

IBA Finance and Capital Markets Tax Conference

Current and developing issues in cross-border finance

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Interest Deduction Limitations
Recent German Developments

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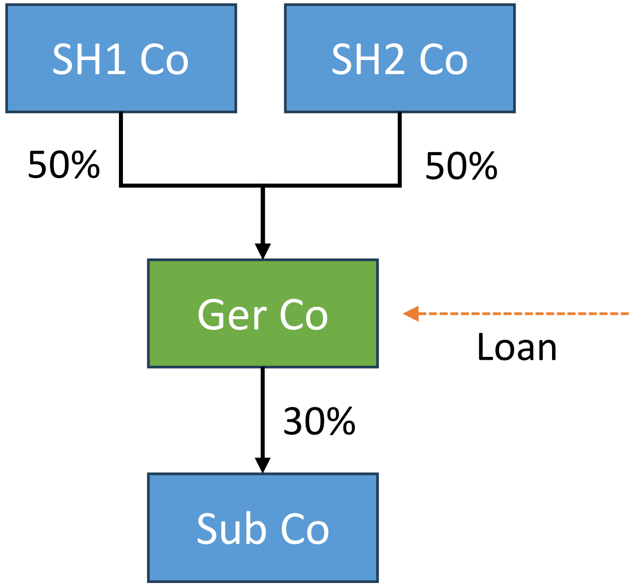
Interest Deduction Limitations – Germany (1)

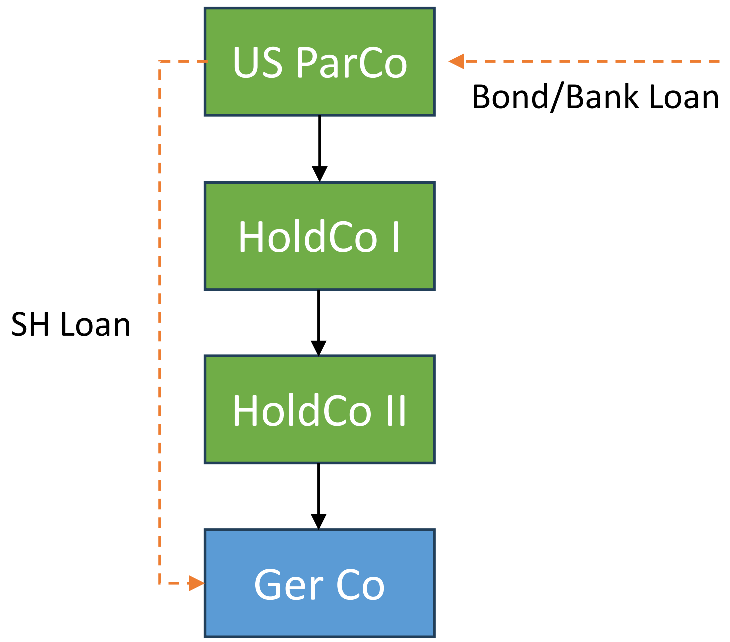
Tightening of Interest Barrier (Zinsschranke) as of 2024



- Interest barrier (Sec. 4h Income Tax Code): limitation of interest deduction to 30% of taxable EBITDA
- Tightening of "stand alone clause" escape
  - Currently, no application of interest barrier if financed entity is not part of group of companies (generally >50% participation)
  - In future, the interest barrier already applies in case of a >=25% participation or maintenance of a foreign permanent establishment
- Broadening of term "interest"
  - Currently only interest on provision of capital
  - In future to include other expenses economically comparable to interest as well as expenses in connection with the procurement of borrowed capital (e.g. arrangement fee)

Interest Deduction Limitations – Germany (2)

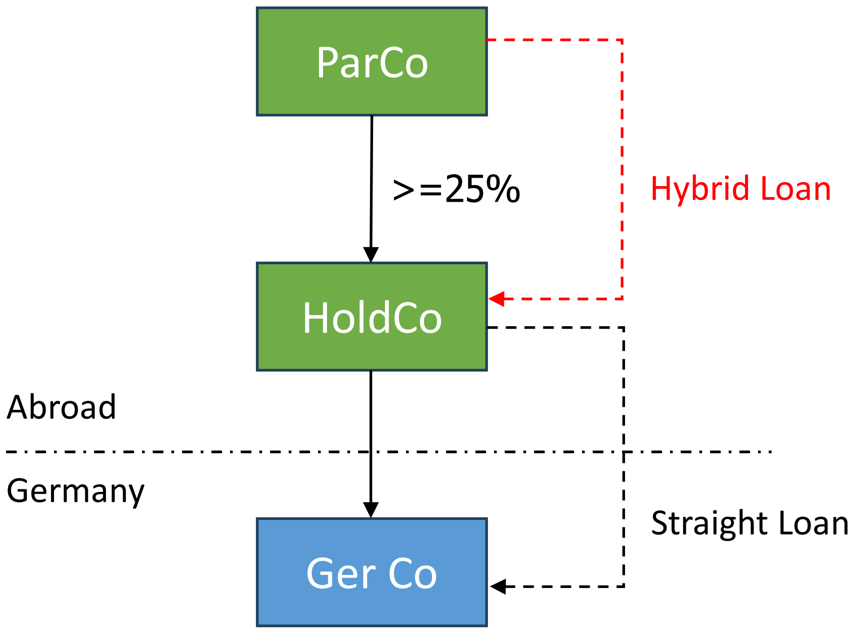
Introduction of new interest rate cap for intra-group financing



- Arm's length interest rate for SH loan generally to be determined based on credit rating of Ger Co
- Proposal for new interest rate cap for intra-group financing (two different approaches are discussed)
- Proposal 1 (Interest Ceiling – *Zinshöhenschranke*):
  - Maximum interest rate at two percentage points above the base interest rate according to German civil law (as of 1 July 2023, the base interest rate is 3.12%, the maximum interest rate would thus be 5.12%), unless taxpayer demonstrates that the ultimate parent company could only have obtained the financing at a higher rate
- Proposal 2 (tightening of arm's length rules for cross-border group financing):
  - Arm's length nature of interest rate to be assessed based on group rather than stand alone rating and financed entity must credibly demonstrate that (i) it needs the financing economically and (ii) will be able to service and repay the loan

Anti-hybrid Rules Highlights – Germany

Broad interpretation of imported mismatches



- “Related party” for anti-hybrid requires only >=25% affiliation
- Imported hybrid mismatch does not require any (economic) link between Hybrid Loan and Straight Loan (!)
- No elimination of mismatch at level of HoldCo or ParCo

Interest Deduction Limitations
Recent Spanish Developments

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Interest deduction limitations - Spain

- **General rule - Corporate Income Tax (“CIT”)**:

  Net financial expenses are deductible
  - capped at the annual maximum limit of 30% of the Operating Profit (the “**30% Rule**”).
  - in all cases, up to €1 million each tax, subject only to transfer pricing requirements.

  - “Operating Profit” → similar to EBITDA
  - “Net Financial Expense” → interest expense borne, net of financial income.
    - Any Net Financial Expenses not deducted in a certain period due to the application of the 30% Rule may be deducted in the subsequent FYs with no time limit, together with those of the relevant FY (being the aggregate sum subject to the 30% Rule).
    - Should the Net Financial Expense accrued during a certain period be below the 30% cap, then the difference between those two amounts will be added to the general cap of the subsequent 5 years, until such difference is deducted for tax purposes

- Special rules (additional limits) on LBO transactions.
- Interest deduction limitations are **not applicable to** credit institutions and insurance companies.
- **Amendments** to the CIT Law to be aligned with the ATAD rules with effect **from January 1, 2024**:
  - ➢ The calculation of the Operating Profit will no longer consider expenses or income that is excluded from the CIT base (i.e. dividends eligible for the application of the participation exemption).
  - ➢ **Securitization funds will no longer be excluded** from the application of the 30% Rule.

Interest Deduction Limitations
Recent UK Developments

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Overview

- UK company generally eligible for tax relief for interest and other finance costs.
- But numerous restrictions may apply, depending, potentially, upon:
  - purpose of borrowing (e.g. whether actuated by tax avoidance motive);
  - quasi-equity features of borrowing (e.g. convertibility, results dependent interest and lengthy (≤50 years) term to maturity); or
  - structural limitations on deductibility, i.e. under UK's corporate interest restriction or "CIR" rules.
- This is a complex area, therefore, which frequently changes, including as regards the recent developments covered in the following slides.

Development 1: increase in UK corporation tax rate

- Increase in UK’s main CT rate from 19% to 25% in April 2023 means restrictions on interest deductibility more costly than before.
- UK has introduced full expensing regime for expenditure on certain types of plant and machinery to mitigate rate rise.
- But there has been no relaxation of restrictions on interest deductibility, and none seems likely at present.

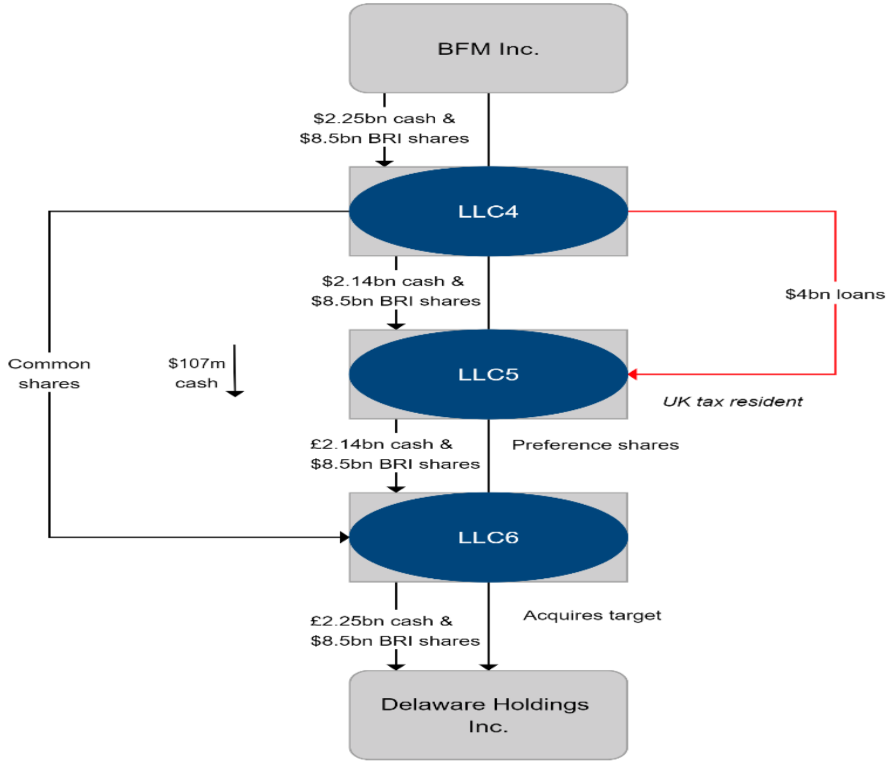
Development 2: unallowable purpose rules

- UK company denied tax relief, potentially, if its main purposes for being party to loan include securing of tax advantage.
- Previously, these unallowable purpose provisions were seen by some as relatively “toothless”.
- But have now morphed into powerful HMRC weapon against tax-motivated parking of debt in UK, i.e. regardless of headroom under CIR regime.
- Recent developments include *Blackrock* and *JTIAC* cases, which at present fully endorse HMRC’s expansive approach to provisions.
- Another recent development is HMRC’s updating of guidance on rules, which may modify potential harshness of caselaw *to some degree*.
- However, provisions may be an obstacle to UK tax relief for finance costs in certain cases, e.g. as regards tax-motivated debt pushdown into UK.

Blackrock case [2022] UKUT 00199 (TCC)

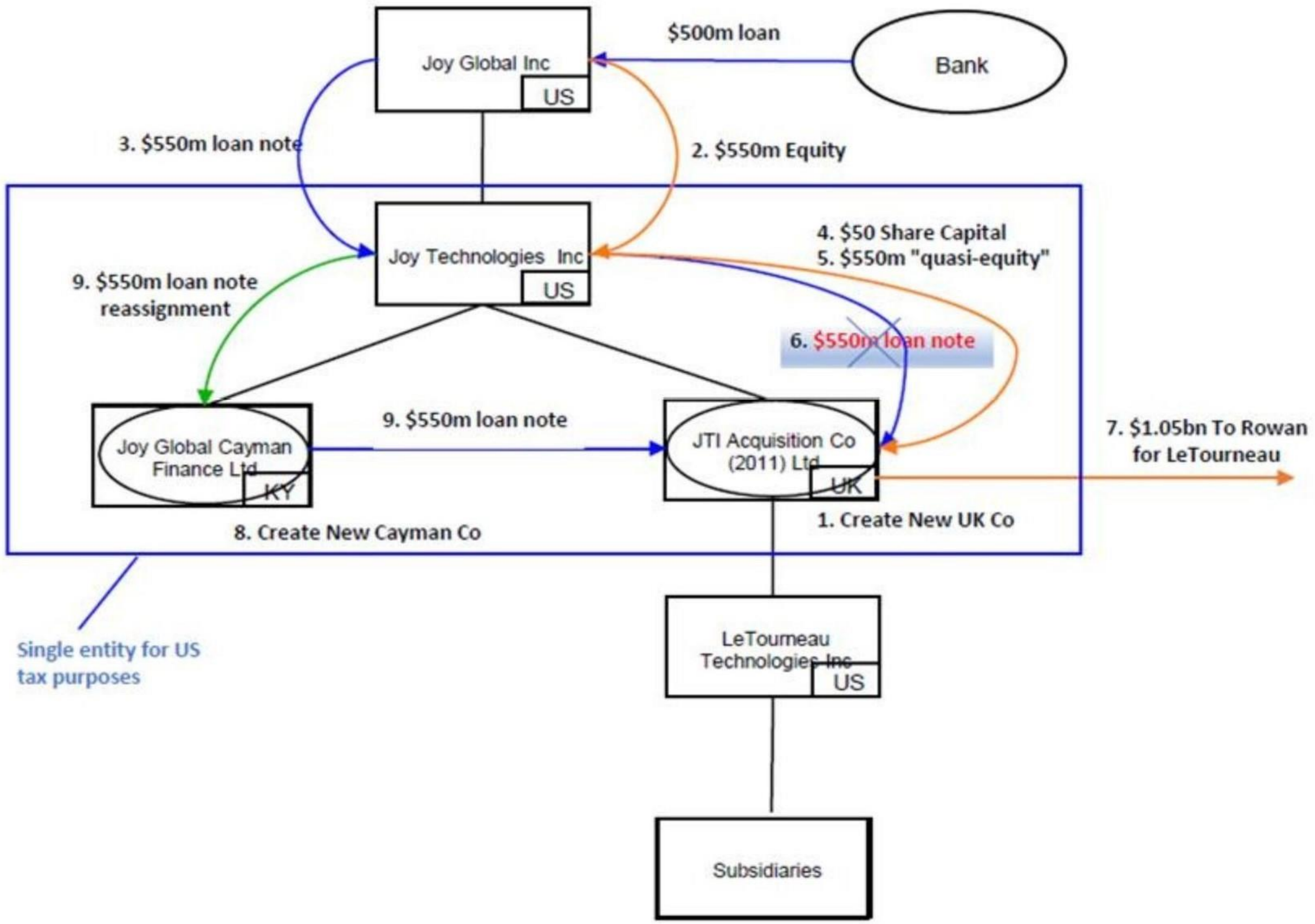
- In connection with acquisition of target group, LLC 4 contributed cash and shares to LLC 5 in return for ordinary shares and loan notes totalling $4 billion.

- UK Upper Tribunal has denied tax relief for interest expense under $4 billion debt under both UK's transfer pricing rules and UK's unallowable purpose provisions since, in latter case, creation of debt between LLC4 and LLC5 was held to be primarily UK-tax-motivated.



JTI Acquisition ("JTIAC") case [2022] UKUT 194 (TCC)

- JTIAC fact pattern has similarities with Blackrock.
- Crucial difference was that UK SPV (JTI Acquisition Co) borrowed to fund acquisition of target group from third party purchaser for arm's length price, albeit from originally parent company.
- But result so far nevertheless the same. Because UK SPV and intragroup debt it borrowed held to be created for predominantly tax reasons, no tax relief for interest under unallowable purpose rules.



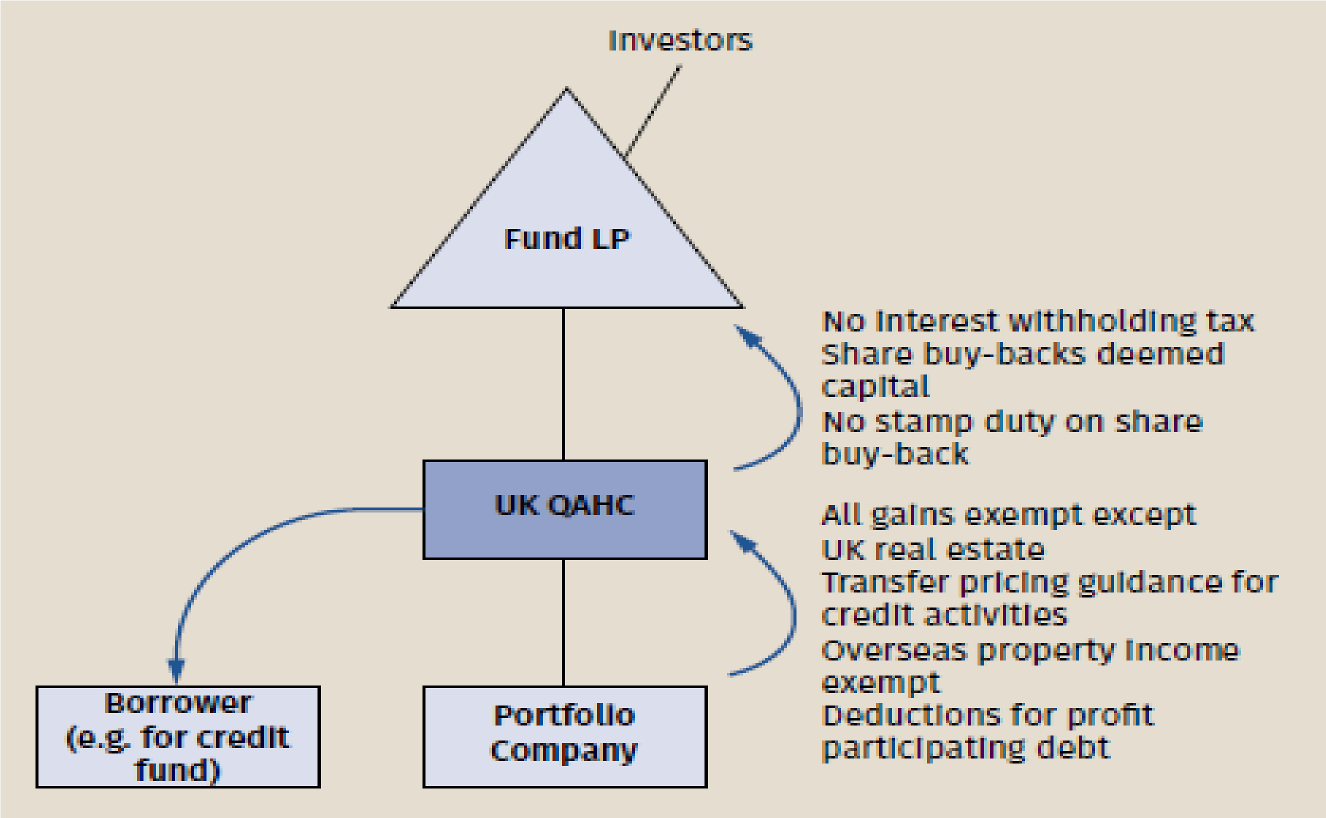
Development 3: reform of UK's TP/thin cap rules

- UK's thin cap rules contained within wider transfer pricing rules.
- But, otherwise, they ask the usual questions in this area.
  - Would loan have been made absent connection, at what rate and on what other terms?
- HMRC have recently consulted on reform of rules, e.g. in relation to:
  - aligning rules more closely with OECD approach;
  - removing participation condition or broadening it to encompass parties (e.g. major creditor) exerting "excessive influence or control" over others; and
  - limiting rules to UK-UK transactions that create net UK tax advantage.
- Significant changes to the rules seem likely, therefore, and in ways that won't always favour the taxpayer.

Development 4: UK’s QAHC regime

- UK has recently enacted qualifying asset holding company or “QAHC” regime to facilitate establishment of investment fund AHCs in UK.
- Regime generally ensures QAHC’s tax neutrality in UK, e.g. through tax exemptions on most forms of income and gains.
- However, crucial part of this intended tax neutrality is relaxation of interest deductibility restrictions for UK QAHCs.
- E.g. QAHCs escape certain aspects of UK’s distribution and anti-hybrid rules that might deny tax relief in respect of profit participating debt.

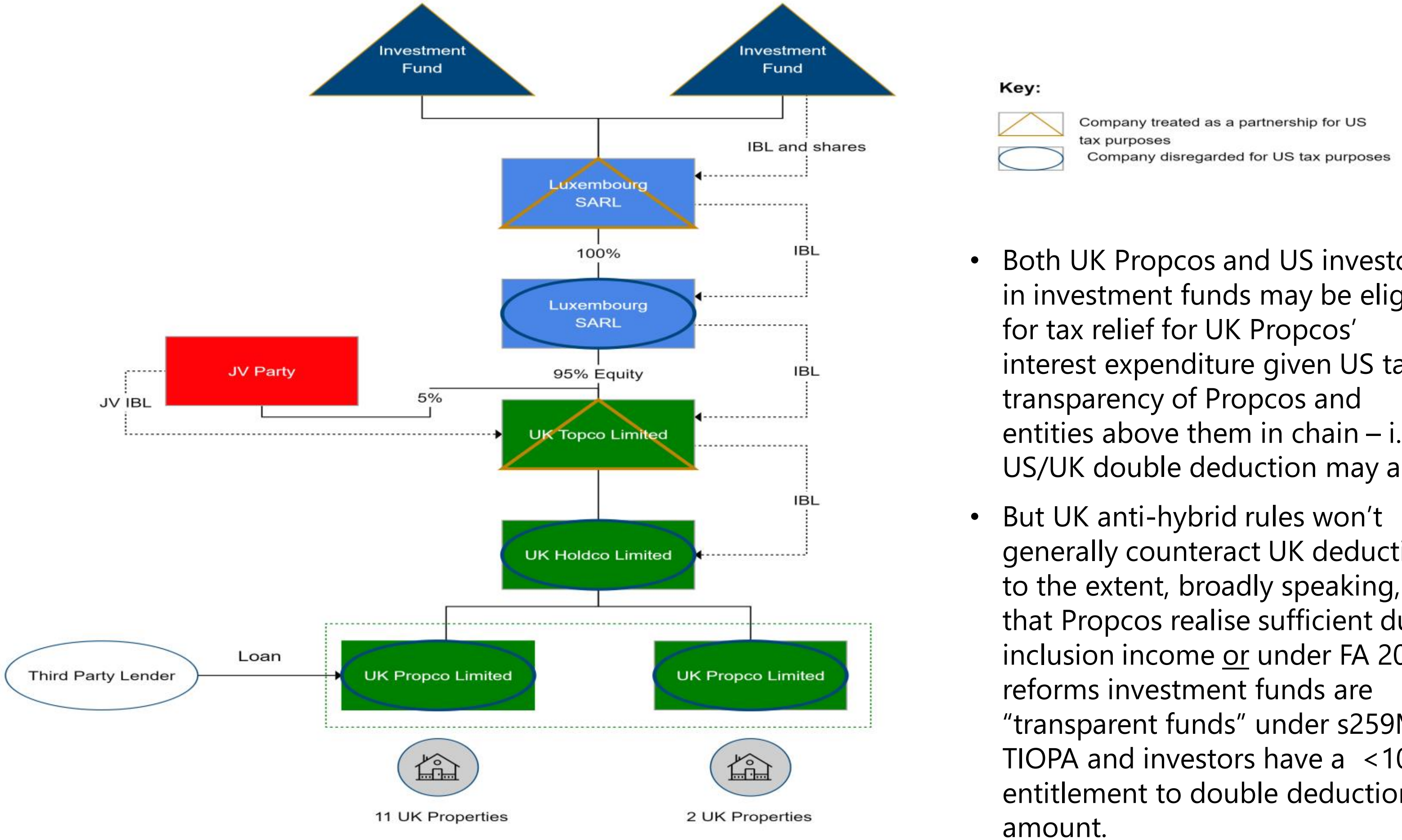
Standard QAHC structure



Development 5: reform of CIR and hybrid regimes

- UK has both anti-hybrid and corporate interest restriction rules, latter of which may deny interest deductibility above a % of "tax-EBITDA".
- Important reforms, however, have been made to both sets of rules in recent years, the UK's anti-hybrid rules, in particular.
- Reforms to hybrid rules include:
  - making it less likely that rules will apply to arm's length borrowings, including as regard "double deduction trap" (next slide); and
  - making imported mismatch rules easier to apply, i.e. by asking whether overseas mismatch jurisdiction is *generically* "OECD mismatch compliant".

The double deduction trap



- Both UK Propcos and US investors in investment funds may be eligible for tax relief for UK Propcos' interest expenditure given US tax transparency of Propcos and entities above them in chain – i.e. a US/UK double deduction may arise.
- But UK anti-hybrid rules won't generally counteract UK deduction, to the extent, broadly speaking, that Propcos realise sufficient dual inclusion income <u>or</u> under FA 2021 reforms investment funds are "transparent funds" under s259MC TIOPA and investors have a <10% entitlement to double deduction amount.

Australia

Elissa Romanin
MinterEllison

Important changes to Australian thin capitalisation regime <

Reform from assets to earnings-based tests <

Introduction of new debt creation rules <

Australian thin capitalisation regime: state of play

Existing thin capitalisation regime

- Assets-based 60% safe harbour debt test
- Alternative worldwide gearing debt test and arm's length debt test

Proposed new thin capitalisation rules

- New earnings-based and other tests
- Transfer pricing rules require both quantum of debt and terms (including interest rate) of debt to be arm's length
- New 'debt deduction creation rules' (DDCR)
- Amendments will materially impact all multinational companies with debt funding that have Australian entities with foreign owners or foreign subsidiaries

Expected timeline

- Advanced draft legislation currently being considered by Senate committee
- Once enacted, thin capitalisation provisions will be retrospective, applying to debt deductions for income years beginning on or after 1 July 2023
- Once enacted, DDCR will also be partially retrospective, applying to debt deductions for income years commencing on or after 1 July 2024, irrespective of when debt was issued

Who do amended rules apply to?

- General class investors (consisting of outward investor (general), inward investment vehicle (general) and inward investor (general) sub-categories)
- Outward investing financial entities (non-ADI)
- Inward investing financial entities (non-ADI)
- There are some exemptions

Cross border interest remains subject to 10% IWHT even if there is a debt deduction denial – if there is debt deduction denial, the effective cost of the debt is 40%

Three new alternative tests

1. Default fixed ratio test (FRT)

- FRT is earnings-based default test that replaces current assets-based 60% safe harbour debt test
- Allows an entity to claim net debt deductions (being interest, amounts in nature of interest or amounts economically equivalent to interest) of up to 30% of its annual tax EBITDA
- Tax EBITDA is broadly an entity's taxable income or tax loss, adding back net interest deductions, tax depreciation / capital works deductions (other than immediately deductible amounts) and prior year tax losses (with various other adjustments, e.g. exclusion of dividends from certain associate entities)
- Tax EBITDA headroom of downstream Australian entities that have chosen FRT (e.g. companies, unit trusts and partnerships) that are 50% or more owned may be utilised
- Disallowed deductions may be carried forward for up to 15 years, subject to satisfaction of modified continuity of ownership test or continuity of business test (and choice not made to apply alternative tests in subsequent years)
- Excess interest deduction capacity cannot be carried forward

Three new alternative tests

2. Group ratio test (GRT)

- Alternative earnings-based test that replaces current worldwide gearing test
- Broadly, worldwide group's (**GR Group**) net third party interest expense divided by GR Group EBITDA equals Group Ratio
- GR Group EBITDA broadly is sum of GR Group's net profit (disregarding tax expenses), GR Group's net third party interest expense and GR Group's depreciation and amortisation expense (with various adjustments, e.g. exclusion of dividends, trust distributions and partnership distributions where 10% or more interest)
- GRT allows annual net debt deductions up to Group Ratio multiplied by entity's tax EBITDA
- GR Group comprised of relevant worldwide parent entity and generally, all other entities that are fully consolidated on line-by-line basis in parent's consolidated financial statements
- No carry forward of denied deductions

Three new alternative tests

3. Third party debt test (TPDT)

- Alternative test that replaces current arm's length debt test.
- Broadly allows an entity to claim all third party debt deductions, subject to satisfying third party debt conditions, including that debt is issued to non-associate, lender's recourse (by way of guarantee, security or other credit support) materially only to Australian assets held by borrower, membership interests in borrower or Australian assets held by members of obligor group, and borrower uses debt funds to operate Australian business
- If entity chooses to apply TPDT, associate entities that are part of same obligor group (with creditors having recourse to assets of obligor entities in obligor group) deemed to have made choice to apply TPDT
- All related party debt deductions disallowed under TPDT
- Special rules for conduit financing, which allow entities to borrow funds from third parties and on-lend to associate entities, subject to certain conditions
- DDCR do not apply if TPDT applies
- No carry forward of denied deductions

Interaction with Australian transfer pricing regime

- Under current thin capitalisation regime, taxpayers required to adopt transfer pricing approach to calculating debt deductions by applying arm's length interest rate to actual amount of debt but are not otherwise required to demonstrate that actual quantum of debt is arm's length
- Amendments to transfer pricing rules require general class investors to demonstrate that both quantum of debt / prevailing capital structure and terms (including interest rate) of debt adhere to arm's length principle (i.e. are consistent with how independent parties would enter into same or similar arrangements) prior to using either FRT or GRT to calculate allowable net debt deductions

Debt deduction creation rules (DDCR)

Rationale for DDCR

- Apply generally to entities subject to thin capitalisation rules and aim to mitigate base erosion arising from debt creation schemes which lack genuine commercial justification, where artificial interest-bearing debt is created within multinational group

From when do DDCR apply?

- DDCR apply to debt deductions for income years commencing on or after 1 July 2024
- Retrospective application from first income year commencing on or after 1 July 2024 to future debt deductions relating to financial arrangements entered into prior to that time

In what circumstances do DDCR apply?

- DDCR broadly apply to debt deductions arising from debt issued to associates where debt used for:
  - Acquisition of CGT assets, or legal or equitable obligations, from associates of acquirer with certain exceptions (e.g. new membership interests in Australian entity or foreign company, certain new tangible depreciating assets and new debt interests issued by associates) (Limb 1); and
  - Funding or facilitating funding of payments or distributions (e.g. dividends, capital returns or royalties) to associates (Limb 2)
- Debt can be either foreign or domestic
- Post-global acquisition Australian sub-group restructures involving debt creation may be caught by Limb 1
- Debt deduction from on-lending on same terms to Australian associate and refinancing of existing debt otherwise not caught by DDCR exempt from Limb 2

DDCR

- DDCR contain specific anti-avoidance provision empowering Commissioner of Taxation to determine that DDCR apply to any scheme where reasonable to conclude that principal purpose was to avoid application of DDCR. Does not apply to mere restructuring, without artificiality or contrivance, of arrangement that would otherwise be caught by DDCR
- DDCR can catch ordinary commercial transactions, e.g. dividends and capital returns – vigilance is therefore required
- DDCR apply prior to FRT or GRT, so any debt deductions denied under DDCR are excluded from FRT or GRT calculations

Some key issues

Cost of debt

- Cross border interest remains subject to 10% interest withholding tax even if there is interest deduction denial under DDCR and / or new thin capitalisation provisions, in which case effective Australian tax cost is 40%

Ability to use TPDT remains limited

- Broadly, TPDT remains limited to ‘plain vanilla’ security structures with no foreign assets and limited parental guarantee support (mostly to development structures)
- TPDT limited where lender has recourse to foreign assets that are not ‘minor and insignificant ineligible assets’

Care required when switching between alternative tests

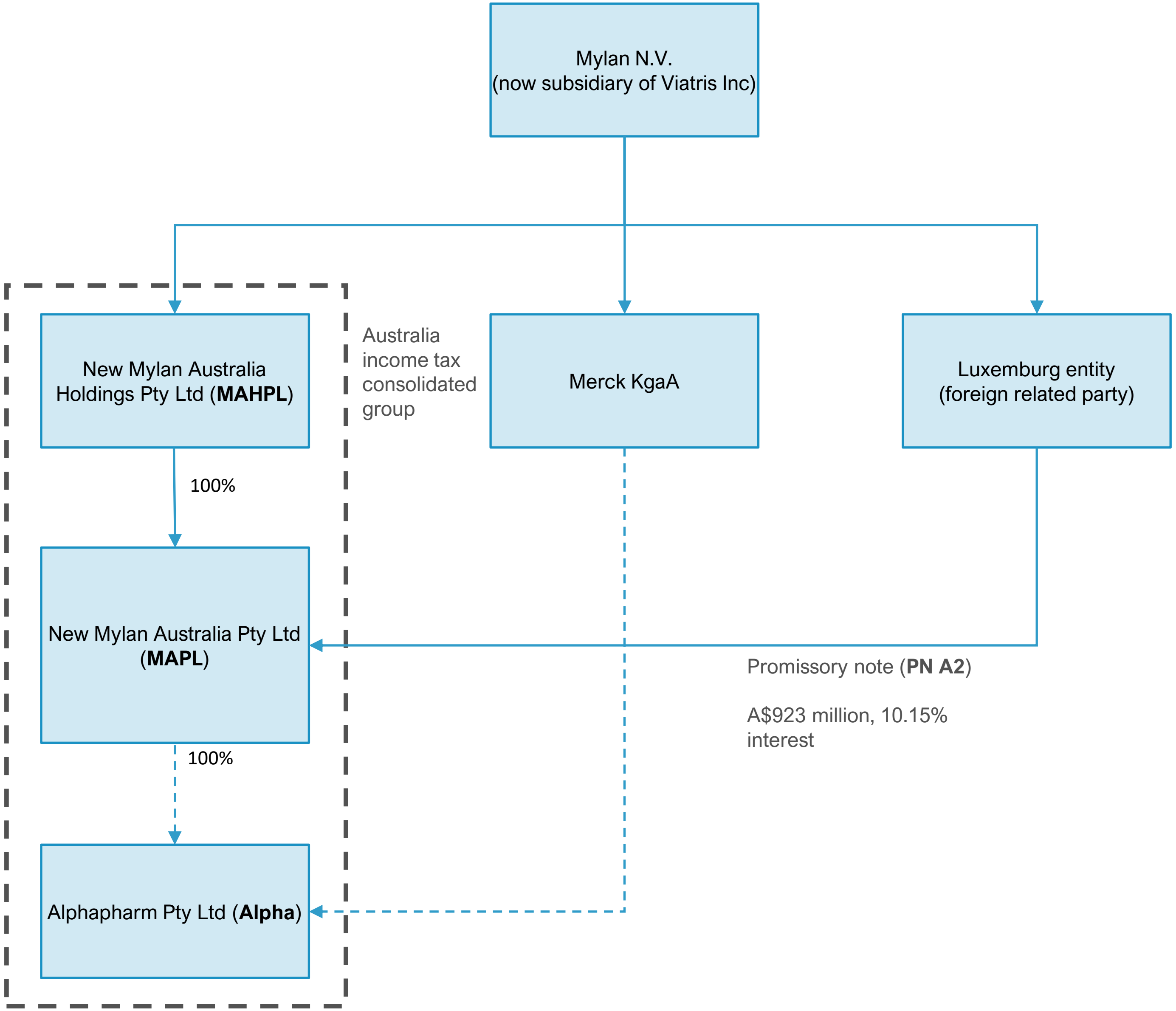
- If moving from FRT, disallowed deductions carried forward are foregone
- All associate entity members of same obligor group deemed to apply TPDT if one entity in group makes choice to apply TPDT

Volatility and uncertainty

- Previous assets-based test provided more certainty for taxpayers
- New earnings-based tests create volatility and uncertainty, especially for entities that significantly invest in projects up-front with earnings expected later and entities whose earnings fluctuate considerably
- Accurate forecasting is crucial

‘Death’ of related party debt in Australia?

Mylan Australia Holding Pty Ltd v Commissioner of Taxation (VID 770 of 2021, VID 526 of 2022)



- Part IVA ‘debt push down’ case concerning foreign related-party debt - currently before the Federal Court of Australia.
- MAHPL & MAPL created and formed a tax group & acquired Alpha funded by a promissory note (75% of the value of Alpha) and equity.
- Main counterfactual – no Australian acquirer.
- Second and third counterfactual – third party debt or lower related party debt.
- Commissioner has sought:
  - tax modelling (incl US tax losses);
  - MaPL Interest servicing analysis; and
  - information around how the interest rate was determined.

Anti-Hybrid Measures – Impact on Capital Markets
Recent Canadian Developments

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Anti-Hybrid Rules (Canada)

- Generally, non-participating interest payments by Canadian taxpayers to non-residents are not subject to Canadian withholding tax provided the parties deal at arm’s length (and assuming the debt is not subject to Canadian thin cap rules) – i.e. a statutory withholding tax exemption
- Rules in respect of “hybrid mismatch arrangements” first proposed April 2022, with proposed effective date of 1 July 2022 (with no grandfathering), targeting structures giving rise to a deduction/non-inclusion mismatch
- Revised rules contained in Bill C-59, currently at Second Reading in Parliament (proposed effective date unchanged)
- If rules apply to interest payment by Canadian payor, not only will the deduction be denied, but the payment will be a deemed dividend for Canadian withholding tax purposes

Anti-Hybrid Rules (Canada)

- Rules apply where either (a) parties do not deal at arm's length or are "specified entities" (similar to thin cap specified shareholder concept, but broader), or (b) the arrangement is a "structured arrangement"
- A structured arrangement arises where it can reasonably be considered that the economic benefits of a mismatch are priced into arrangement, or that the arrangement is intentionally designed to produce a mismatch
  - The pricing point, combined with the deemed dividend withholding tax consequence, has given rise to issues with providing "clean" Canadian tax disclosure in offering documents
- Explanatory notes to Bill C-59 include helpful clarifying comments regarding issuances of securities in foreign jurisdictions where local tax treatment may differ from Canadian tax treatment

Beneficial Ownership / Conduit Financing
Spanish, Italian and Canadian perspectives

Beneficial ownership issues for interest payments – Spain

- The Spanish domestic exemption for interest payments made to EU recipients ("**EU Interest Exemption**") is previous (1993) and broader than that set forth under the Directive 2003/49/EC → does not contemplate the beneficial ownership ("**BO**") requirement.
- Unlike the regulations affecting WHT on royalty payments, the EU Interest Exemption was not modified when the Directive 2003/49/EC ("**Interest Directive**") was enacted.
- Nonetheless, the position of the Spanish Tax Authorities and Administrative Courts (Rulings issued by the Central Administrative Court in 2019) is that the judgements of the ECJ in the joined cases C-115-16, C-118/16, C-119/16 and C-299/16 (the so-called "**Danish Cases**") are **directly applicable in Spain**.
- But in the Danish cases the ECJ looked into the **Danish transposition of the Interest Directive** (which includes the BO requirement). Said legislation also lacked anti-abuse clauses. The situation in Spain is different (there is no direct or indirect BO requirement and there are plenty of **general anti-abuse rules –GAAR-**).
- So, technically, for the challenging of the application of the EU Interest Exemption the Spanish Tax Authorities should follow **the GAAR provided by the General Tax Law** (Sham, Conflict in the application of a tax law and Re-characterization), which provide for a separate, non-ordinary audit proceeding. Along these lines, the BO clause should not be regarded as an objective **requirement** for the application of the EU Interest Exemption but rather as an evidence of the existence of an abusive behavior.
- This discussion should be ruled by the National Appelate Court / Supreme Court in the following years.
- Big impact on dividend and even capital gain cases. According to the Spanish Courts (not entirely clear on the BO discussion) the specific or general anti-abuse rules provided by the Spanish legislation should prevail. In principle, the burden of proof on the abuse lies on the Spanish Tax Authorities.

Beneficial Ownership and Conduit companies
Recent Italian Case Law Developments

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Legal Background - The Beneficial Owner under Italian Law

Article 26-quater DPR 600/1973 (implementing Interest and Royalties Direcitve): Outbound interest and royalties are exempt from any Italian tax, provided that:

- the recipient is an associated company of the paying company and is resident in another EU Member State or such a company's permanent establishment situated in another EU Member State. Two companies are "associated companies" if (i) **one of them holds directly at least 25% of the voting rights** of the other or (ii) a third EU company holds directly at least 25% of the voting rights of the two companies.

- the relevant companies must have a legal form listed in the Annex of the Interest and Royalties Directive (2003/49) and be subject to a corporate income tax.

- a 1-year holding period is required.

- **the recipient is the beneficial owner of the payment**, i.e. it receives the payments **as final beneficiary and not as an agent, nominee or fiduciary of another person**

Legal Background - The Beneficial Owner under Italian Law

The evolution of the position of Italian tax Administration in relation to BO concept:

- «…The receiving company qualifies as **BO if has the right to use and the availability** of the income received and has an economic benefit by the transaction carried out» (circ. 47/2005)

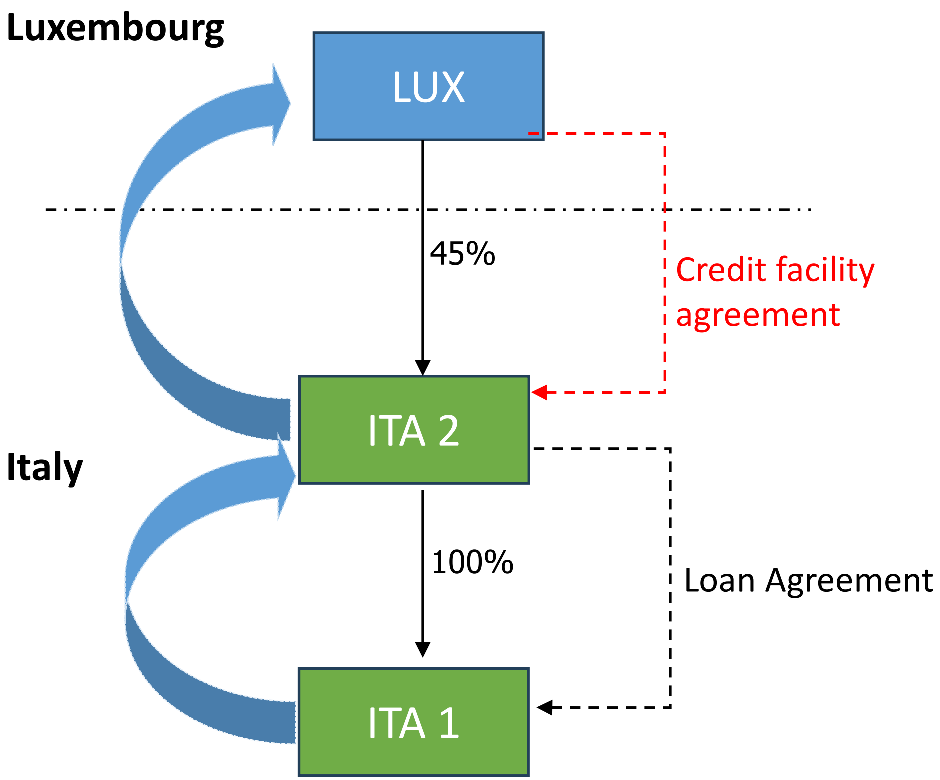
- «…it is necessary to take into account (i) the economical and contractual aspects of the transactions realized, (ii) the presence **of an adequate structure, and (iii) also the financial risks capacity**» (circ. 41/2011)

- It may not be considered a BO of an interest payment, **<u>an entity without a genuine and a substantial economic activity that is a mere conduit company subject to a legal and contractual obligation to pay back the income received with regard to a single transaction</u>** (a typical back-to-back transaction) (Circ. No.6/2016)

The Decisions of February 2023

- With specific regard to withholding tax exemption on infra-group interest payments in accordance to Italian domestic law implementing the I&R Directive law On February 28, 2023, the Italian Supreme Court (*Corte Suprema di Cassazione*) issued some "twin" decisions (No. 6005; 6031; 6045; 6046, 6048, 6050, 6061, 6065, 6067, 6070 and 6079) stating all the following principles:
  - with regard to the exemption provided article 26-quarter of DPR 600/73 (I&R Directive), the taxpayer must prove to be the beneficial owner of the payment, passing the 3 following tests:
    a. The substantive business activity test
    b. The dominion test
    c. The business purpose test
  - an Italian company paying interest income to another Italian company must operate a withholding tax at source, if the receiving company is not the "beneficial owner" of the income (and although the payment is not made to a non resident company).
  - the beneficial owner concept can be applied also to domestic infra-group interest payments

Italian Supreme Court Decision No. 6005/2023 – Engie Case



- **During 2006, in the context of a financial group reorganization:**
  - ✓ ITA 2 acquired the 100% of shares in ITA 1
  - ✓ LUX acquired 45% of ITA 2
  - ✓ LUX had a Loan Agreement with ITA 1
- **In 2011, following the reorganization above:**
  - ✓ LUX transferred to ITA 2 the credit (rights and obligations) deriving by the loan agreement it had with ITA 1
  - ✓ LUX and ITA 2 entered into a Credit facility agreement for the same amount of the loan agreement allowing ITA 2 to pay the transfer of the credit
- **Therefore:**
  - (i) ITA 1 had to pay interest to ITA 2 under the loan agreement and
  - (ii) ITA 2 had to pay interest to LUX under the credit facility agreement (back – to back)

Italian Supreme Court Decision No. 6005/2023 – Engie Case

- **According to the Italian Tax Administration**:
  - ITA 2 had the obligation to pay back interest income to ITA 1
  - with regard to the interest payment, **ITA 2 was a mere conduit company while LUX was the beneficial owner of the income**
  - ITA 1 did not pay directly interest income to LUX and therefore:
    - The exemption provided by article 26-quarter of DPR 600/73 (I&R Directive) was not applicable
    - ITA 1 had to apply the ordinary withholding tax at source

- **The First and Second Courts decisions rejected the appeal of the taxpayer on the basis that**:
  - There was a “symmetrical connection” between the 2 agreements (subscribed on the same date and having the same terms and conditions)
  - ITA 2 used to account the passive interest payment to LUX in a “specular way” of the interest received from ITA 1
  - The elements above proved that ITA had not power regarding the interest income and was obliged to immediately pay such income to LUX

- **The Supreme Court confirmed the decisions above stating that**:
  - The beneficial ownership clause may apply also to domestic relationships (i.e. ITA 1 and ITA 2)
  - ITA 2 should not apply the exemption provided by I&R Directive on the payments deriving from ITA 1, being ITA not directly controlled by LUX

Supreme Court reasoning and principles

- Clear difference between “**abuse of law**” and “**beneficial ownership**” concepts:
  - the abuse of law - under a technical perspective - is an artificial arrangement through which a company of a group may benefit of the tax exemptions provided by I&R Directive and its implementing , while
  - the beneficial ownership clause regards the requirements to be met in order to benefit of the tax exemption above

- The tax regime of cross-border interest income needs to ascertain if the recipient of the income is the beneficial owner, taking into account that “*a company of a Member State is considered as the beneficial owner of interest and roylaties only if it receives such income as final beneficiary and not as an intermediary, an agent, a nominee or a fiduciary of another person*”

- The investigation on the beneficial owner has to be carried out through the assessment of the “effective” role performed by the intermediary company (conduit company) of a group of companies. In this respect – **as clarified by the Court in Decision No. 14756/2020** – a pure sub-holding may be considered as the beneficial owner of interest income **<u>following the investigation on some “spy elements”, to be performed through specific and different tests.</u>**

Supreme Court reasoning and principles

- **1° Test: the substantive business activity test,** in order to ascertain if the receiving company is an artificial arrangement**:**

  - the taxpayer must prove that the receiving company carries out of an effective and genuine economic activity

  - if the receiving company does not pass the test, **there is an abuse of law** and therefore it is not possible (i) to apply the I&R Directive regime and (ii) to be covered by the freedom and rights granted by the TFUE

  - if the receiving company pass the test, it has to be performed the dominion test.

Supreme Court reasoning and principles

- **<u>2° Test: dominion test</u>,** in order to ascertain if the receiving company has the power to freely use the income received**:**
  - the taxpayer must prove that the receiving company is not obliged to pay the income received to third parties (as in case of back-to-back arrangements) also belonging to the same group.
  - the payment obligation may derive by a contract or by some factual elements, as in particular:
    - the narrow period of time between the receiving of active interest and the payment of passive interest under the loan agreement;
    - the regularity of the payments to the controlling company;
    - the small mark-up applied on the interest payments received;
    - the circumstance that the intermediate receiving company and the final receiving company have the same management
    - the circumstance that the intermediate receiving company did not take the decision on the loan, does not bear any risk or may not renounce to the loan amount.
  - If the test is not passed, the receiving company may not be considered as the beneficial owner of the income but, however, may be covered by the freedom and rights granted by the TFUE
  - If the test is passed, than it has to be performed the business purpose test

Supreme Court reasoning and principles

- **3° Test: business purpose test,** in order to ascertain the reasons of the "deviation" of the income flow:
  - the taxpayer must prove that the presence of the intermediate company across the income flow is based on specific business reasons and not on pure tax reasons

- **Look through approach**
  - Where the beneficial ownership requirement is not met but there is no "abuse of law" (i.e. when the first test is passed, but not the 2° or the 3°), however it is possible to apply the tax exemption if the final/real beneficial owner of the income meets the requirements provided by the Directive
  - ECJ C-115/16, par. 94 (Danish cases) «*It should also be stated that the mere fact that the company which receives the interest in a Member State is not its 'beneficial owner' does not necessarily mean that the exemption provided for in Article 1(1) of Directive 2003/49 is not applicable. It is conceivable that such interest will be exempt on that basis in the source State when the company which receives it transfers the amount thereof to a beneficial owner who is established in the European Union and furthermore satisfies all the conditions laid down by Directive 2003/49 for entitlement to such an exemption*.»

Supreme Court conclusions

- The withholding tax exemption provided by article 26-quarter **does not apply in the case at hand**, on the basis that ITA 2 :
  - is a mere conduit company with regard to the international income flow
  - has no direct or indirect benefit deriving by the amounts received and paid
  - has no risks or costs related to the transaction
  - has the sole function of receiving the amounts from LUX and providing such amount to its controlled Italian companies, ITA 1
  - has no power to dispose or use the income received
- The withholding tax exemption does not apply also with regard to the payment to LUX in the case at hand, by the Look through approach, being ITA 1 not "directly participated" by LUX (in accordance to the provisions of the I&R Directive)
- <u>**It has to be excluded the "domestic" nature of the transaction**, considering that it is related to a cross-border payment of interest</u>

Beneficial Ownership and related Mandatory Disclosure Recent Canadian Developments

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Beneficial Ownership (Canada)

- The concept of beneficial ownership in Canada has been relatively settled since 2009, as a result of the Federal Court of Appeal's decision in *Prevost Car* (followed by the Tax Court of Canada in *Velcro* (2012))
  - A recipient of income is considered to be the beneficial owner of the income if the payment is received for the recipient's own use and enjoyment and the recipient assumes risk and control over the payment
- 13 December 2023 TCC decision in *Husky Energy* dealt with the appropriate withholding tax rate (Part XIII tax) on dividend payments by Husky to two non-resident recipients (HWEI and LFL) who had borrowed Husky shares on which the dividends were paid under securities lending arrangements from two other non-residents (predecessors to HWLH and LFMI)
- Case is actually three decisions, in respect of each of Husky, HWLH and LFMI

Beneficial Ownership (Canada)

- HWEI and LFL were residents of Luxembourg for purposes of the *Canada-Luxembourg Tax Treaty* (which has a typical 15%/5% regime for dividends), and HWLH and LFMI predecessors were residents of Barbados for purposes of the *Canada-Barbados Tax Treaty*
- The rate under the Luxembourg treaty was asserted to be 5%, and the rate under the Barbados treaty was 15%; Husky withheld at 5%

Beneficial Ownership (Canada)

- Minister assessed Husky, HWLH and LFMI on the basis that HLWH and LFMI predecessors were the beneficial owners of the dividends and so the 15% rate under the Barbados treaty applied
- In the Husky assessment, the Minister argued alternatively that if HWEI and LFL were the beneficial owners, the higher rate of 15% under the Luxembourg treaty should apply since neither corporation directly or indirectly controlled at least 10% of the voting power of Husky, and in the alternative that the difference in rates could be assessed under the GAAR
- In the HWLH and LFMI assessments, the Minister argued alternatively that it could assess them for the difference in rates under GAAR

Beneficial Ownership (Canada)

- TCC held that the Husky appeal was dismissed, but the HWLH and LFMI appeals were allowed, and the Court found as follows:
  - Regardless of which entities were the beneficial owners of the dividends, ITA s. 212(2) (the withholding tax charging provision) did not apply to the HWLH or LFMI predecessors since Husky did not pay or credit the dividends to either of them
  - However, Husky, as the dividend payor, was liable for the full amount of Part XIII tax required to be withheld
  - The Barbados treaty could not apply to the dividends, since they had not been paid to a resident of Barbados
  - HWEI and LFL were not the beneficial owners of the dividends, since they were legally obligated to return the full amount of same to the HWLH and LFMI predecessors

Beneficial Ownership (Canada)

- TCC findings (cont'd):
  - Husky was required to withhold at 25% (the statutory rate), but the Court had no power to increase the Minister's assessment of Husky's Part XIII liability
  - With respect to the GAAR, the Court found that the purpose of the transactions was primarily to withhold Part XIII withholding tax, but the GAAR did not apply because the transactions did not abuse the ITA or either treaty because they did not result in any overall reduction of withholding tax <u>but instead increased the tax rate from 15% to 25%!</u>

Beneficial Ownership (Canada)

- Implications of *Husky*?
  - Beneficial ownership
  - Treaty rate “arbitrage”

Mandatory Disclosure (MD) - Notifiable Transactions (Canada)

- Canada’s relatively new mandatory disclosure rules have caused a significant amount of consternation in the tax community given both the breadth of the legislation and certain interpretive uncertainty
- Rules are comprised of “reportable transactions”, “notifiable transactions” and “uncertain tax treatments”
- List of notifiable transactions are published on the CRA website
- Reporting required by taxpayers who benefit from such transactions as well as advisors or promoters in respect of same (and unlike under the reportable transaction regime, reporting by advisors is not limited to those who receive specified types of fees)

MD - Notifiable Transactions (Canada)

- 90-day reporting deadline (from <u>earlier</u> of signing and execution); penalties for failure to timely report, and statutory assessment period of taxpayer remains open
  - Due diligence defence may be available
  - Series of transactions concept may create practical issues with meeting deadline
- Solicitor-client privilege exception
  - Currently the subject of a constitutional challenge re application to <u>Canadian</u> lawyers; an injunction is currently in place preventing the rules from applying to lawyers pending outcome of the challenge

MD - Notifiable Transactions (Canada)

- Notifiable transactions are transactions that are “the same as, or substantially similar to,” specific designated transactions that have been identified by the Canada Revenue Agency (CRA) as potentially abusive or as transactions of interest
- “substantially similar” means that the subject transaction is either factually similar to, or based on the same or similar tax strategy as, a listed transaction
  - No specific guidance on these concepts, except that the “substantially similar” test is intended to be interpreted broadly in favour of disclosure (which is a new interpretational concept in Canadian income tax legislation)
- Notifiable transaction list released 1 November 2023

MD - Notifiable Transactions (Canada)

- List includes 5 “transactions”, the most concerning of which is “Back-to-Back(BTB) Arrangements”
- BTB Designation includes a vague description under each of two headings: “Thin capitalization” and “Part XIII tax”, both of which refer to the provision of indirect financing by one non-resident through another non-resident to a Canadian taxpayer
  - Generally, thin cap rules deny an interest deduction on related party debt in excess of a 1.5:1 debt-to-equity ratio, with the denied deduction treated as a deemed dividend subject to withholding tax
  - Part XIII imposes withholding tax on payments of interest, dividends, royalties, management fees, etc. to non-residents

MD - Notifiable Transactions (Canada)

- Thin cap designation:

“Non-resident 1 (NR1) is a relevant non-resident in respect of a taxpayer). NR1 enters into an arrangement with an arm’s length non-resident (NR2) to indirectly provide financing to the taxpayer. The taxpayer files, or anticipates filing, its income tax returns on the basis that the debt or other obligation owing by it, and the interest paid thereon, is not subject to the thin capitalization rules. ”

- Part XIII designation:

“A non-resident person (NR1) enters into an arrangement to indirectly provide financing to a taxpayer through another non-resident person (NR2). If interest had been paid by the taxpayer directly to NR1, it would be subject to Part XIII tax. The taxpayer’s income tax reporting reflects, or is expected to reflect, the assumption that the interest it pays in respect of the arrangement is either not subject to withholding tax at all or is subject to a lower rate of withholding tax than the rate that would apply on interest paid directly by it to NR1.

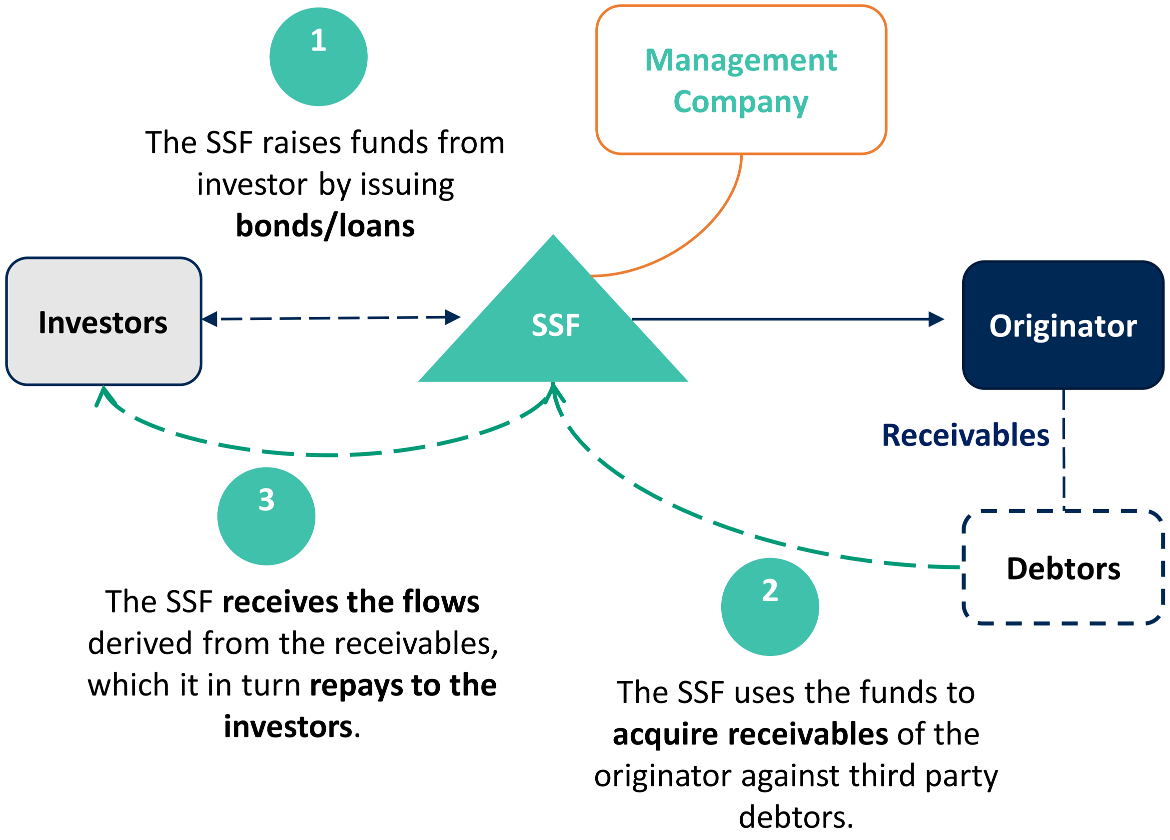
Alternatively, similar arrangements are entered into in respect of rents, royalties or other payments of a similar nature, or to effect a substitution of the character of the payments.”

MD - Notifiable Transactions (Canada)

- Canadian tax rules already contain very detailed back-to-back anti-avoidance rules dealing with interest, royalties and character substitution
- Inclusion of BTB designation suggests that the government has some suspicion that tax avoidance is occurring but does not have information about the specific transactions being implemented
- Scope of described “transactions” in BTB designation is potentially very broad, and without further guidance there will likely be considerable uncertainty

Fund Financing Transactions
Spanish and UK perspective

Fund financing: Spain – Securitization funds



- Spanish securitization funds ("**SSF**") regulated under Law 5/2015 are regular **taxpayers under the Spanish CIT**, subject to the general tax rate of **25%**.
- SSF are therefore eligible for the application of Spanish DTTs (subject to the beneficial ownership test) and **able to obtain a valid tax residency certificate** → significant advantage over existing securitization vehicles in other jurisdictions, usually regarded as "look through" entities.
- Wide range of assets are eligible for securitization (loans, mortgages and all kind of credit rights) → flexible for regulatory purposes.
- Spanish source **interest income obtained by the SSF is exempt from WHT**. No similar provisions for payments to non-Spanish tax resident SSFs (potential infringement of TFEU principles?)
- Issuance of listed instruments made by SSF **may benefit from the Special Tax Regime** applicable to listed debt instruments (see below) with simplified reporting obligations. So no WHT would normally apply to interest payments to nonresident investors.
- As anticipated, for tax periods beginning on or after January 1st, 2024, SSF will **no longer be excluded** from the application of the **interest expenses' limitation rule.** However, since in these vehicles interest expense is normally matched with interest income, the tax effect of falling within the interest limitation rules is very limited (zero "Net Financial Expense").

Fund financing: Spain – listed debt instruments

- **Special Tax Regime**, initially granted to credit entities (1985) and further extended to listed companies (whether financing entities or not) and non-listed companies complying certain requirements (2014). Applicable to Spanish companies and EU entities fully controlled by Spanish qualifying companies

- Applicable to **preferred securities (hybrid instruments) and debt instruments** issued in Spain (or the EU) and listed in regulated markets, multilateral trading facilities or other organized markets.
  - Broad interpretation by the Spanish Tax Authorities of de Debt Instrument definition → any instrument other than those that constitute an equity interest in an entity, regardless of its accounting treatment and any other characteristics of the instrument. (binding ruling V0143-21).

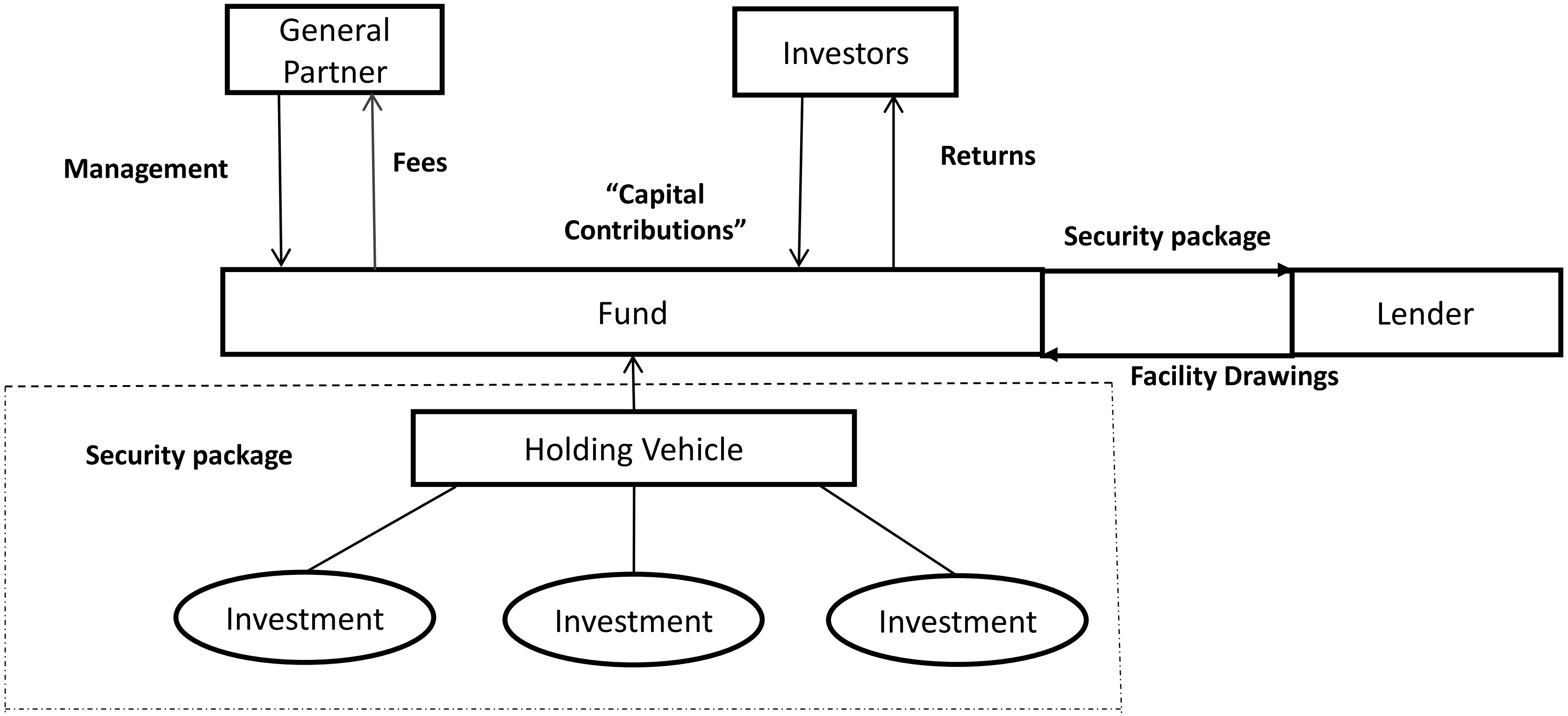
- Requirements: debt instruments
  - Must not grant political rights
  - Must not grant pre-emptive subscription rights in respect of future issuances
  - Must be admitted to trading on regulated markets

- Content of the Special Tax Regime :
  - Interest expense accrued under the preferred securities/debt instrument → **deductible for CIT purposes** for the Issuer regardless of its consideration for accounting purposes (i.e. “interest expense” borne under equity like instruments).
  - **No WHT** on interest payments to nonresident holders, regardless of the nature and country of residence of the holder.
  - **Disclosure and reporting obligations** for issuances registered in the Spanish clearing system (only payments made to individuals with tax residency in Spain will be subject to WHT) and in an OECD country (all payments free of Spanish WHT).

Fund financing transactions: UK perspective

- Fund financing transactions come in many different forms.
  - E.g. capital call and NAV credit facilities, CFO/CLO structures and others
- UK tax treatment of transactions will depend upon their UK nexus, if any.
- But potential issues include:
  - UK WHT on interest paid by fund/SPV borrower even if borrower based outside UK, e.g. if interest funded from UK-derived income such as dividends or interest from UK AHCs.
  - Potential dry UK tax charges on moving collateral such as shares in AHCs or interests in other funds to SPV as part of NAV financing.
  - Interest deductibility restrictions for UK individual members of fund partnership or partnership SPV, which may be solved through funder acquiring preferred equity in structure.
- NB, new UK QAHC regime may facilitate e.g. NAV structures involving UK AHCs given UK tax neutral treatment for QAHCs it generally provides for.

Example NAV Credit Facility Structure



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Rafael joined Garrigues in 1998 and is a partner since 2011

He has pursued his career in the area of international taxation, advising Spanish multinationals as well as nonresident investors (multinational groups and investment funds) in their transactions in Spain.

Rafael specializes in EU tax law and has led relevant litigation proceedings before the Spanish and EU Courts on State Aid and taxes contrary to the freedoms of establishment and movement of capital.

He is a member of the Madrid Bar, a Director at IFA's Spanish Branch and a regular lecturer on International and EU Tax Law in several Spanish universities and business schools.

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Florian has 25 years of experience in providing tax advice to large international companies and financial investors on M&A transactions, reorganizations, financings, structured finance products and fund investments. His expertise in the area of capital markets tax law is also particularly noteworthy.

In recent years, he has increasingly participated in internal investigations in the financial sector. He represents leading national and international banks in tax and civil law matters related to current and past equity transactions.

Career Development

- Studied Law in Munich
- Admitted to bar in 1998
- Since 2005 Partner at Magic Circle Firm
- With Allen & Overy since February 2023
- Lectures at Bucerius Law School

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- German
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Matthew Mortimer is a partner in Mayer Brown's international tax practice. He concentrates predominantly on the tax aspects of acquisition and structured finance, M&A transactions, intragroup reorganisations and debt restructurings.

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Matthew is admitted to practise in England and Wales and is a Member of the Law Society's Corporation Tax Sub-Committee. He joined Mayer Brown in 2019.

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- Elissa specialises in providing tax structuring, tax due diligence, contract drafting and general income tax advice. Many of the matters Elissa work on involve corporate income tax issues related to mergers and acquisitions, divestments and capital reorganisations. Elissa's experience extends to obtaining a number of favourable formal rulings from the Australian Taxation Office, including in relation to large scale corporate transactions.

- Elissa's clients benefit from her ability to connect various tax aspects in her matters including in relation to transactions, mergers and acquisitions and tax risk management strategies.

- In addition to large corporates, her clients include high net wealth individuals and privately owned groups in Australia and abroad. She works with these clients to help structure their wealth ownership in a way that tax-effectively achieves their succession planning and asset protection objectives.

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Luca deals with tax law with particular attention to international and EU tax issues. He regularly assists multinational groups and clients, including institutional clients, operating both in Italy and abroad.

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Paul also has experience assisting clients with the resolution of Canadian federal and provincial tax audits and appeals at all stages.

He has written articles and spoken at different venues regarding cross-border and domestic tax issues. He is a member of the Canadian Bar Association, the Ontario Bar Association, the International Fiscal Association and the Canadian Tax Foundation.

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