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Tax and global M&A: the changing landscape for deductibility of finance costs on acquisition debt

Tax always plays a significant part in the structuring of cross-border mergers and acquisitions. Issues include ensuring the target shareholders receive tax neutral treatment where they take paper in the bidder, mitigating any transfer taxes, ensuring that any target losses and other reliefs are preserved following a change of control mitigating any withholding taxes on profit repatriation, and securing tax deductions for the finance costs of acquisition debt.

The international norm is to allow interest and other financing expenses to be deducted for tax purposes. In takeovers and mergers, it has always been a crucial feature to ensure that the finance costs associated with the acquisition debt qualify for tax relief. Until recently, this tax relief has attracted very little attention. It was often seen as one of the more arcane elements in the overall deal structuring, and, certainly, it did not hit the headlines.

However, in the last few years, primarily because of the attention focused on private equity led acquisitions, there has been an unprecedented interest in this topic from various groups including the media, trade unions and organised labour bodies, and, ultimately, politicians.

We now find ourselves in a landscape where the international norm of treating interest as deductible has come under attack. Some jurisdictions have severely restricted tax relief for finance costs, and, in doing so, they have influenced the structuring of M&A transactions, including in some cases the capital structure of companies.

Investors may find that acquisitions in those jurisdictions which restrict tax deductions may no longer be economically viable. Governments that introduce these restrictions have to be aware of the delicate balance between revenue raising and stifling inward investment.

What's all the fuss about?

At this stage, it is worth going back to basics. Using the analogy of a private investor in real estate, if one purchased a rental property from a debt-free seller that was financed by a 100 per cent loan secured on the property, the private investor would expect to be able to set that interest expense against its rental income. Indeed, this is possible in most jurisdictions. After all, it is a legitimate business expense, and denying a deduction would create an unfair tax asymmetry in favour of the revenue authority (with the interest received by the lender being subject to tax in its hands).

Buying debt-free companies with highly leveraged debt is really no different. At the most basic level, this scenario is no different from our private real estate investor: the bidder would expect to set the interest expense against the income of the company that has been acquired. This has for some time been the norm in most jurisdictions.

In theory, this is all rational but the analysis starts to break down when transactions are cross-border. For example, where the target and the lender are in different jurisdictions, the loan into the target company's jurisdiction may come from the lender's home state so that the government of the target company's jurisdiction will be giving relief for interest to the borrower but receiving no corresponding taxable income on the lender.

Different governments have approached this issue in various ways.

How is the landscape changing?

Competing forces are often at play when governments determine their approach. It is generally fair to say, at least in the European Union (EU), that there are increased levels of tax competition, with some states specifically tailoring their tax regimes to make them more favourable to inward investment. It is usually possible to do this without infringing State Aid rules or the EU's Code of Conduct on Harmful Tax Competition. The key is to treat residents and non-residents equally and also not to favour one sector over another. Ireland is a good example of a jurisdiction that has created a very attractive tax regime for inward investment which carefully avoids potential EU obstacles.

Part of the general tax competition trend is to reduce headline corporate tax rates but then to increase the tax base by, for example, restricting reliefs, including tax deductions for interest.

Some jurisdictions have also simply changed policy in relation to these tax deductions, regarding the relief as too generous, particularly in the current climate where tax revenues have been depleted. In situations where the tax deductions can wipe out the entire taxable income of the target with no corresponding interest income receipt in that state, the sword is gradually falling.

Another issue is that, following the "credit crunch", there has been a growing perception that debt is "bad" and that tax systems should not be biased towards encouraging debt finance over equity finance.

A counter-force at play is the fact that some jurisdictions have used their tax regime as an element in their stimulus package. A minority of jurisdictions have improved their rules to attract foreign investment. In fact, some of the jurisdictions that have introduced the most draconian restrictions on interest deductibility have had to relax them because of the current economic climate.

The tax issues in more detail

In terms of a company's capital structure, it is generally accepted that dividends on shares are not tax deductible whereas interest on debt is. This is referred to by some commentators as "tax's original sin".

A simple tax efficient structure would therefore be for the bidder to fund the acquisition with debt to obtain the tax deduction. It may be that the bidder would seek to obtain any tax deductions in its home jurisdiction if, for example, the corporate tax rate there was higher than in the target's jurisdiction. This dynamic would be reversed where the rate is higher in the target's jurisdiction.

Generally, these considerations would apply both to acquisitions by corporate groups and by private equity houses.

However, in the private equity sphere, where there may not be operations in other jurisdictions, it will normally be the goal to seek tax deductions on acquisition debt against the profits of the target in the same jurisdiction. This is often referred to as "debt pushdown". A typical structure would be for a private equity fund to establish an acquisition vehicle in the target's home jurisdiction and that acquisition vehicle would borrow from both its shareholders and third-party banks. The goal would be to set the interest expense against the target's profits using some form of local tax consolidation or other relief. In some jurisdictions, it may be possible to push the acquisition debt directly into the target after acquisition.

Using the analogy of an individual's investment in real estate again, there should be no reason why anyone should get particularly excited by this. In general, private equity houses are using exactly the same tax relief that trade bidders have always sought to use.

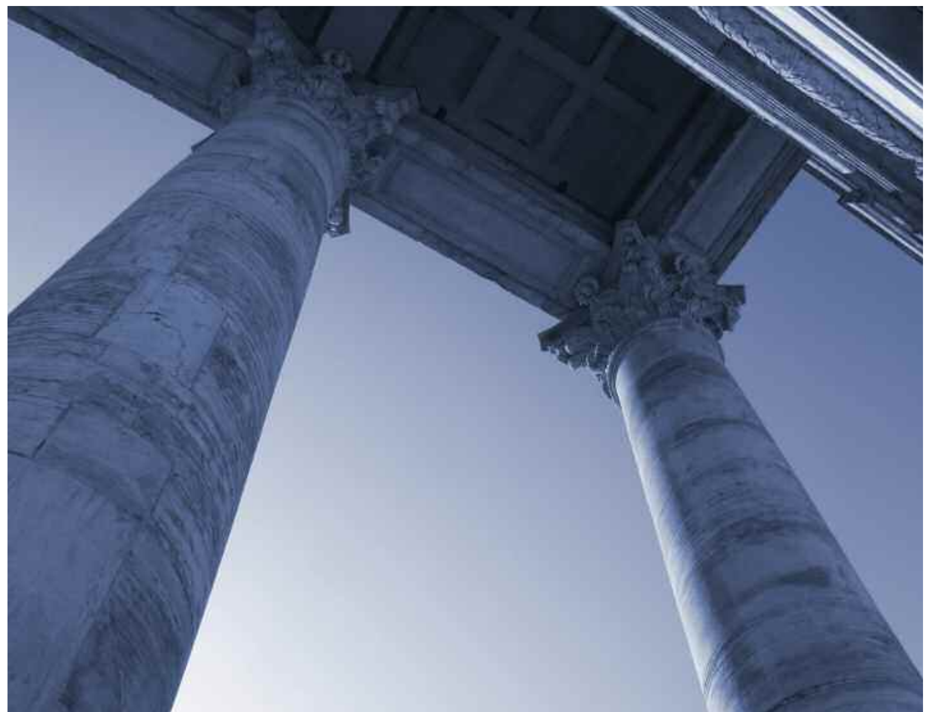
However, governments have become concerned about shareholder debt in certain private equity transactions where they consider that the acquisition debt really performs the function of equity. This issue is further complicated by the fact that, if the shareholders/bank lenders are not in the same jurisdiction, some governments will be giving tax relief for no obvious return. It is also fair to say that, in general, private equity acquisitions tend to be more highly leveraged and the sums involved can be enormous.

Governments tackle this issue in lots of different ways. There are, however, some base international norms. Most countries will have rules which deny tax deductions for interest which has "equity-like" features – for example, where the interest rate paid depends on the profits of the borrower. It is usually straightforward to avoid these rules. Of more importance is to consider thin capitalisation rules and any local earnings stripping/anti-base erosion rules.

Thin capitalisation

This has been a feature of many countries' tax rules for many years and is the preferred weapon to deny tax deductions on debt which really performs an equity function.

Generally, these rules will apply to shareholder debt where the level of debt



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is more than would have been the case had there been a third party, arm's length lender.

For example, in the Netherlands the main rule is that tax deductions will be disallowed to the extent a 3:1 debt–to–equity ratio is exceeded. Most jurisdictions' thin capitalisation rules will apply only to shareholder loans but that is not always the case and each jurisdiction's rules need to be examined in detail.

Earnings Stripping/Anti-Base Erosion rules

In addition to thin capitalisation, or in some cases replacing thin capitalisation rules, there has been a recent trend in some jurisdictions to provide a specific interest deductibility cap or disallowance, even if the debt in question is arm's length.

This trend started in **Denmark** where there was political concern that outside private equity investment into Denmark was leading to the situation identified above where tax deductions for acquisition debt were wiping out the taxable income of the Danish target companies without any Danish resident lenders paying tax on the interest received (the lenders were all outside Denmark). Their response was to introduce a cap on the amount of interest that can be deductible.

Rules in selected jurisdictions

The trend that was started by Denmark was soon followed by **Germany** which, in 2008, introduced rules that essentially capped the tax deduction for net interest expense to 30 per cent of a German company's earnings before interest, tax, depreciation and amortisation (EBITDA), although interest disallowed under the rules can be carried forward to be set against income in future years (subject to the same 30 per cent cap).

If the net interest expense in a fiscal year is less than 30 per cent of the company's taxable EBITDA and no exception to the earning stripping rules is applicable, the difference between 30 per cent of the EBITDA and the net interest expense (i.e. the unused EBITDA) can be carried forward for a maximum of five fiscal years, thereby increasing the ceiling for deductible interest.

The rules in Germany contain exceptions where either the German company is not fully consolidated in a group of companies, or the German company is part of a group of companies and the adjusted debt–to–equity ratio of the German company does not fall short by more than two percentage points of the debt–to–equity ratio in the consolidated financial statements of the group. These exceptions are subject to restrictions in the case of "harmful" shareholder debt.

In general, there is no interest deduction limitation, if the net interest expense is less than EUR 3 million.

It transpired that the original version of the German interest cap rules proved to be too strict and this led the German government to relax some aspects of the rules (including increasing the *de minimis* threshold from EUR 1 million to EUR 3 million), in particular because of the perceived unfair application of the rules to companies in financial distress. However, even the relaxed rules are regarded as being too strict.

Italy has gone a similar way to Germany. In 2008, it introduced a cap on net interest expense to 30 per cent of the individual company's gross accounting profits. The rules cover both external and intra-group debt.

Companies in a domestic tax consolidated group may determine their allowable net interest expense on a group basis and may also take into account the gross profits of non-Italian resident entities. Generous rules apply to banks and insurance companies which are, in principle, entitled to a tax deduction of 96 per cent of interest expense.

Both Germany and Italy were able to abolish their thin capitalisation rules because of the introduction of their interest cap rules.

Jurisdictions such as the **Netherlands** and the **United Kingdom** have both thin capitalisation rules and earnings stripping/anti-base erosion rules.

The Dutch thin capitalisation rules have as their main rule a 3:1 debt-to-equity ratio. As an alternative to applying this ratio each year, a taxpayer may elect to apply the debt-to-equity ratio of the group of which it is a part. The group is not restricted to Dutch entities but also includes foreign entities. Under this test, the taxpayer's and the group's debt-to-equity ratio is determined on the basis of the group's consolidated commercial accounts.

Additionally, the Dutch "Base Erosion" rules may restrict the interest on debt taken up from related parties to finance the acquisition of an equity interest in a company that becomes a related entity after its acquisition. However, the interest paid on the debt may nevertheless be deductible if the taxpayer can demonstrate that there were predominantly valid business reasons for entering into the transaction and also for funding the transaction with debt.

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In the **United Kingdom**, the thin capitalisation rules have no "safe harbour" ratios. The revenue authority negotiates the arm's length amount of debt on a case by case basis. The UK thin capitalisation rules only apply to related party debt, but this also includes bank finance obtained with the benefit of a parent company guarantee.

Even if one can justify the level of debt as arm's length under the UK thin capitalisation rules, there is now a new, additional, interest deductibility restriction. The rules, which are known as the "Worldwide Debt Cap", can deny a deduction for interest where, in general terms, the amount of UK debt exceeds the external debt of the consolidated worldwide group. For example, if an equity funded international group seeks to finance a UK acquisition with UK debt, this rule would deny UK tax deductions on the debt pushdown.

These rules would not affect acquisitions where the bidder's worldwide group is itself highly leveraged. In that regard, the UK rules are far less draconian than, for example, those in Germany and Italy.

France, like other jurisdictions, has rules restricting the deductibility of interest. The French rules are a combination of thin capitalisation rules and base erosion rules. The rules only apply to related company debt. This means that, unlike the United Kingdom, a loan from a third-party bank that is secured by a parent company guarantee is not caught by the rules. A number of exceptions and safe harbour provisions may apply depending on the circumstances.

In addition, the French have a specific anti-debt pushdown provision, known as *Amendement Charasse*. This provision applies when a bidder seeks to form a tax group with its French target. It can result in a proportion of the interest costs on the acquisition debt being non-tax deductible. These rules are aimed at excessive leverage, but France has, in some respects, gone against the international trend and recently relaxed these rules to make the French tax system a friendlier tax environment for M&A.

In **Belgium**, interest costs on acquisition debt can generally be set against the profits of the target using debt pushdown, although the general 3:1 debt–to–equity ratio needs to be observed for shareholder debt.

Belgium has come up with a novel way of levelling the playing field, when dealing with the distinction between the tax treatment of interest and dividends. It has recently introduced a notional interest deduction for equity. All companies that are subject to Belgian corporate tax are entitled to deduct from their taxable income a fictitious amount of interest calculated as the basis of their shareholders' equity (net assets). But the overall trend internationally is for a levelling of the playing field by denying tax deductions for interest.

Spain relies only on its thin capitalisation rules to attack excessive levels of debt. Unlike most other EU states, Spain does not apply its thin capitalisation rules when the related lender is in another EU member state.

The **United States** has both thin capitalisation and earnings stripping rules. The US's position on loans from foreign related parties is that, generally, the US denies deductions for interest where the borrower has a debt-to-equity ratio exceeding 1.5:1 and the aggregate related- and unrelated-party interest expense exceeds 50 per cent of taxable income before interest, depreciation, and certain other items. Further, interest

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on foreign related-party loans is deductible only when paid. There are also various rules that limit interest deductions regardless of the identity of the lender. The most significant of those rules may result in either a deferral, or a denial of interest deductions where interest rolls up unpaid for more than five years, and the yield on the loan exceeds certain thresholds.

The Future

In the current climate where debt finance is seen as "bad" and governments are struggling with their public finances, particularly in some parts of the Eurozone, we are likely to see further jurisdictions consider either the introduction of interest caps, or, potentially, a total disallowance of interest expense (possibly, government deficits permitting, with a driving down of corporate tax rates). Those states that introduce the most draconian interest deductibility restrictions are likely to attract less investment from private equity houses. Trade buyers may have more flexibility and be able to obtain tax relief in their home jurisdiction, or elsewhere where they have operations.

However, there is a delicate balance here. If the tax rules become too draconian, inward investment will dry up, affecting corporate taxes and employment and indirect taxes. At worst, existing companies may emigrate. There are plenty of other jurisdictions that are looking to use their tax systems as a tool for encouraging inward investment. Ireland is one such example.

The new UK government is well aware of this issue. The UK is unlikely to introduce rules like those in Germany and Italy. Instead it has announced that it intends to make the UK a more competitive environment for corporates. A gradual lowering of the headline corporation tax rate (broadly at the cost of a reduced rate of capital allowances) has recently been announced with further plans to make the UK corporate tax system simpler and more stable.

The UK government has clearly taken note of recent corporate emigrations and the UK's response is a sign that considerations of tax competition (retaining existing corporates and attracting new inward investment) are more important than using the corporate tax system to shore up depleted reserves. This longer term strategy is, probably, the right way to go. Indeed, the Organisation for Economic Co-operation and Development (OECD) has recently warned Finland against increasing its corporate taxes to reduce its budget deficit.

The governments of those jurisdictions that are considering severe restrictions should be wary of using the tax system as a tool for dictating a company's capital structure. This should be governed by business economics, and not by tax. It is right that governments should be concerned with "excessive" levels of debt (which perform the same function as equity) but in many respects the "credit crunch" has resulted in the market itself reducing leverage, so it may not be necessary to use the tax system as a policy tool. In addition, jurisdictions need to think through carefully the implications of any dramatic restrictions on tax relief for finance costs.

At the most basic level, this will put up the cost of borrowing for many groups at a time when margins are already tight, which could lead some groups to fail and, at worst, it could have a further impact on inward investment. This means that, in the long term, governments may find that corporate tax receipts diminish.

It is possible that other jurisdictions will consider introducing an interest cap or total disallowance. In practice, it may be that there may not be many further draconian rules as levels of debt fall back to "normal" levels. Furthermore, the forces of ever increasing tax competition are likely to outweigh considerations of using the corporate sector to increase public finances.

Planning for an acquisition

When considering an acquisition in any jurisdiction the details of each country's rules need to be carefully studied. There are often subtle variations in, for example, jurisdictions' thin cap rules that can make massive differences to how a transaction is structured. It is also important to consider how 'stable' a jurisdiction is in terms of any future changes to the law – particularly in light of the dire state of some jurisdictions' public finances and the hostile attitude to highly leveraged transactions. Investors have to be aware of the complex rules in various jurisdictions but also keep an eye on how things may change in the future. One thing on the horizon is the attempt to create a common tax base in the EU, but it is highly unlikely that there will ever be a one size tax system for all member states.

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Authors

David Harkness
Tax Partner London,
Global Head of Tax
T : +44 20 7006 8949
E : david.harkness@cliffordchance.com

Thierry Blockerye
Tax Partner Brussels
T : +32 2533 5061
E : thierry.blockerye@cliffordchance.com

Eric Davoudet
Tax Partner Paris
T : +33 14405 5272
E : eric.davoudet@cliffordchance.com

Carlo Galli
Tax Partner Milan
T : +39 0280634 525
E : carlo.galli@cliffordchance.com

Jose Ignacio Jiménez-Blanco
Tax Partner Madrid
T : +34 91590 7514
E : joseignacio.jimenez-blanco@cliffordchance.com

Nick Mace
Tax Partner London
T : +44 20 7006 4679
E : nicholas.mace@CliffordChance.com

David Moldenhauer
Tax Partner New York
T : +1 212 878 8384
E : david.moldenhauer@cliffordchance.com

Dr. Uwe Schimmelschmidt
Tax Partner Frankfurt
T : +49 69 7199 1628
E : uwe.schimmelschmidt@cliffordchance.com

Ate van IJlzinga Veenstra
Tax Partner Amsterdam
T : +31 20 711 9711
E : ate.veenstra@cliffordchance.com

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