Cross Border Financing Update

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Exemptions from Interest Withholding Tax – Recent Developments

- *Recent Developments in Brazil and Italy*
- *Beneficial ownership considerations*
- *Principal Purpose Test considerations*

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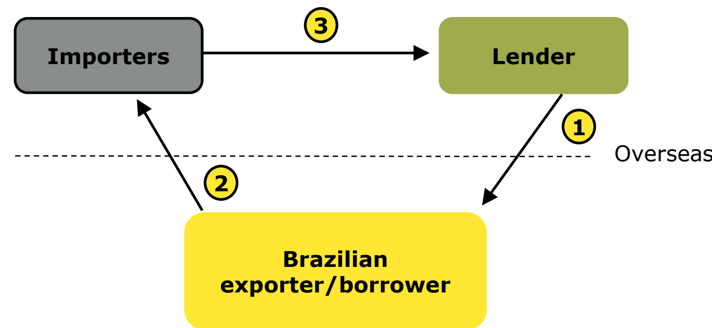
Export Financing Program - PPE

Alternative

1. Lender advance funds to Brazilian exporter prior to shipment of goods/export of services.

2. Brazilian exporter ships goods/exports services to importers abroad.

3. Lender paid trough importers remitances in satisfaction of exporter oligations under the PPE.



Comments

- Pre-export finance arrangements (PPE) are financing mechanisms whereby Brazilian exporters/borrowers anticipates the revenues out of future export transactions from any non-residente lenders and commit to setlle the finance with the effective shipment of goods or rendering of services under an export transaction.

Tax Aspects

- Brazilian tax legislation grants a favorable tax treatment to long term export financing debt: WHT at a 0% rate on interest and commissions
- Applicable even if the beneficiary is located in a low tax jurisdiction or benefiting from a privileged tax regime.
- *Controversy:* relevant tax litigation relies on the absense of "export financing" clear concept definition. Tax authorities challenge the applicability of the benefit under the concept of misuse of PPE proceeds.
- Intragroup arrangements are commonly put in place whereby an offshore subsidiary raises funds abroad and remits them to Brazil under PPE arrangements.

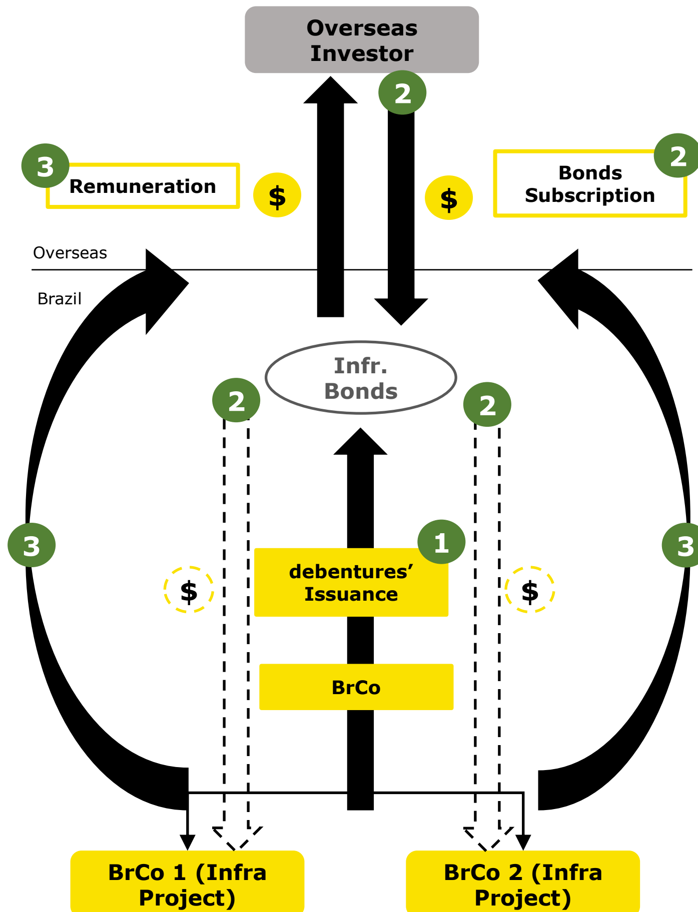
Infrastructure Debentures

Alternative

1. The Corporation detained the Infraestructure projects that issues infrastructure debentures.

2. Overseas investor subscribes the infrastructure debentures.

3. Remuneration paid to the Holder of the Infraestructure debentures.



Comments

- Funds raising via issuance of debentures by Brazilian corporations investing in infrastructure areas deemed priority by the Brazilian government or related to the intense economic production, research, development and innovation may benefit from a special tax treatment.

- The amounts received must be used in the enterprise implementation and allocated to future payment of costs, expenses or debts related to the project, including R&D.

Tax Aspects

- Payments made under infrastructure debentures benefit of:

- 0% WHT: the remittances to beneficiaries abroad i

- 0% IOF/Exchange: on the inflow of funds by the non-resident investor to acquire the infrastructure bonds and the outflow of funds for payment of the infrastructure debenture, including interests

- Not applicable if beneficiary is located in a low tax jurisdiction or benefiting from a privileged tax regime. Except severing funds.

Public Placement Bonus MP 1137/22

Comments and tax Aspects
• The goal is to attract foreign credit and encourage the issuance of private debt securities. (0% WHT was already afforded to public debt). • Executive Order 1,137/2022 introduced a 0% (WHT) on income paid to foreign investors out of private securities, such as (i) securities subject to public distribution, issued by private legal entities, excluding financial institutions (ii) Fund Credit Holder (FIDIC) whose originator or grantor of the credit rights portfolio is not a financial institution and other institutions authorized to operate by the Central Bank of Brazil; (iii) financial notes (iv) investment funds that invest exclusively in securities mentioned in (i) and (ii); federal government securities; assets producing exempt; and repo operations backed by federal public securities or units of investment funds that invest in federal public securities. • Provisional Measure is an legislative act issue by President of Brasil that shall be passed into law by Congress within max 120-day period. • Zero rate does not apply if the beneficiary of the income is located in a low tax jurisdiction or is beneficiary of a privileged tax regime.

Italy - The introduction of the WHT exemption

- Art. 22(1) of Law Decree No. 91 of 24 June 2014 introduced a WHT exemption for certain non-Italian lenders granting medium-term loans to Italian enterprises, by adding paragraph 5-*bis* to Article 26 of Presidential Decree No. 600 of 29 September 1973.

- The original wording of paragraph 5-*bis* was the following: *"The withholding tax under paragraph 5 does not apply to interest and other proceeds derived from medium and long-term loans to enterprises granted by credit institutions established in EU Member States, insurance companies incorporated and authorized under provisions issued by EU Member States or unleveraged collective investment vehicles collective investment funds, even if not tax subjects, established in EU States or in EEA States included in the decree to be issued by the Ministry of Economy and Finance according to Article 168-bis of the Presidential Decree No. 917 of 22 December 1996".*

- The provision entered into force on 25 June 2014 and applied to the financing structures already in place.

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Amendments to the original wording of paragraph 5-*bis*

- Law No. 116 of 11 August 2014 (that converted into law the Law Decree No. 91 of 24 June 2014) extended the subjective scope of the WHT exemption to entities established under articles 2(5), numbers 4 to 23, of Directive 2013/36/EU (*i.e.*, certain development promotion institutions established in the EU that do not fall within the category of credit institutions).

- Art. 6 of Law Decree No. 3 of 24 January 2015 (as converted into law by Law No. 33 of 24 March 2015) replaced the passage "*unleveraged collective investment vehicles collective investment funds, even if not tax subjects, established in EU States or in EEA States […]*" with the following: "*foreign institutional investors, even if not tax subjects, under Article 6(1)(b) of Legislative Decree No. 239 of 1 April 1996, subject to supervision in the foreign Countries in which they are formed*". The purpose of this amendment was to broaden the subjective scope to further categories of institutional investors, irrespective of the State in which they are established and the circumstance that they are leveraged.

- Art. 17(2) of Law Decree No. 18 of 14 February 2016 (as converted into law by Law No. 49 of 8 April 2016) amended paragraph 5-*bis* by adding the following wording "*Without prejudice of the provisions concerning the reserved nature of financing activities performed vis-à-vis the public set forth by Legislative Decree No. 385 of 1 September 1993 [the Italian Banking Act], the withholding tax under paragraph 5 does not apply […]* ". The amendment was aimed at specifying that the WHT exemption applies only to foreign lenders falling within the category of paragraph 5-*bis* and that are allowed to lend to Italian borrowers according to the relevant provisions.

WHT exemption: the current version

- Article 26(5-*bis*) of Presidential Decree No. 600/1973 provides for a “WHT exemption” from the domestic 26% rate WHT ordinarily applicable to outbound interest payments by Italian resident entities to certain foreign resident recipients.

- The WHT exemption applies provided that all the following conditions are jointly met:
  i. the lender qualifies as: (a) a EU Bank, (b) a financial entity under EU Directive 2013/36/EU, (c) a EU authorized insurance undertaking, or (d) a white-list regulatory supervised foreign “institutional investor”;
  ii. the lender does no act in breach of Italian provisions concerning the reserved nature of financing activities performed *vis-à-vis* the public (s.c. “regulatory caveat”);
  iii. interest relate to a medium-long-term loan, *i.e.,* a loan having an original maturity of more than 18 months;
  iv. the borrower is an Italian enterprise, *i.e.,* an entity carrying out an entrepreneurial activity.

- It is not expressly provided that the foreign recipient of the interest payments shall be the beneficial owner of such payments.

Lenders: guidelines by the ITA

- According to ITA guidelines, the term “institutional investor” refers to an entity that, regardless of the legal form and the tax regime it is subject to in its country of establishment, has as its core business the management of investments for its own account or on behalf of third party investors.

- For the purposes of the WHT exemption, institutional investors must be subject to forms of supervision in the foreign country in which they are established (for this purpose entities subject to the AIFMD are considered as regulated). In principle, the supervision requirement is satisfied when either the entity itself or the relevant management company is subject to supervision by the competent foreign regulator (Reply No. 125/2021).

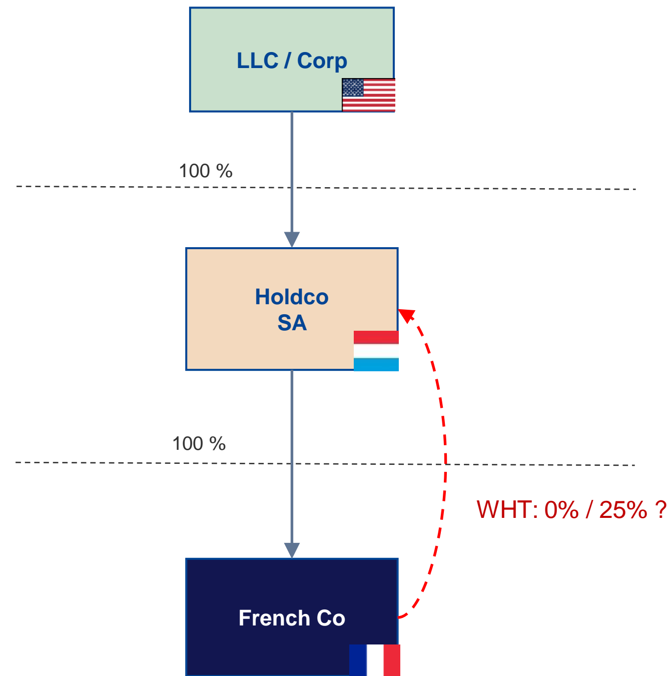
- Non-EU banks are eligible for the WHT exemption only if their financial activity is carried out through a permanent establishment in the EU (Reply No. 839/2021).

Borrowers: guidelines by the ITA

- Pursuant to Article 26(5-bis), "*borrowers*" must be: "*companies, commercial entities, individual entrepreneurs, and permanent establishment of foreign entities*", *i.e.* entities carrying out an entrepreneurial activity in Italy.
- Holding companies fall in the scope of such definition (Resolution No. 76/2019).
- Conversely, Italian UCIs and SICAFs are not eligible for the WHT exemption (Reply No. 98/2019).

Beneficial Ownership Considerations

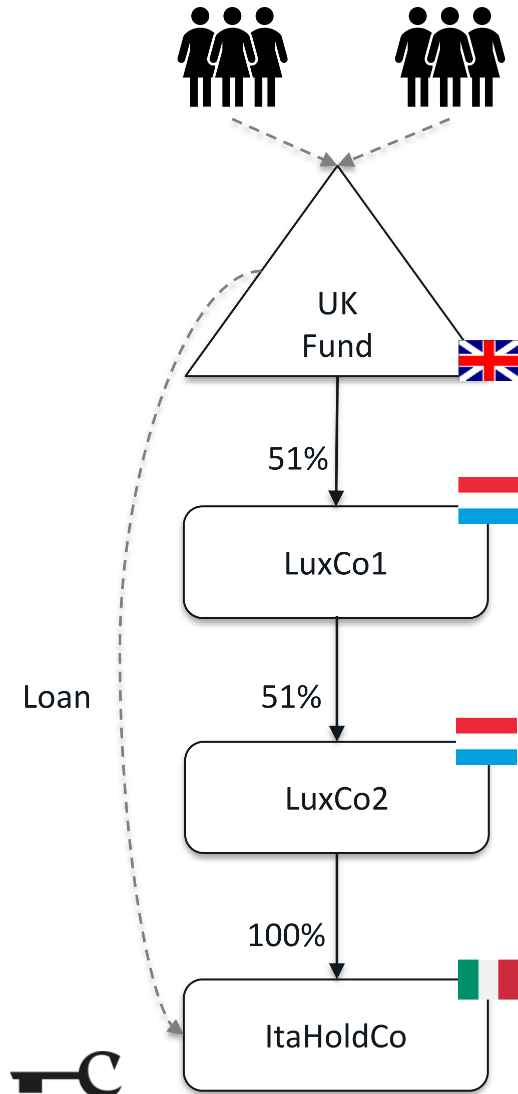
BENEFICIAL OWNER AND RESIDENCE – INCREASED LEAKAGE RISKS IN PRACTICE FOR CROSS BORDER FINANCING STRUCTURES



- The beneficial owner test is autonomous and applies irrespective of any PPT challenge (CE 5 February 2021 – Performing Rights Society)
- Beneficial ownership is a factual assessment: increased risk of challenge by FTA
- Possible to apply the DTT with the beneficial owner i.e. triangular situation (CE 20 May 2022 – Ste Planet)
- Tendency of the FTA to challenge the seat of management to deny benefit of EU Directive (and DTT) even when the decisions are made locally if the company has only a “fiduciary substance” and the decisions are prepared abroad (CAA Paris 14 October 2021 n° 20PA03918 ; CE (na) 21 July 2022 n° 459455 / TA Paris 7 December 2022, n°1921855 SAS Cofima)

Beneficial ownership: ITA’s resolution No. 76/2019

Regulated fund / intragroup financing



- Several partners provided the UK Fund with financial resources so that the latter **was** able to grant a medium-long-term loan to its indirectly controlled ItaHoldCo.

- Since the WHT exemption requires, *inter alia*, that lenders qualify as white-listed regulated “institutional investors”, the WHT exemption was applicable to the UK Fund irrespective of its quality as beneficial owner of the interest.

- In ITA’s view, the WHT exemption applies to any “recipient” of the interest falling under one of the categories listed by the Article 26(5-*bis*); this provision does not require that such recipient also qualifies as beneficial owner of the relevant income.

- Furthermore, intra-group financings are not in breach of the “regulatory caveat” - and, thus, are eligible for the WHT exemption - even if made through group vehicles without a specific authorization by the regulatory authority (*i.e.*, Bank of Italy).

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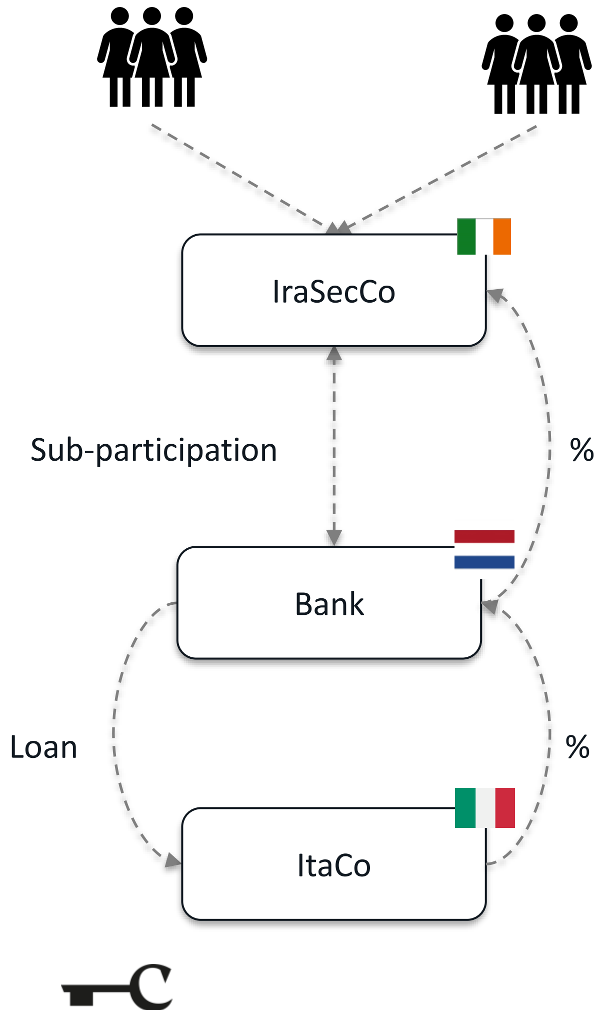
Beneficial ownership: ITA's reply No. 423/2019

Partial sub-participation



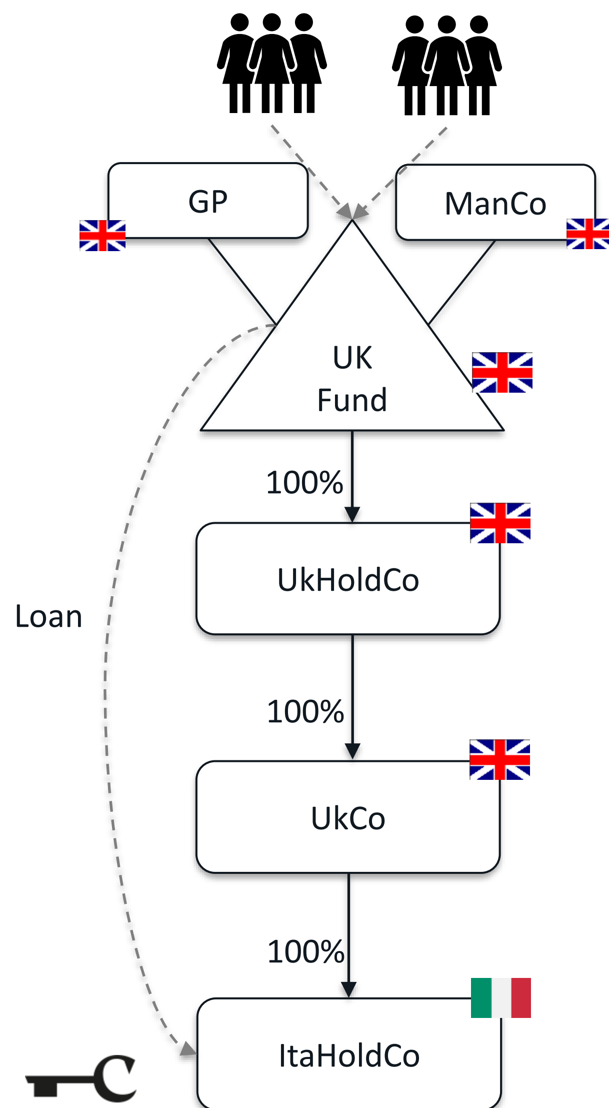
- A Dutch Bank - two years after the disbursement of a medium-long-term financing to ItaCo - concluded a sub-participation agreement with IraSecCo (securitization vehicle) to shift part of the risk of the financing already granted to ItaCo.

- In this scenario, ITA confirmed that the WHT exemption was applicable *vis-à-vis* the Dutch Bank with respect to all interest payments made by ItaCo under the credit facility, since the Dutch Bank, as fronting bank, was the sole "recipient" of such interest, regardless of the fact that the portion relating to the sub-participated tranche was to be on-paid by the Dutch Bank to the IraSecCo.

- A "look-through" approach is not applicable for the purposes of the WHT exemption.

Beneficial ownership: ITA's reply No. 125/2021

Unregulated fund / regulated Manco



- UK Fund and its general partner are not subject to any regulatory supervision in the UK. Conversely, the management company is: (i) authorised to carrying on regulated activities and; (ii) subject to supervision by the UK competent authorities. Against this background, the UK Fund grants a medium-long-term loan to its indirectly controlled ItaHoldCo.

- In ITA's view, the UK Fund can be considered among the "institutional investors" provided that its management company is subject to supervision by the competent foreign regulator.

- Therefore, the WHT exemption applies to any "recipient" of the interests falling under one of the categories listed by the Article 26(5-*bis*) that, instead, does not require that such recipient also qualifies as beneficial owner of the relevant income.

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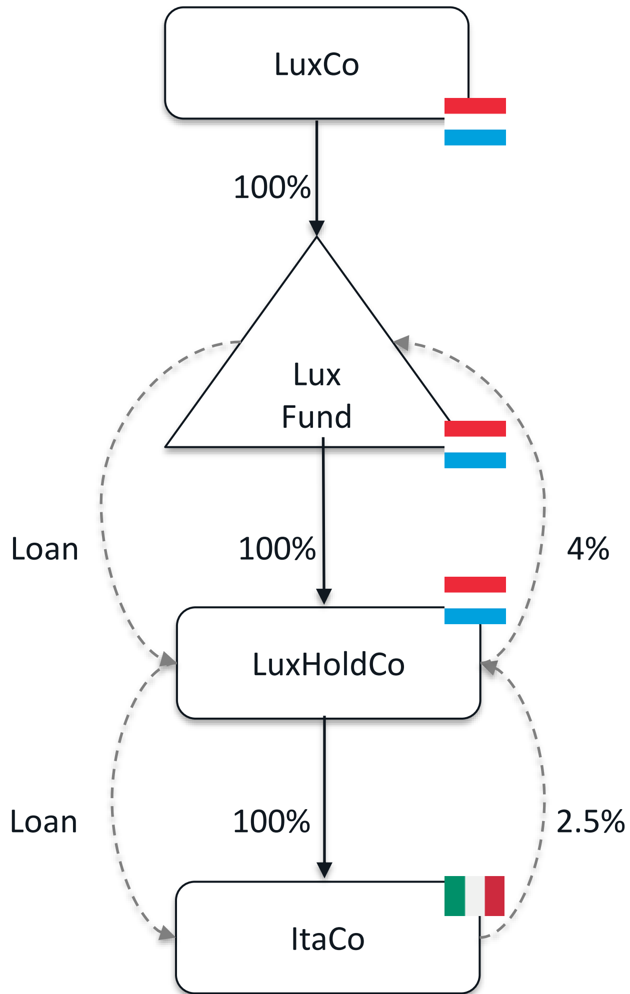
Beneficial ownership: ITA's reply No. 569/2021

Recipient as beneficial owner?



- Lux Fund granted a loan to LuxHoldCo that, in its turn, granted a credit facility to ItaCo. According to the Applicant, a look-through approach was applicable and Lux Fund had to be considered as the beneficial owner of the interest payments for the purposes of the WHT exemption.

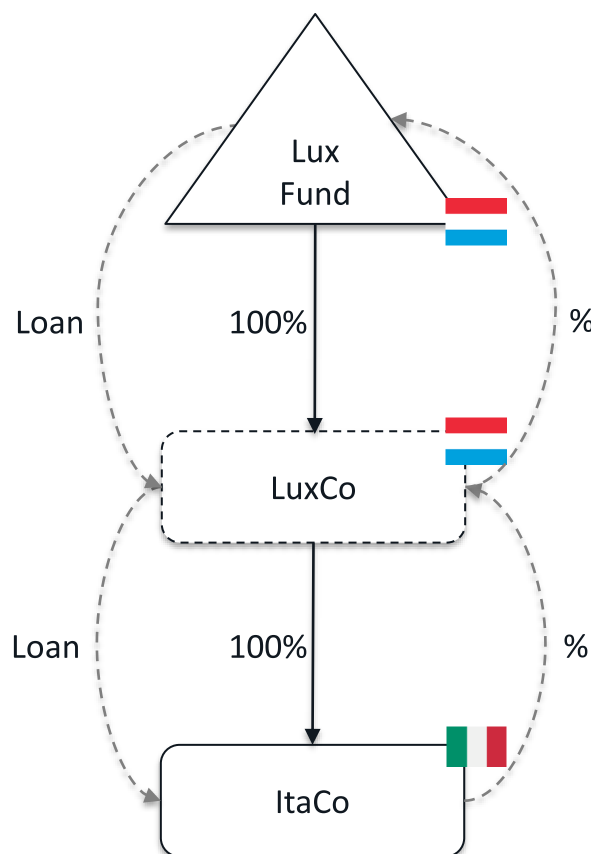
- On the other hand, ITA confirmed that the WHT exemption (i) applies to any "recipient" of the interests falling under one of the categories listed by the Article 26(5-*bis*), and (ii) cannot apply to a beneficial owner of the interest if it is not "also" the direct recipient of that income.

- Moreover, according to the ITA, the financing transaction at stake could not be considered as a single financing from Lux Fund to ItaCo, since the two credit facilities entailed different contractual terms (*e.g.*, different interest rates).

- This position opened a grey area since, on the one hand, it seems to require both the "recipient" and "beneficial ownership" conditions being met by the lender, while, on the other hand, it seems to open for a look-through approach in presence of back-to-back structures with full mirroring of financing conditions (where interest are fully repaid up to chain to the final beneficial owner).

Beneficial ownership: case-law No. 4708/2019 and 3324/2022

Look-through approach



- Lux Fund indirectly granted a loan to ItaCo through its subsidiary LuxCo.
- ITA: LuxCo could not benefit from the exemption as not the beneficial owner of the interest (that was LuxFund).
- Court: Looking beyond the direct recipient of interest is admissible - the WHT exemption is applicable to interest payments by ItaCo to LuxCo even if Lux Fund was not the formal lender nor the direct recipient of interest. Direct and indirect financing should be subject to the same tax treatment with respect to 26(5bis).
- Look-through approach allowed; this may prevent the enforcement of the indemnity and gross-up clauses in the hands of ItaCo.
- In the same sense, see also case-law No. 295/2022.

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Principal Purpose Test Considerations

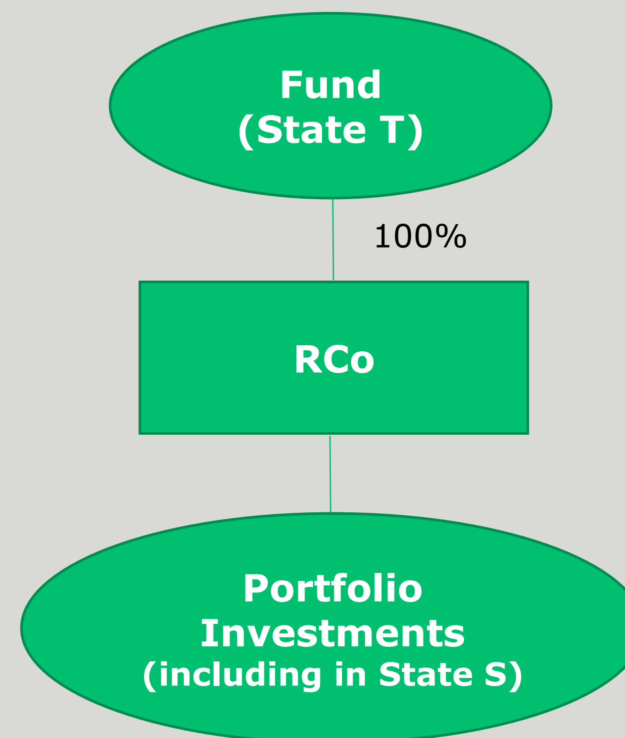
PPT for Non-CIV Funds

OECD Public Discussion Draft on Action 6 – Factors in determining PPT for non-CIV fund

- Context in which investment was made must be considered – availability of experienced directors, skilled multilingual workforce, extensive treaty network, common currency etc.
- Composition of ultimate investor base is relevant –investors entitled to similar or better treaty benefits on a direct investment (although existence of a differential in withholding tax rate on a direct investment vs. investment via non-CIV fund is not of itself sufficient to trigger PPT)
- Diverse portfolio also can be helpful
- Substance in the non-CIV fund also relevant – examples provided look to experienced personnel locally providing management services, experienced board of directors of which the majority are local residents, etc
- Tax treatment of non-CIV fund can be considered – if it is taxed in its own right, that can be helpful

PPT for Non-CIV Funds – Regional Investment Platform Example

- RCo, a resident of State R is a wholly owned subsidiary of a Fund (resident of State T). RCo is the regional investment platform for the Fund.
- RCo makes an investment in State S (among other investments).
- Withholding tax rates for dividends under the R-S Treaty is 5% compared to 10% under the S-T Treaty.
- Conclusion per discussion draft:
  - RCo would not fail PPT



Interpretation of principal purpose test (1)

- Burlington Loan Management DAC v Revenue & Customs Commissioners [2022] UK FTT 290 (TC)
- UK & ROI treaty, Article 12(5)

> *The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this article by means of that creation or assignment.*

Interpretation of principal purpose test (2)

- Whose purpose?
- Meaning of “take advantage”
- Should UK caselaw approaches have been applied in interpreting the UK & ROI treaty?

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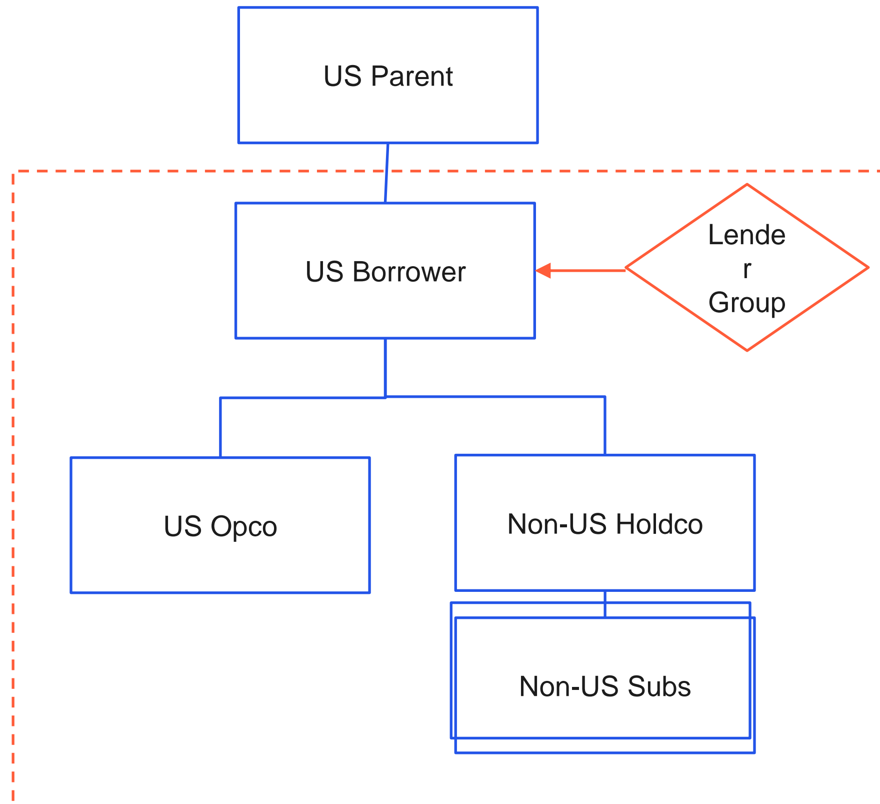
Multi-Jurisdictional Co-Borrower Structures

Scenario 1a – US Parented Group --US Borrower -- Non-US Credit Support

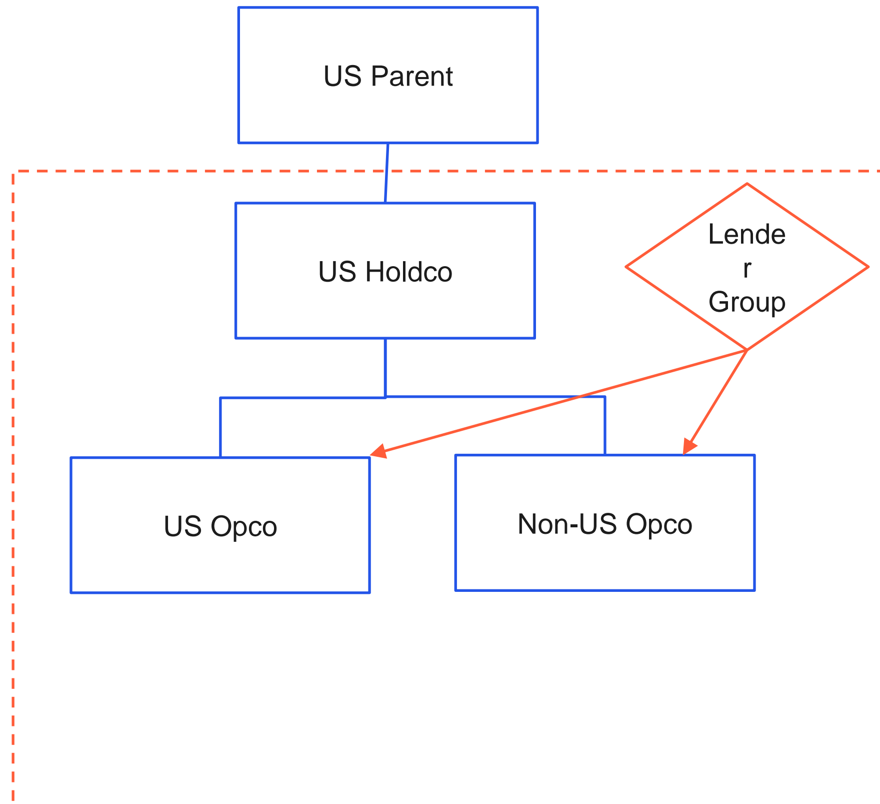


- US parent borrower; credit support (guarantees and pledges) from all subsidiaries; additional parent providing single point of enforcement not shown
- Proceeds either pushed down as intercompany debt or as intercompany equity.
- Debt service through dividends or intercompany interest payments.

t**Considerations**

- Does IRC Section 245A permit efficient credit support from non-US subsidiaries?
  - Absent relief from IRC Section 245A, IRC Section 956 causes deemed dividend inclusion by US Parent Group of Non-US sub "earnings and profits" in value of credit support.
    - Historically solved by no guarantee; pledges limited to 2/3 of voting stock of Non-US Holdco.
    - GILTI inclusions counted first; high-tax kick-out may mean no such inclusions.
  - Regulations under IRC Section 245A permit deduction for inclusion if certain conditions are met.
    - Hybrid instrument exception.
    - Trap for unwary if non-US subs have historic E&P deficit, then start generating E&P (until E&P is net positive).
- Are there transfer pricing implications (e.g., imputed guarantee fees) that create leakage?
- Is the interest deductible?
- Is there withholding tax on cash used to service the debt?

Scenario 1b – US Parented Group – US and Non-US Co-Borrowers

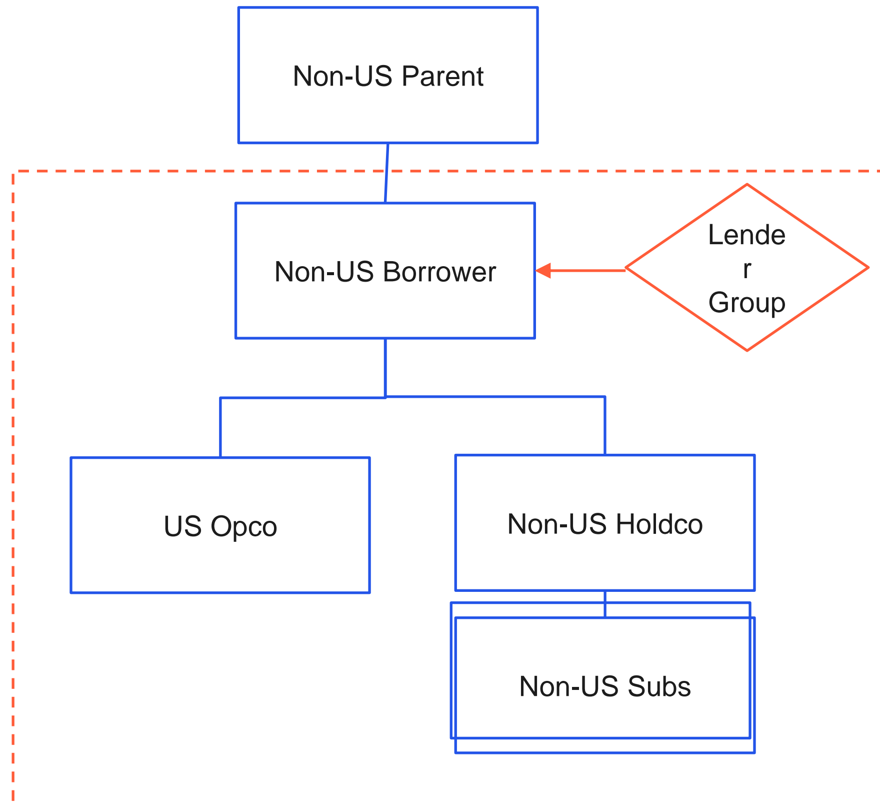


- US and non-US coborrowers; credit support (guarantees and pledges) from all subsidiaries; additional parent providing single point of enforcement not shown
- Debt service generally at operating companies in proportion to amounts borrowed.

t**Considerations**

- Same IRC Section 245A considerations; however, could consider a ring-fenced facility where the US group guarantees the non-US debt but the non-US subsidiaries only support the US debt to the extent of a 66 2/3% pledge of voting stock.
  - Very tricky to get correct; subject to IRS challenge
- Are there transfer pricing implications (e.g., imputed guarantee fees) that create leakage?
- How do you size the debt?
- Is the interest deductible?
- What happens if debt service needs to come from a different silo?

Scenario 2a – Non-US Parented Group, Non-US Borrower, Global Credit Support

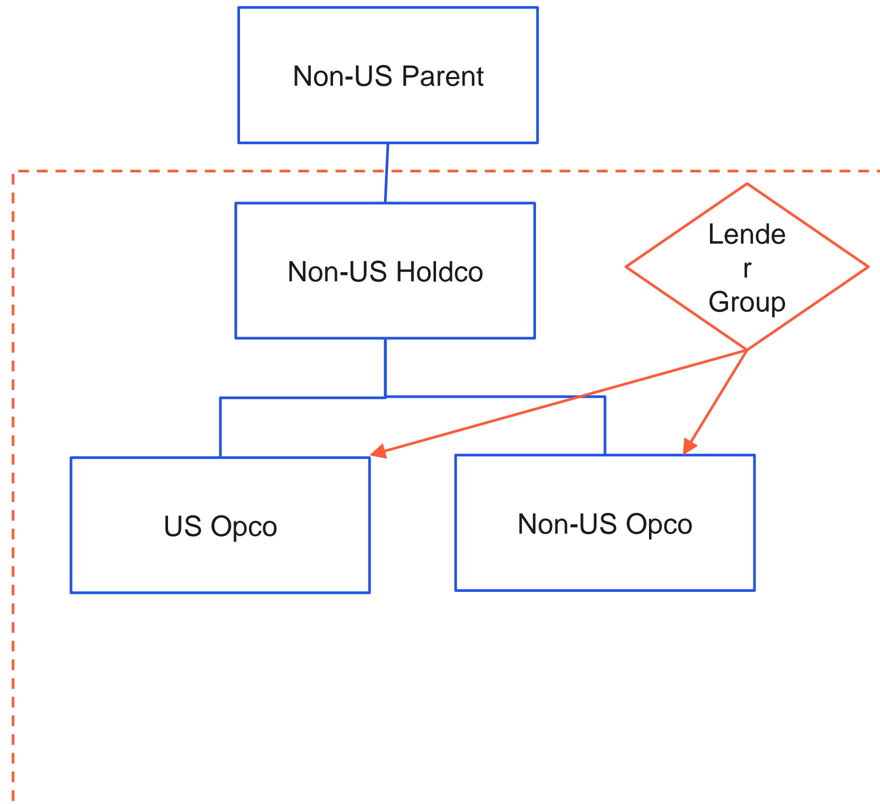


- Non-US parent borrower; credit support (guarantees and pledges) from all subsidiaries; additional parent providing single point of enforcement not shown
- Proceeds either pushed down as intercompany debt or as intercompany equity.
- Debt service through dividends or intercompany interest payments.

t**<u>Considerations</u>**

- US Opco may be subject to BEAT depending on how proceeds pushed into group and size of group.
- Are there transfer pricing implications (e.g., imputed guarantee fees) that create leakage?
- Is the interest deductible?
- Is there withholding tax on cash used to service the debt?

Scenario 2b – Non-US Parented Group – US and Non-US Co-Borrowers

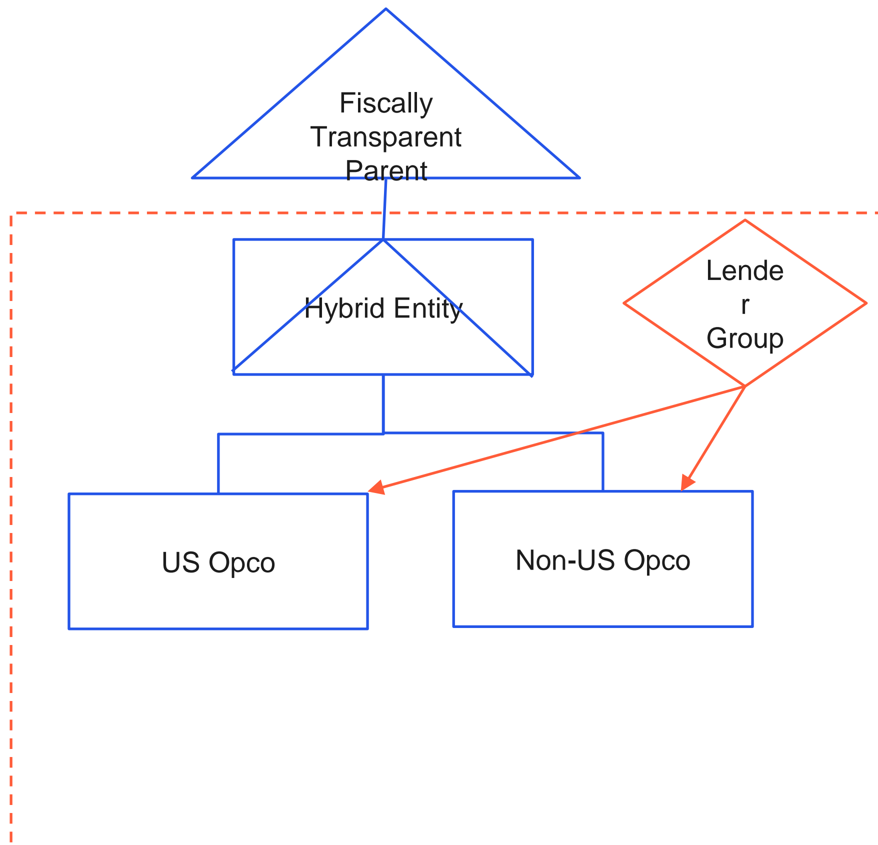


- US and non-US coborrowers; credit support (guarantees and pledges) from all subsidiaries; additional parent providing single point of enforcement not shown
- Debt service generally at operating companies in proportion to amounts borrowed.

t**Considerations**

- Are there transfer pricing implications (e.g., imputed guarantee fees) that create leakage?
- How do you size the debt?
- Is the interest deductible?
- What happens if debt service needs to come from a different silo?

Scenario 3 – Fiscally Transparent Parent



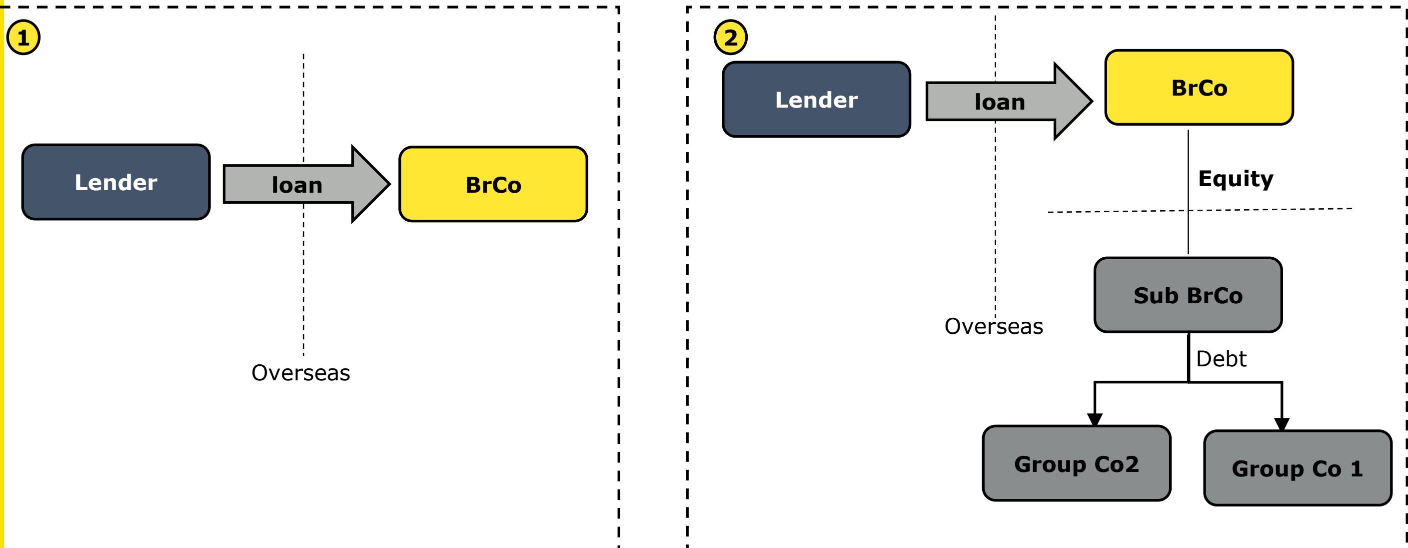
- Flow-through holding structure from a US perspective. Intermediate entity may or may not be transparent under non-US law
- US and non-US coborrowers; credit support (guarantees and pledges) from all subsidiaries; additional parent providing single point of enforcement not shown
- Debt service generally at operating companies in proportion to amounts borrowed.

tConsiderations

- Transfer pricing implications (e.g., imputed guarantee fees; imputed dividends) that could create leakage?
- How do you size the debt?
- Is the interest deductible?
- What happens if debt service needs to come from a different silo?

Multijurisdictional Co-borrower Structures

Alternative



Tax Aspects

- Loan Fx variantions are taxable and deductible on a cash basis as a rule (accruel may be elected).
- Equity pick up fx variation is tax neutral.
- In a scenario of Br currency devaluation the structure offers a hedging effect with lower tax impact.
- In Br currency valuation scenario the tax impact is adverse.

FX Tax Regimes

Tax Regimes

1. Cross border debts and credits
   - Brazilian company perspective: losses are deductible, and gains are taxable
     - Cash regime as a rule // accrual regime may be elected
   - Overseas lender / borrower: FX variations are tax neutral.

   Cash regime as a rule // accrual regime may be elected Overseas lender / borrower: FX variations are tax neutral

2. Equity investments
   - Brazilian investors' perspective: FX variations on equity are tax neutral
   - Foreign investors' perspective: FX variations (gains) – controversy

Co-borrower structures: UK interest WHT (1)

- General obligation to withhold UK tax from cross-border payments of yearly interest arising in the UK
- "Source" requires a multifactorial assessment (*National Bank of Greece, Ardmore, Perrin*)
  - Residence of debtor and location of debtor's assets
  - Place of performance of contract
  - Method of payment: true origin of funds
  - Proper law and competent jurisdiction for enforcement
  - Residence of guarantor and location of security

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Co-borrower structures: UK interest WHT (2)

- Cash flow considerations
  - direct payment by UK co-borrower
  - indirect payment by UK co-borrower via non-UK co-borrower
- Origin of funds
  - UK operating profits, UK real estate rents, dividends from UK companies
  - Relevant to non-UK payors too
- Reliance on Quoted Eurobond exemption
  - Bond must be issued by a company

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Debt Push-Downs and Debt Location

Financing for equity buy-backs or dividends & debt-push-down structures

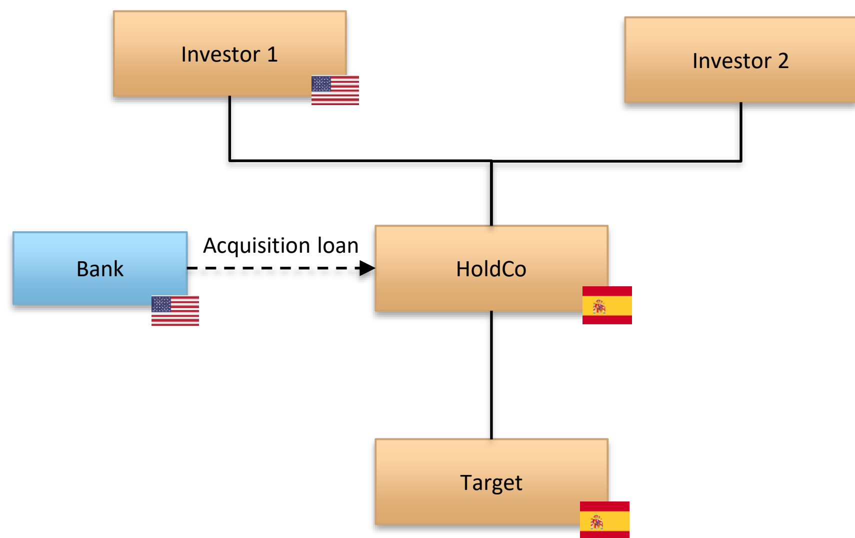
Historical challenges

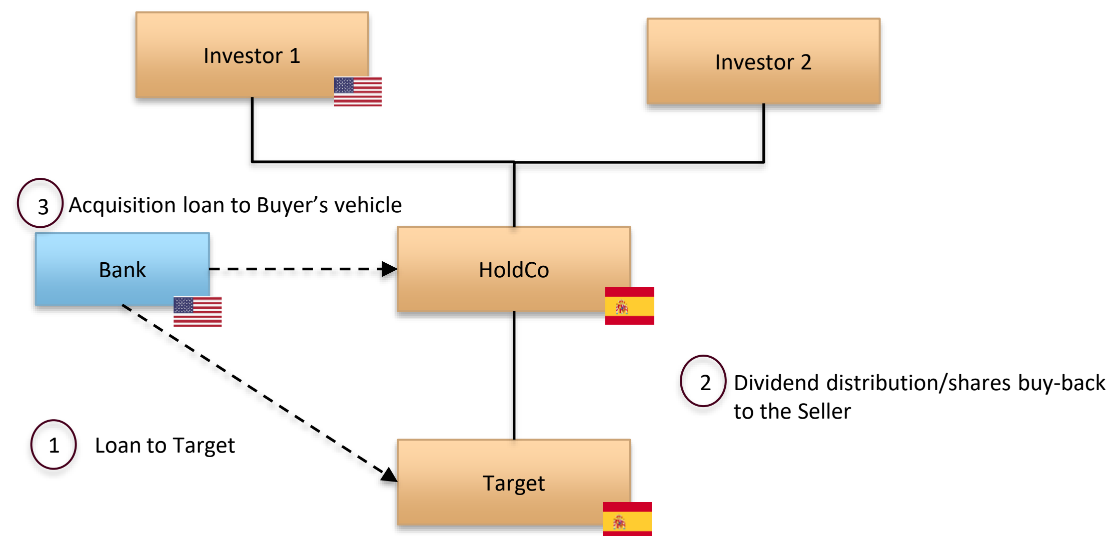
- Although there were some favorable tax rulings, the Spanish tax authorities have been challenging interest deductibility for debt structures connected to equity transactions, mainly dividend distributions, share premium distributions, shares buy-backs and capital reductions.
- Arguments to challenge these transactions:
  - Interest was considered a gift, since the expense was not connected to the company's activity (in terms of income generation) but assumed in benefit of the shareholders; and
  - Interest was considered equity payment.
- These criteria were validated by some Spanish courts.
- In 2021, the Spanish Supreme Court issued a resolution allowing deductibility in a shares-buy-back structure.

Current situation

- In July 2022, the Spanish Supreme Court issued 3 resolutions stating that:
  - Interest payments cannot be considered a gift, since there is no *animus donandi* on its payment;
  - The connection between expenses & income should be general and not direct. Financing allows the entity to preserve company's assets or wealth; and
  - The interest should not be considered equity payment.
- They do not solve situations where the equity becomes negative after the transaction.
- It does not preclude the possibility of considering the existence of abuse. In September 2022, the Spanish committee that evaluates the existence of abuse in the framework of tax audits published a resolution denying the deductibility of interest in an equity transaction where the equity distributed had been registered as a consequence of a previous restructuring transaction.

Financing for equity buy-backs or dividends & debt-push-down structures

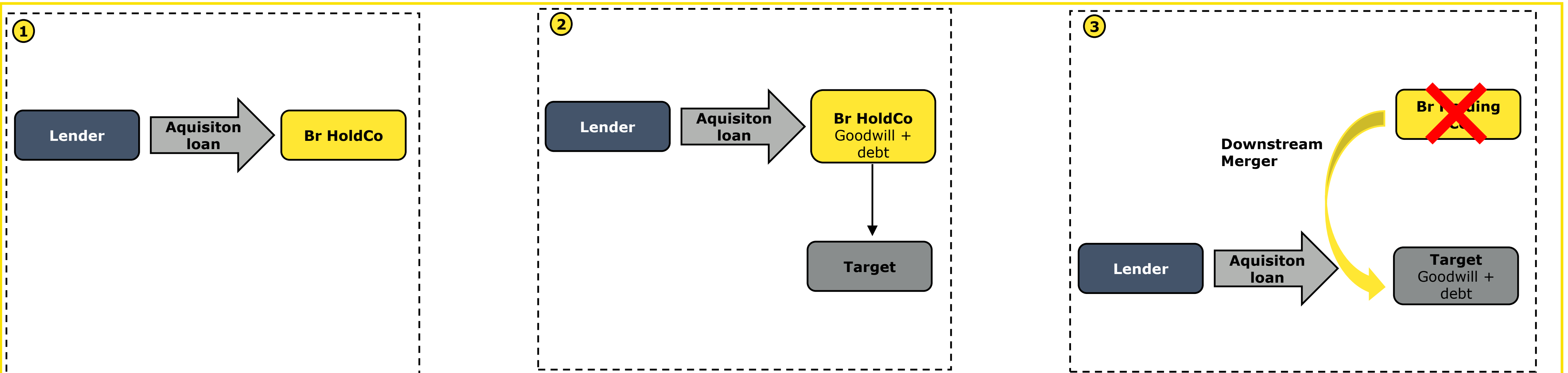




- Optimal structure for the Buyer
- Debt push down under the Spanish tax consolidation regime
- Spanish HoldCo should be founded on business reasons
- The bank should have a pledge over shares in target (HoldCo) but not direct recourse on the Target assets

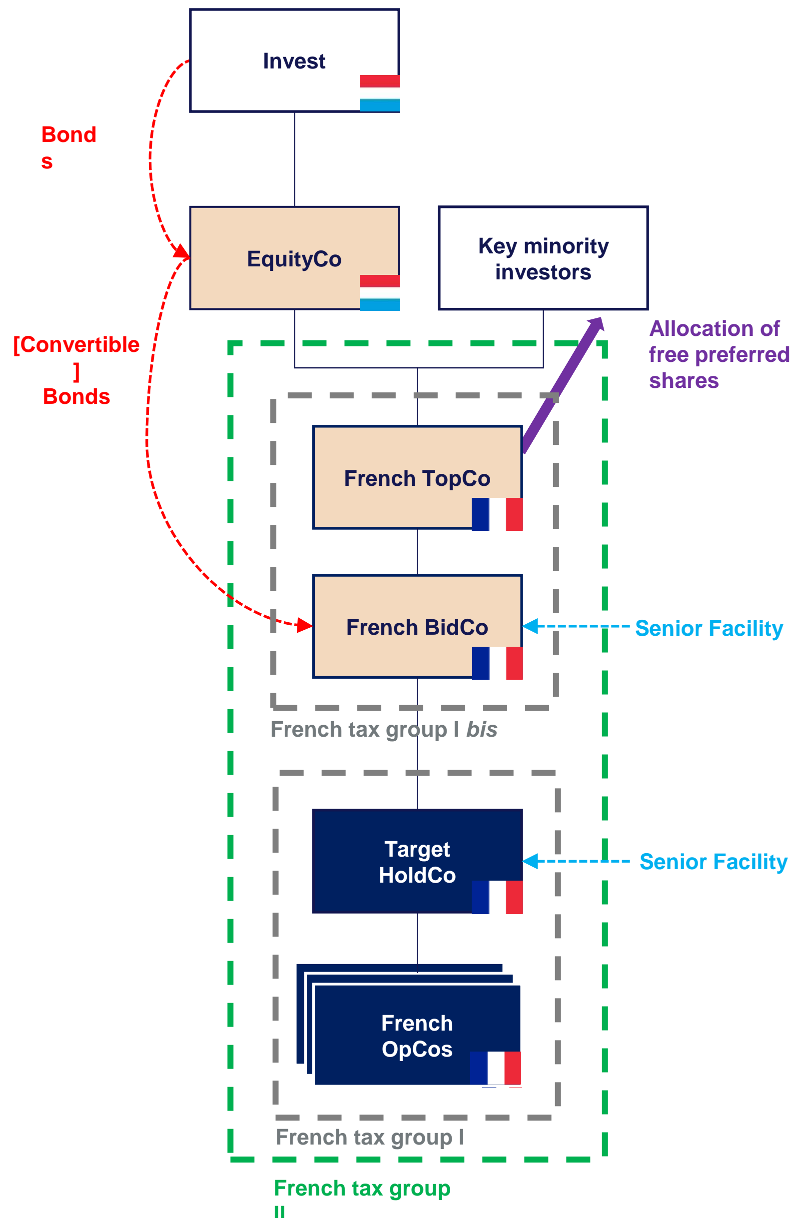
- Optimal structure for the Buyer and for the bank that will have direct recourse over the assets
- Debt push down under the Spanish tax consolidation regime + direct loan to the target
- Spanish HoldCo should be founded on business reasons.
- Loan to target cannot be higher than its equity value

Acquisition Financing – Debt Push Down

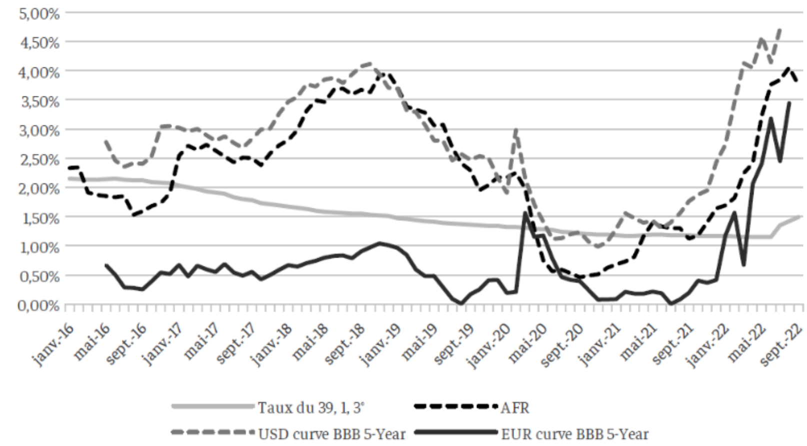


Comments	Tax Aspects
• Debt Puhs Down is usual in o Leveraged buyout ("LBO") where the acquirer registers goodwill eligible for tax amortization . • Merger is a requirement for goodwiil amortization. • Downstream merger entitles goodwill amortization and results in debt push down.	• Expense deductibility test: linkage between expense and future Generation of revenues (expenses shall be deemed "needed" within the bussiness context of the company). • Controversy: expense "needed" for acquisition continues to be "needed" after downstream merger in the context of target´s operation? When does the test shall be applied? • Effects of the merger: legal succession. • Relevant court cases: Atento, Atacadão and Biosev.

DEBT PUSHDOWN – TYPICAL FINANCING STRUCTURE FOR FRENCH TARGET

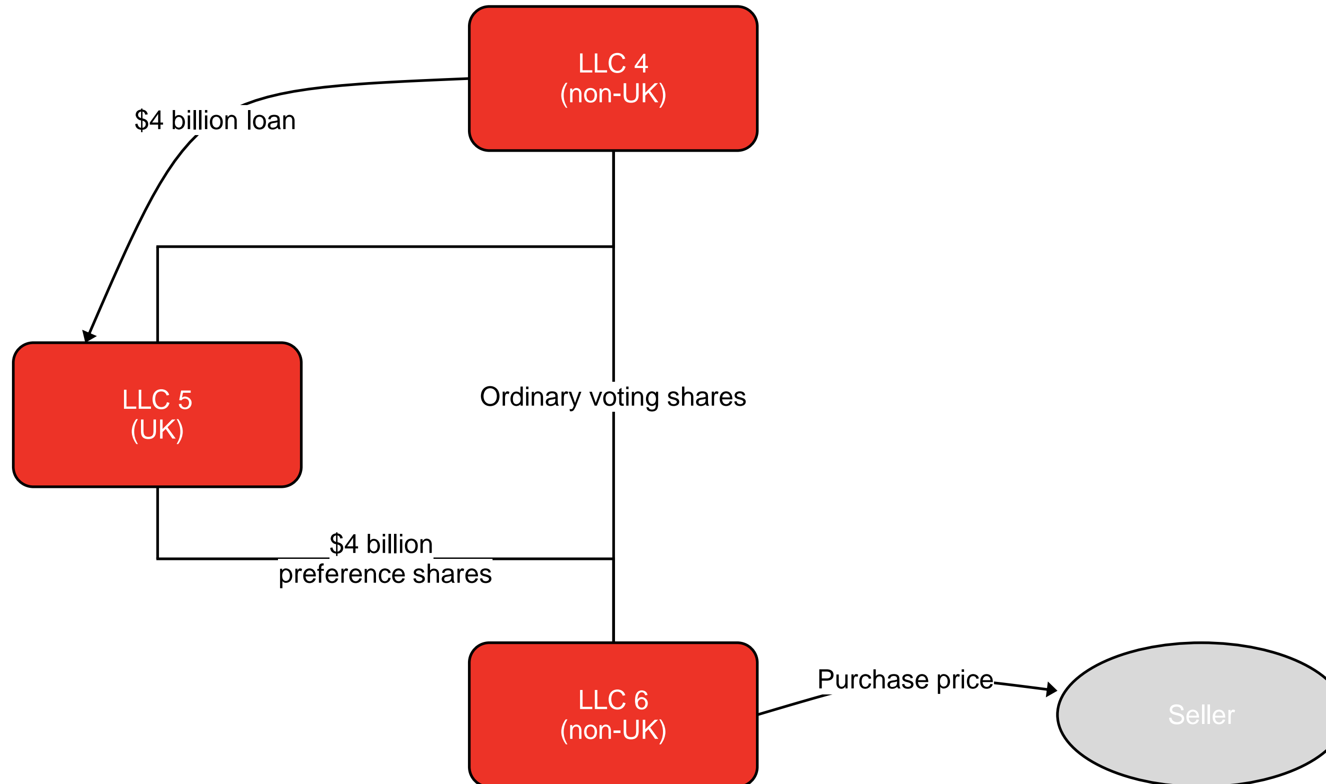


- No withholding tax on French source interest except if paid to a non-cooperative State or territory
- Justification of the arm's length character of the interest on intragroup loans (Art 39,1,3°) / incentive for co-borrowers structure



- Value of convertible bonds depends on who owns them (CE 16 November 2022 – EDF International)
- How to assess the joint control over the purchaser to apply the anti-debt pushdown rules within a tax consolidated group? (CE 6 December 2021 – Financières des Eparses)
- PPT and debt pushdown: distribution of retained earnings financed by bond redeemable in shares (CE 13 January 2017 – 19 July 2017)

Internal debt funding for external acquisition



LLC 5 case: key issues

- Transfer pricing
  - Importance of covenant support
  - Implications for intra-group debt documentation
- Unallowable purpose
  - Both commercial and non-commercial (i.e. tax) main purposes found as fact
  - Allocation between the two: what is just and reasonable?
- Unfinished business

Distressed Debt Considerations for Distressed Acquisitions

Irish Section 110 companies
-
Acquiring NPL portfolios across Europe

ATAD I and II

Anti-Hybrid Rules

Deduction of interest on PPN denied if:

- Notes give rise to deduction without inclusion mismatch outcome (i.e. hybrid instrument)
- Noteholder is an "associated enterprise" (if orphan SPV, consolidation / board representation)
- No inclusion at Noteholder level

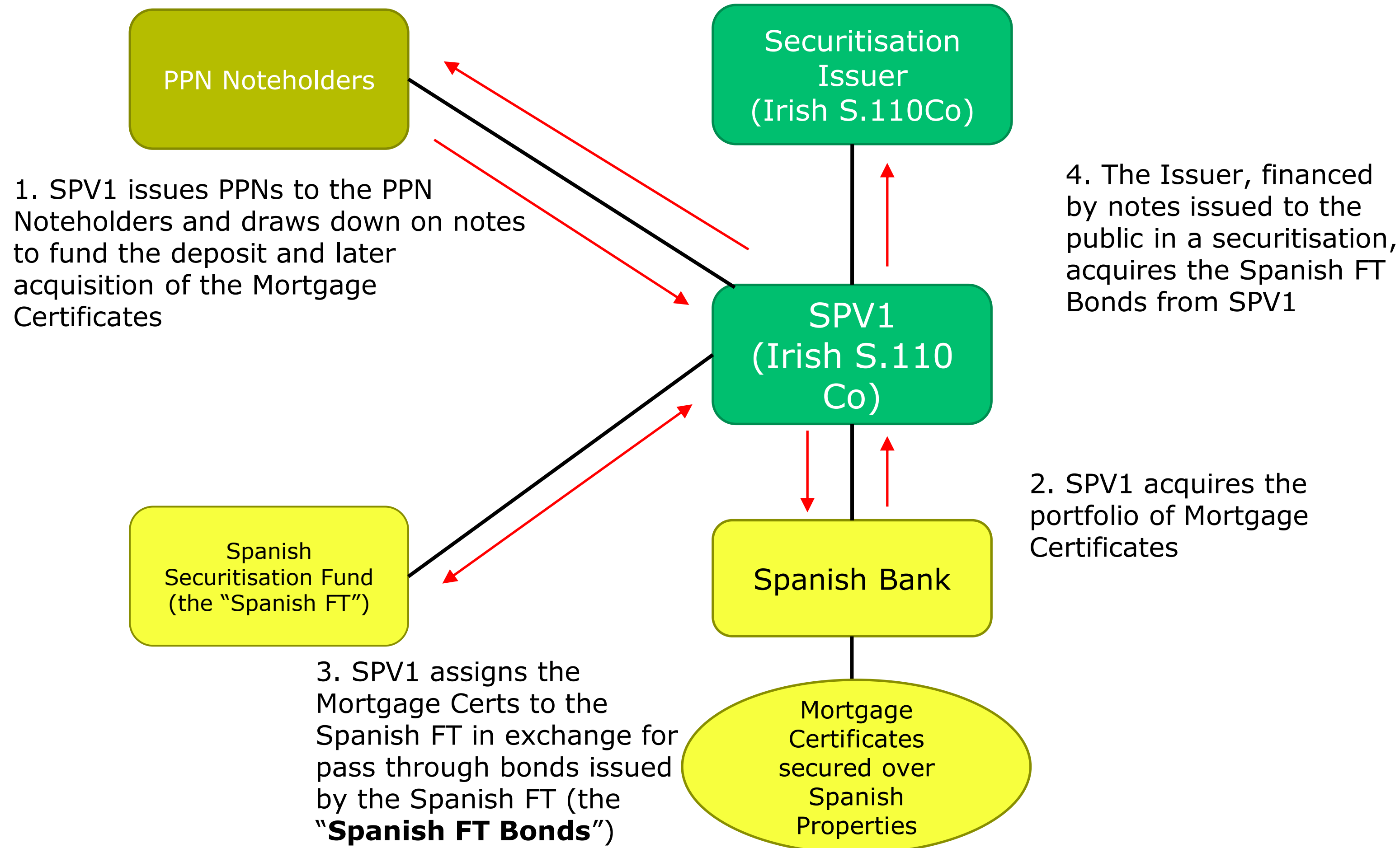
Deduction also denied if "structured arrangement" (mismatch outcome priced in / arrangement designed to give rise to a mismatch outcome)

Interest Limitation Rules

Restricts deductibility of net interest expense to 30% of EBITDA

- Exemptions include:
  - PPN issued before 17 June 2016
  - Net interest is less than €3 million per year
- Equity escapes for "single company worldwide group" – requirement:
  - not a member of a consolidated group (for accounting purposes)
  - no "associated enterprises" hold debt

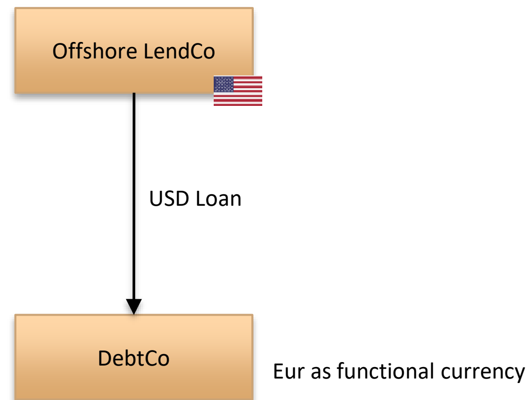
Spanish Mortgage Securitisation Structure via Irish S.110 Cos



Tax Considerations include:

- Spanish WHT
- Deductibility of interest at SPV1 and Issuer level:
  - Anti hybrid rules
  - Interest limitation rules

Currency exchange & debt issues



- If Eur is functional currency of DebtCo → yearly currency exchange differences on the loan will have a taxable impact on DebtCo P&L
- If USD is functional currency of DebtCo → DebtCo will register conversion differences directly in the equity, i.e. not yearly taxable impact on P&L
- Functional currency is not an option. The currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash and assumes risks.
- Conversion differences registered in the equity of DebtCo will be transferred to P&L upon liquidation, spin off or any transaction that implies an investment recovery for DebtCo shareholder

Questions?

Thank you!