment of the waiver of a debt is a complex area, with different tax rules applying to transactions between connected parties and those between unconnected parties. The tax treatment is also determined by the type of debt in question (for example debts which constitute loan relationships, trading debts or other debts). The comments that follow apply to loan relationships.

In a connected party situation, no deduction is available to the lender for the full or partial release of the debt. Where there is an informal release of a debt, an accounting credit would be taxable on the borrower. However, a formal release would not be taxable so it is typically preferable to structure a waiver as a formal release of the debt in a connected party context.

In a non-connected party situation, a deduction should generally be available to the lender on the release of a debt provided that an accounting debit arises in the lender's financial statements. A formal or informal release would be taxable if a credit arises in the accounts of the borrower.

As noted above, it is necessary to distinguish carefully between formal and informal debt releases as their tax treatment may be different. To achieve a formal release, the agreement between the debtor and creditor must either be executed by way of a deed or evidenced by a valid contract for valuable consideration.

The repayment or release of a loan should not attract UK stamp taxes.

United States

The following article provides an overview of the U.S. federal income tax rules associated with financing U.S. business operations by foreign corporations. The article first describes the current economic environment related to financing U.S. business operations and then focuses on the relevant tax rules associated with determining whether a particular financing constitutes equity or indebtedness for U.S. federal income tax purposes and the consequences of such characterization. [1]

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Financing Environment in the United States

Most U.S. businesses have a capital structure that is comprised of a mix of debt and equity. The U.S. federal income tax implications of financing U.S. operations with debt or equity, particularly when the lender is a foreign related party, often influence a company's decision regarding the capital structure of its U.S. investment for two key reasons: (1) the tax rules provide that interest on indebtedness is generally deductible for U.S. federal income tax purposes, whereas dividends paid on equity are generally non-deductible; and (2) repayments of principal generally are not subject to U.S. federal income tax or withholding. Moreover, payments of interest made by a U.S. corporation to a related foreign corporation may be subject to a lower rate of U.S. tax and withholding than payments of dividends. Thus, the tax implications of the characterization of an instrument as debt or stock are integral to a foreign investor's decision regarding how to finance U.S. business operations.

The following chart demonstrates the debt to equity ratios of large and small U.S. companies. For most large companies, the debt to equity ratio has remained largely constant - hovering around 90 percent over the past decade, excluding those years that were impacted by the global financial crisis. This percentage indicates that large U.S. companies' capital structures (measured by book value) are generally comprised of slightly less than 50 percent debt.

The proportion of debt issued by small U.S. companies appears to be more volatile than for large companies and to have decreased over the past five years. This perhaps indicates an increase in the regulatory restrictions placed on potential borrowers and lenders after the financial crisis, or increased scrutiny from U.S. regulatory agencies, including the Internal Revenue Service.[2] Although the reasons behind the fluctuations are unclear, it is clear that both large and small companies include debt as an integral part of their capital structure, albeit at different levels.

[1] A discussion of the U.S. laws applicable to debt and equity instruments is outside of the scope of this article as PwC U.S. is not permitted to engage in the practice of law in the United States.

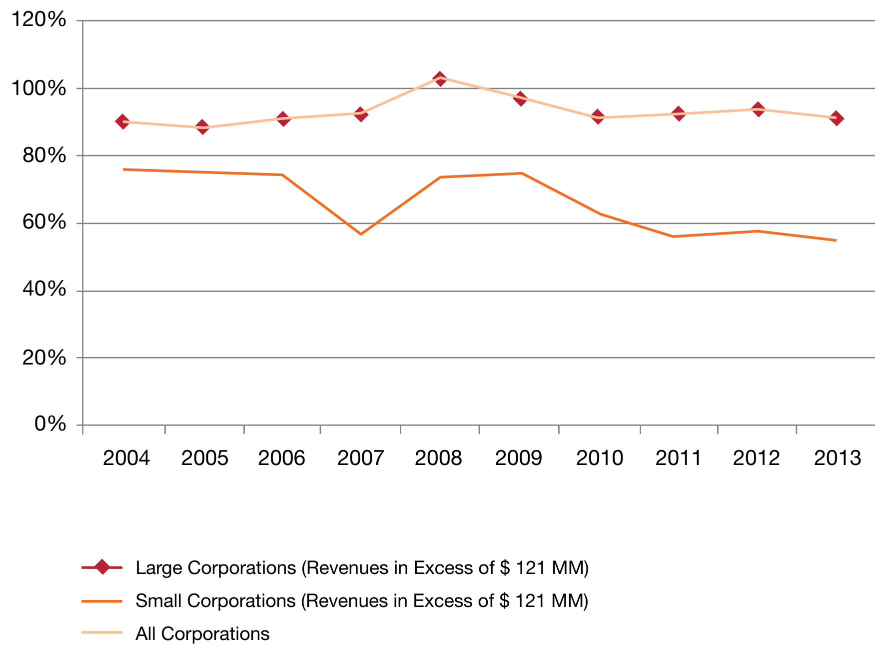
[2] References to the "IRS" or the "Service" are to the U.S. Internal Revenue Service.

3 Notice 94-47, 1994-19 I.R.B. 1 (Apr. 18, 1994).

4 Farley Reality Corp. v. Comm'r, 279 F.2d 701 (2d Cir. 1960); United States v. Title Guarantee & Trust, 133 F.2d 990, 993 (6th Cir. 1943).

5 Gilbert v. Comm'r, 248 F.2d 399, 402 (2d Cir. 1957), cert. denied, 359 U.S. 1002 (1959).

Debt-Equity Ratio of US Corporations



Source: PwC US calculation based on data from Capital IQ. Financial companies were excluded from this data set.

Definition of Debt versus Equity

In the United States, investors can finance their U.S. business operations with equity, debt, or some combination thereof. In general, whether a particular instrument constitutes "equity" or "debt" for U.S. federal income tax purposes is based on the terms of the instrument and all surrounding facts and circumstances.[3] This analysis requires an examination of various factors that have been developed in U.S. case law. Hybrid instruments are also used to finance U.S. business operations and, unless specific U.S. federal income tax rules apply, require an analysis of the same factors applied to a debt or equity instrument in order to determine whether the hybrid instrument is treated as debt or equity for U.S. federal income tax purposes.

An equity interest has traditionally been described as "embarking on a corporate venture and taking the risks of loss attendant upon it so that one might share in the profits of its success."[4] A debt, on the other hand, is a contractual relationship that involves "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof."[5]

U.S. federal tax law draws a clear distinction between the U.S. federal income tax consequences of debt and equity. In general, U.S. federal tax rules provide that interest incurred under the terms of an instrument that is properly treated as indebtedness, is deductible by the U.S. corporate issuer, whereas dividend distributions on equity are nondeductible.

Thus, for U.S. federal income tax purposes, U.S. corporations often consider financing some portion of their business operations with third-party or related party indebtedness. Consequently, much of the development of the U.S. federal tax rules associated with the characterization of an instrument as either debt or equity arose in situations where the IRS challenged a taxpayer's debt characterization of a particular instrument.

Notwithstanding the significant amount of controversy in this area of U.S. tax law, no uniform set of standards exists for determining whether an instrument constitutes debt or equity for U.S. federal income tax purposes. As noted above, U.S. courts and the IRS have articulated various factors to be considered in the analysis. To determine which factors are relevant to a particular taxpayer's instrument, the taxpayer must generally look to the applicable case law that exists in the jurisdiction where the corporation's principal place of business or principal office is located in the United States. If the corporation does not have a principal place of business or office in the United States, it must look to the relevant case law in the jurisdiction where the corporation's U.S. federal income tax return is, or would be, filed with the IRS. However, although the case law in the relevant jurisdiction may be of particular importance, a corporation's analysis of whether an instrument constitutes debt or equity for U.S. federal income tax purposes must also consider pertinent U.S. case law that is seminal in the development of the U.S. debt-equity analysis and may be used to assess the characterization of a particular instrument.

U.S. Statutory Rules

Although the U.S. Internal Revenue Code includes a specific statutory provision, section 385,[6] which purports to address the characterization of a financial instrument for U.S. federal income tax purposes, it does not provide a specific definition of when a particular instrument will constitute equity or debt for U.S. federal income tax purposes. This provision authorizes the Secretary of the U.S. Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an "interest" in a corporation is to be treated as stock or indebtedness (or as part stock and part indebtedness). Section 385(b) sets forth some of the factors that any such regulations must take into account in determining whether a debtor-creditor relationship exists. These factors include: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity of the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.[7]

Proposed Regulations which set forth the factors to be considered in determining whether an instrument is stock or debt first were issued in 1980 and final regulations followed the same year (with a delayed effective date that was extended several times). Those final regulations, however, were withdrawn in 1983.[8] There was no regulatory guidance until April 4, 2016, when Treasury and the Service released new proposed regulations under section 385. The Proposed Regulations recharacterize certain interests issued between related parties as stock for U.S. federal income tax purposes, even where they are issued in the form of indebtedness. Because the proposed regulations under section 385 characterize certain instruments as equity, but do not definitively characterize any instruments as debt, debt instruments still must be evaluated under multi-factor tests set forth in case law.

Section 385(c) indicates that a U.S. corporation's characterization of an instrument at the time of issuance is binding on the parties to the instrument (subject to potential recharacterization under the proposed regulations).

[6] Unless otherwise noted, all "section" or "§" references contained herein are to the Internal Revenue Code ("IRC" or the "Code") of 1986, as amended, or to the Treasury Regulations ("Treas. Reg.") promulgated thereunder.

[7] Section 385(b).

[8] T.D. 7920, 1983-2 C.B. 69.

[9] John Kelley Co. v. Comm'r, 326 U.S. 521 (1946).

[10] Notice 94-47, 1994-19 I.R.B. 1. The IRS issued this Notice to address certain considerations related to instruments that are treated as debt for U.S. federal tax purposes but that are treated as equity for regulatory, rating agency, or financial accounting purposes, and that therefore, contain a combination of debt and equity characteristics. However, the Notice outlines the IRS's view of the important factors to consider in the analysis.

Thus, once an issuer characterizes a financing arrangement as either equity or indebtedness, the parties are bound by that characterization and cannot argue against it without disclosing inconsistent treatment on the U.S. corporation's U.S. federal income tax return. This binding characterization rule does not apply to the IRS.

Factors Considered in the U.S. Analysis

Consistent with the statutory standards described above, the IRS announced its view that the characterization of an instrument as debt or equity for U.S. federal income tax purposes depends on the terms of the instrument and all surrounding facts and circumstances,[9] including:

i. whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future,

ii. whether holders possess the right to enforce the payment of principal and interest,

iii. whether the rights of the holders of the instrument are subordinate to rights of general creditors,

iv. whether the instruments give the holders the right to participate in the management of the issuer,

v. whether the issuer is thinly capitalized,

vi. whether there is identity between holders of the instruments and the equity holders of the issuer,

vii. the label placed upon the instrument by the parties, and

viii. whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes.[10]

Although the precise list of factors varies throughout the U.S. court system, the foregoing IRS factors generally highlight the key issues that must be analyzed when making a characterization determination of a particular instrument. The factors can generally be broken down into four sub-groupings of related categories:

1. Formalities of the Instrument: Factors (i) whether there is an unconditional promise on the part of the issuer to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future, and (vii) the label placed upon the instrument by the parties, relate to the formalities of the instrument in terms of whether the instrument on its face purports to establish a debtor-creditor relationship or a shareholder-corporation relationship.

2. Intent of the Parties: Factors (vi) whether there is identity between the holder of the instruments and the equity holders of the issuer, and (viii) whether the instrument is intended to be treated as debt or equity for non-tax purposes, including regulatory, rating agency, or financial accounting purposes, provide information concerning certain factors that go beyond the face of the instrument, which further shed light on the intent of the parties and the genuineness of the undertaking.

3. Creditors' Rights: Factors (ii) whether the holder possesses the right to enforce the payment of principal and interest, (iii) whether the rights of the holder of the instrument are subordinate to rights of general creditors, and (iv) whether the instruments give the holder the right to participate in the management of the issuer, pertain to creditors' rights and remedies and the extent of their involvement in the operations of the issuer.

4. Debt Capacity: Factor (v) whether the issuer is thinly capitalized, relates to the issuer's capacity to repay the advance and is related to similar factors traditionally emphasized by the courts, including the source of repayment and the ability of the issuer to obtain loans from outside lenders on similar terms. The common denominator for each of these factors pertains to whether there is a reasonable expectation that the issuer will meet its obligations under the instrument as it relates to timely repayments of interest and principal on the required dates specified in the instrument.

The enumerated factors above demonstrate that for U.S. federal tax purposes, there is no bright-line test that applies to determine whether an instrument is stock or debt. Moreover, the factors are generally not weighed equally by either the IRS or the U.S. courts when applying them to a taxpayer's particular set of facts. When a U.S. corporate issuer seeks to characterize an instrument as debt, one key factor that must be carefully considered is whether, at the time of issuance, the issuer can demonstrate an ability to repay both the interest and principal within the term of the instrument. Related party transactions will likely raise additional scrutiny by the IRS and U.S. courts and therefore, it is imperative that the parties act according to the intended treatment of the instrument as either stock or debt.

Proposed Regulations under Section 385

Even though a financial instrument is properly characterized as debt for U.S. tax purposes under the multi-factor tests described above, the proposed regulations can change this result.

The Proposed Regulations are comprised of four sections:

a. Prop. Treas. Reg. 1.385-1 includes a rule that allows the Service to treat a Purported Debt Instrument as part indebtedness and part stock.[11] This rule would apply to instruments issued or deemed issued on or after the date the Proposed Regulations are finalized.

b. Prop. Treas. Reg. § 1.385-2 prescribes the documentation that taxpayers must prepare and maintain to substantiate the treatment of a Purported Debt Instrument as indebtedness for federal tax purposes. Failure to do so within thirty days of issuance results in the instrument being treated as stock for U.S. tax purposes. The required documentation must demonstrate: (i) an unconditional obligation to pay a sum certain; (ii) creditor's rights; (iii) a reasonable expectation of repayment; and (iv) actions evidencing a debt-creditor relationship. This rule would apply to instruments issued or deemed issued on or after the date the Proposed Regulations are finalized.

c. Prop. Treas. Reg. § 1.385-3 provides additional rules that may treat purported debt instruments as stock for U.S. federal tax purposes if they are issued in, or treated as funding, certain related-party distributions, stock acquisitions, or asset reorganizations. This rule would generally be applicable to purported debt instruments issued on or after April 4, 2016, though re-characterization under this rule would occur 90 days after the date on which the final regulations are issued.[12] These rules have wide-ranging consequences for global multinationals.

d. Generally, the Proposed Regulations only apply to Purported Debt Instruments issued between members of an "expanded group," meaning an affiliated group as defined in Section 1504(a), with various modifications.[13] The expanded group definition includes non-U.S. and tax-exempt corporations, corporations held indirectly (e.g., through partnerships)[14] and corporations connected by ownership of 80% vote or value.[15] Special rules apply to attribute ownership.

[11] Prop. Treas. Reg. § 1.385-1(d).

[12] Prop. Treas. Reg. § 1.385-3(h).

[13] Prop. Treas. Reg. § 1.385-1(b)(3)(i)(A)-(C).

[14] Prop. Treas. Reg. § 1.385-1(b)(3)(ii).

[15] Prop. Treas. Reg. § 1.385-1(b)(3)(i)(C).

Equity Financing

Corporate Formation

In general, money or other property can be contributed to a U.S. corporation in exchange for stock in such corporation without the recognition of gain or loss by either the contributing shareholder or the U.S. corporation.[16] If the transferor receives money or other property in the exchange (in addition to any stock) the transferor will recognize gain as the result of the transfer to the extent of the fair market value of the property received.

In order to qualify for tax-free treatment on the contribution of property, the transferor must have or obtain "control" of the corporation immediately after the exchange. For this purpose, "control" is defined as the actual (and not constructive) ownership of stock of the transferee corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the transferee corporation.[17]

What it means for the transferor to be in control of the transferee corporation "immediately after the exchange" is the subject of a significant amount of litigation between taxpayers and the IRS. Therefore, careful consideration should be given to whether this requirement is satisfied.

The stock that may be received in the exchange by the transferee generally includes either common stock or preferred stock of the U.S. corporation. Certain preferred stock where the issuer is required, or is more likely than not, to redeem, or preferred stock which has a dividend rate that varies with reference to interest rates, commodity prices, or other similar indices, is generally considered to be "nonqualified preferred stock" and is treated as "boot" in an exchange.[18] Thus, if the transferor receives nonqualified preferred stock as part of the exchange, the transferor must generally recognize gain even if the other requirements for tax-free treatment are satisfied.

Corporate Distributions

In general, distributions of property made by a U.S. corporation to its shareholders are considered to be dividends to the extent that the distribution is made out of the corporation's current or accumulated earnings and profits.[19] Broadly, the concept of "earnings and profits" attempts to approximate a corporation's economic income that is available for distribution to its shareholders; however, the term is not specifically defined for U.S. federal income tax purposes. In general, the determination of a corporation's earning and profits begins with the corporation's taxable income and various adjustments (additions and subtractions) are made to that amount.[20] The computation of a corporation's earnings and profits is made at the end of a given tax year. If a corporation has no current or accumulated earnings and profits, a distribution by the corporation is not considered to be a dividend distribution for U.S. federal income tax purposes.

If a corporation makes a distribution in excess of its current and accumulated earnings and profits, such distribution is first applied to reduce the shareholder's basis in its stock of the corporation and is treated as a return of capital distribution.[21] Any distribution in excess of the shareholder's basis in its stock is treated as gain from the sale or exchange of property.[22]

Taxation of Distributions

Dividend distributions (i.e., distributions made out of current and/or accumulated earnings and profits) made to foreign persons are subject to U.S. tax and withholding at a rate of 30 percent, unless such amount is reduced under an applicable U.S. income tax treaty.[23] Return of capital distributions are generally non-taxable to shareholders (whether U.S. or

16 Sections 351 & 1032.

17 Section 368(c).

18 Section 351(g).

19 See sections 301 and 316.

20 Section 312.

21 Section 301(c).

22 Id.

23 See section 881(a).

foreign) and result in an adjustment to the shareholder's basis in its stock of the U.S. corporation. Distributions in excess of a shareholder's basis give rise to capital gain that, with one exception, are generally not subject to U.S. federal income tax where the shareholder is a foreign corporation. The one exception is where the majority of the U.S. corporation's assets are comprised of U.S. real property.[24]

Distributions made on equity instruments are generally non-deductible for U.S. federal income tax purposes to the distributing corporation.[25] Distributions of appreciated property by a U.S. corporation to its shareholders require the corporation to recognize gain as if the property were sold to the shareholder at its fair market value.[26] However, the recognition of losses resulting from a distribution of depreciated property to a shareholder is not permitted for U.S. federal income tax purposes.

Additional Tax-Related Considerations

Special Rules for Stock Dividends

Special U.S. federal income tax rules apply to distributions by a U.S. corporation of its own stock to a shareholder, i.e., a stock dividend.[27] In general, a stock dividend distributed by a U.S. corporation is not included in the gross income of a foreign receiving shareholder, and therefore, is not subject to U.S. tax and withholding. However, if the stock dividend results in a change to the equity interest of all of the corporation's shareholders (for example, if the shareholders can elect whether to receive a distribution of property or a distribution of the corporation's stock) then such stock distribution may be a taxable dividend distribution. In such case, even though the dividend is not paid in cash, to the extent the distribution is treated as giving rise to dividend income to a foreign shareholder, the distribution is subject to U.S. tax and withholding at a rate of 30 percent, unless reduced by a U.S. tax treaty.

In addition, the proceeds from the sale or redemption of certain types of preferred stock may be treated as a dividend for U.S. federal income tax purposes if it gives rise to the potential for a conversion of ordinary dividend income into capital gain and a reduction in the earnings of the U.S. corporation.[28] These rules can apply if a shareholder received a stock dividend of preferred shares or received preferred stock in a tax-free reorganization and then subsequently sells its preferred stock. Thus, if a foreign corporation owns certain preferred stock of a U.S. corporation, the disposition of such stock may be treated as a dividend distribution that is subject to U.S. tax and withholding at a rate of 30 percent, instead of giving rise to non-taxable capital gains.

Disposition of Stock of a "FIRPTA" Company

As noted above, the sale or other disposition of U.S. corporate stock generally does not give rise to U.S. federal income tax to a foreign shareholder. However, if the fair market value of a U.S. corporation's assets are comprised of 50 percent or more of U.S. real property interests (e.g., land, buildings, other inherently permanent structures, etc.), then the foreign selling shareholder may be subject to U.S. tax and withholding on the sale of its equity interest in the U.S. corporation. The rules under section 897 (commonly referred to as the "FIRPTA" rules) treat gains or losses derived by a foreign shareholder's sale or other disposition of its U.S. corporate stock as if the foreign shareholder were engaged in a U.S. trade or business and as if such gains or losses were effectively connected with such trade or business. Thus, gains arising from the sale of a FIRPTA company by a foreign corporation are subject to U.S. federal income tax at graduated tax rates, i.e., 35 percent for most foreign corporations. A withholding provision applies to dispositions of FIRPTA companies by foreign persons and requires the purchaser (or other transferee) to withhold 10 percent of the gross proceeds from the sale and remit the withholding to the IRS.[29]

Even if a majority of a U.S. corporation's assets are not comprised of U.S. real estate,

[24] See sections 897 and 1445.

[25] Certain distributions made by U.S. corporations to other U.S. corporate shareholders may be eligible for a dividends received deduction with respect to some portion, or all, of a dividend distribution depending on the shareholders ownership interest in the distributing U.S. corporation.

[26] Section 311(a) & (b).

[27] Section 305.

[28] Section 306.

[29] Section 1445.

[30] See Treas. Reg. section 1.1001-3.

[31] Note that this discussion does not include all of the potentially applicable U.S. federal income tax rules that could apply to limit a U.S. corporation's ability to deduct interest expense.

and therefore, the company is not a FIRPTA company, certain procedural and notice requirements are generally required to be filed with the IRS upon a foreign person's sale of stock of the U.S. corporation.

Debt Financing

Granting of Indebtedness and Subsequent Modifications

The issuance of a note by a U.S. corporation to a related foreign corporation generally does not give rise to U.S. federal income tax to either the holder or the issuer. However, the actual or deemed transfer of a debt instrument by either the holder or the issuer can result in the recognition of gain or loss to the holder, and cancellation of indebtedness to the issuer.[30] A deemed transfer may arise if the parties to an existing instrument make modifications to the terms of the instrument and such modifications are "significant."

A "significant modification" results in a deemed exchange of the existing instrument for a new instrument that differs materially either in kind or extent and, based on all of the facts and circumstances, the legal rights or obligations under the terms of the instrument that are altered, and the degree to which they are altered, is economically significant. Various safe harbors exist when determining whether a particular debt instrument has undergone a significant modification as the result of changes to the terms of the instrument.

If a debt instrument issued by a U.S. corporation to its foreign corporate shareholder is significantly modified, the parties are deemed to have exchanged the original instrument for a new instrument in a taxable transaction. Such an exchange generally does not give rise to U.S. federal income tax to the foreign corporate shareholder; however, the U.S. corporate issuer may recognize cancellation of indebtedness income if the repurchase price paid in the actual or deemed exchange is less than the issue price of the original instrument.

Payments on Indebtedness

Payments of principal on an instrument that is properly characterized as debt for U.S. federal income tax purposes are not subject to U.S. federal income tax or withholding. However, interest payments made on a debt instrument are generally subject to U.S. tax and withholding at a rate of 30 percent, which may be reduced under an applicable U.S. income tax treaty.

In general, periodic payments made with respect to an instrument are deductible for U.S. federal income tax purposes only if the instrument is properly characterized as indebtedness of the payor. However, various restrictions may apply to limit the deductibility of such interest even in circumstances where an instrument is properly characterized as indebtedness.

Applicable Limitations on Interest Deductibility[31]

Section 163(j) (commonly referred to as the "earnings stripping rules") applies to limit a payor's interest expense deduction when the interest is paid to a related party where no U.S. federal income tax is imposed on such interest or where such interest expense is subject to a reduced rate of U.S. tax under an income tax treaty. Section 163(j) can also apply to interest payments made to unrelated parties where there is a guarantee of the indebtedness by a related person who is either a foreign person or who is exempt from U.S. tax. The rules under section 163(j) provide a safe harbor where the debtor's debt-to-equity ratio does not exceed 1.5 to 1. In general, the amount of deductible interest expense is limited to the debtor's "excess interest expense" for the tax year, which is broadly intended to measure the company's debt-paying capacity. Any amount of excess interest expense that is not used in the current year may be carried forward by the company indefinitely.

Other rules may also apply to limit interest deductibility in circumstances involving interest payments made to related foreign persons. In general, a company that owes a payment to a related foreign person must report the payments on a cash basis method of accounting in order to deduct the payment.[32] That is, interest payments due under the terms of a debt instrument owed to a related foreign person are not deductible until actually paid and includible in the related party's gross income.[33]

Under section 163(e), certain limitations apply to interest payments made by a U.S. company to a related foreign person on a debt instrument that has original issue discount ("OID"). Similar to the rules under section 267, OID on such instrument must actually be paid before the issuer can deduct the payment for U.S. federal income tax purposes.

Additional rules apply to limit interest deductions on certain types of indebtedness of a corporation where the terms of the instrument provide for repayment using equity of the issuer or a related party.[34] In such case, interest paid or accrued on the indebtedness is non-deductible for U.S. federal income tax purposes.

U.S. transfer pricing rules also generally require that debt between two related parties reflect an arm's length rate of interest. If the debt does not reflect an arm's length rate of interest, section 482 provides the IRS with the ability to make appropriate allocations of the interest in order to clearly reflect income and to adjust U.S. federal income taxation accordingly. The rules provide a safe harbor interest rate that is generally equal to at least the applicable federal rate, as published by the IRS on a monthly basis, and not more than 130 percent of the applicable federal rate.

Additional Tax-Related Considerations

Anti-Conduit Financing Rules

In circumstances where a recipient of an interest payment from a related U.S. corporation seeks to qualify for a reduced rate of U.S. tax and withholding under a U.S. tax treaty, consideration must also be given to the application of the U.S. anti-conduit financing rules.[35] If applicable, the anti-conduit rules may disallow the benefits of an income tax treaty with respect to interest payments made by a U.S. corporation to a foreign corporation.

In general, the anti-conduit financing rules limit the ability of taxpayers to reduce or eliminate tax on obligations through the use of "conduit" entities organized in jurisdictions for which the applicable tax rate is reduced or eliminated by a treaty. These rules permit the IRS to disregard one or more intermediate entities in a financing arrangement if these entities act as conduit entities. If a conduit entity is disregarded, the financing arrangement generally is recharacterized as a transaction between the remaining parties to the financing arrangement and the interest payments are treated as made between those remaining parties. Recharacterization of a transaction by the IRS will result in a U.S. tax obligation and also may result in the application of certain penalties.

Portfolio Interest Exception

Certain types of U.S. source interest paid by a U.S. corporation to foreign persons are exempt from U.S. tax and withholding. Interest that satisfies the requirements of the portfolio interest exception is one example.[36] In general, foreign corporations are not subject to U.S. tax on interest received on portfolio debt instruments.[37] Broadly, portfolio interest includes interest paid on debt obligations that are in registered form and with respect to which the person who is otherwise required to deduct and withhold tax from such interest (e.g., the U.S. corporate issuer), receives a statement that the beneficial owner of the obligation is not a U.S. person.

[32] Section 267(a)(2).

[33] This restriction on deductions for payments made to foreign related persons applies broadly to interest payments as well as other types of U.S. source income.

[34] Section 163(l).

[35] Treas. Reg. section 1.881-3.

[36] Other examples include bank deposit interest, short term original issue discount, and interest from so-called "80-20" companies.

[37] Section 881(c).

An obligation is in registered form if (1) it is issued by a natural person; (2) is not of a type offered to the public; (3) has a maturity date of not more than one year; (4) is reasonably designed to ensure that the obligation will be sold only to a non-U.S. person; or (5) is debt that is held through a dematerialized book entry system or other book entry system specified by the IRS.[38]

Certain parties are excluded from those who may receive portfolio interest. This includes interest paid to: (1) a bank that receives the interest on a loan made in the bank's ordinary course of business; (2) interest paid by a corporation to a shareholder who owns 10 percent or more of the total combined voting power of all classes of stock of the issuing corporation; (3) interest paid by a partnership to a partner who owns 10 percent or more of the capital or profits interest in the issuing partnership; (4) interest that is received by a controlled foreign corporation from certain related persons; or (5) certain types of contingent interest. Because of these restrictions, it is unlikely that most types of related party indebtedness would satisfy the requirements of portfolio debt; however, foreign corporate investors who intend only to make passive-type debt investments in U.S. companies should consider the potential applicability of these rules to exempt interest payments from U.S. federal income tax and withholding.

Parent Guarantees of Third-Party Debt

Third-party debt that is issued by a U.S. corporation and guaranteed by its foreign parent company, may implicate not only the earnings stripping rules described above, but it also may require consideration of whether such arrangement may, in substance, be viewed as a loan made directly by the third-party lender to the foreign parent company. Where it is clear that the third-party lender would never have been willing to make a loan to the U.S. corporation, U.S. case law[39] can apply to recharacterize the lending arrangement as a loan by the third-party to the foreign parent and a capital contribution by the foreign parent to its U.S. corporate subsidiary. If the lending arrangement is so recharacterized, payments by the U.S. corporation would result in non-deductible dividend distributions that may be subject to U.S. tax and withholding, instead of deductible interest payments.

Preventing this potential recast of a financing arrangement generally requires an assessment of whether the U.S. corporation could have obtained the financing from the third-party lender, under similar terms, without the foreign parent guarantee, i.e., on a stand-alone basis. Thus, a debt-equity analysis using the factors described above, must be applied to third-party loans made to a U.S. corporation that are subject to a foreign parent guarantee in order to determine whether the financing arrangement will qualify as indebtedness of the U.S. corporate issuer for U.S. federal income tax purposes.

[38] The portfolio interest exception rules were modified in March 2012 and therefore if an obligation was issued before this date, parties should consider the potential application of the prior rules.

[39] See Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972).

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This document was concluded on 1 November 2016. Subsequent developments have not been included.

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