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Foreign bond issuance and new rules on thin capitalisation

A recent amendment to the Polish Act on Corporate Income Tax has redefined thin capitalisation rules that specify the amount of intragroup loans that may be disbursed between members of a single capital group. The method of calculating this amount has been changed and is in general less favourable than the previous one. The interest on loans above a specific amount is not tax deductible.

This means that the new regulations will have a critical impact on the existing methods of financing Polish companies through bond issues conducted outside Poland (such as eurobond or high-yield issues). Inappropriate transaction structuring may result in unnecessary tax expenses or even undermine the economic sense of foreign bond issues.

Thin capitalisation – new CIT rules

New rules on thin capitalisation apply from 1 January 2015. They do not apply to loans disbursed before 1 January 2015 (i.e. provided that funds were transferred to the borrower on or prior to 31 December 2014). The rules are important to consider in structuring Polish transactions as they impact the extent to which interest paid on intragroup financing will be tax deductible and are therefore of vital importance to the financing of companies located in Poland through affiliates or subsidiaries.
This development impacts financing through loans from foreign SPVs, which is, for tax reasons, a popular way of drawing capital from a eurobond or high-yield issuance. In a typical transaction an SPV that is wholly owned by a Polish company will serve as the issuer of bonds, which are guaranteed by the Polish parent company. In practice, the guarantor is only able to deduct interest on loans from its affiliates to the extent that the debt towards these affiliates does not exceed its current equity, (i.e. according to the new regulations, interest is not tax deductible in the proportion in which debt towards affiliated companies exceeding a company's equity is to the total debt towards these companies).

Key issues

Alternative Model

There is an alternative to the requirement to comply with standard thin capitalisation rules. Provided that the amount of interest on all intra-group and third party loans cannot exceed a certain value the thin capitalisation rules will not apply. This value is calculated as the product of the tax base of its assets (meaning, according to the Polish Accounting Act, the amount that is in principle deductible for tax purposes against any taxable revenues) and a specified ratio (currently 3.25 per cent which is the reference rate of the National Bank of Poland, plus 1.25 percentage points). The alternative model also has a special requirement that such interest cannot, in the aggregate, exceed 50 per cent of the company's' operating profit. However, this requirement does not apply to banks and certain other financial institutions.

The consequence of not complying with the thin capitalisation regulations would be partial non-deductibility of interest causing a higher tax base for the guarantor.

Our proposed solutions

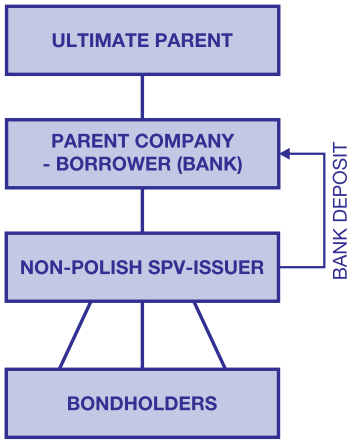
We present below a number of solutions that may help to mitigate or avoid the thin capitalisation issue:

Alternative model

Using the alternative model for calculating tax deductible interest on intra-group and third party loans described above may provide more benefit to certain entities, such as banks or certain other financial institutions.

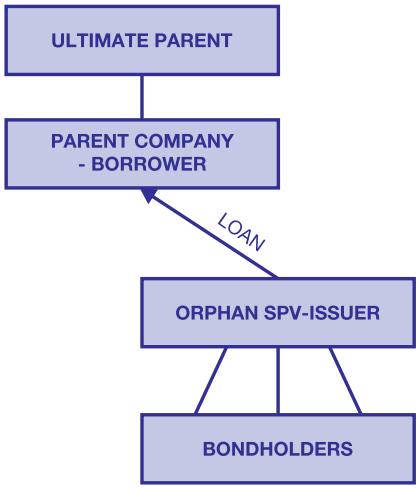
Bank deposit (banks only)

On-lending proceeds of an issue by a foreign wholly-owned SPV to the guarantor by way of a bank deposit as defined in the Polish Banking Law (instead of a loan). This solution is only available to borrowers that are banks in the meaning of Polish Banking Law and requires a tax ruling.



Orphan structure

The issuer may be established as an orphan entity, which means there are no capital or control (voting rights) links, whether direct or indirect, between the SPV and the capital group of the guarantor.



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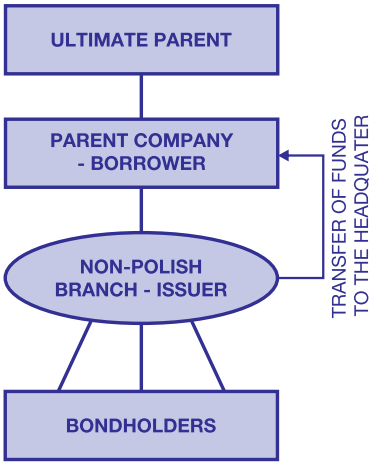
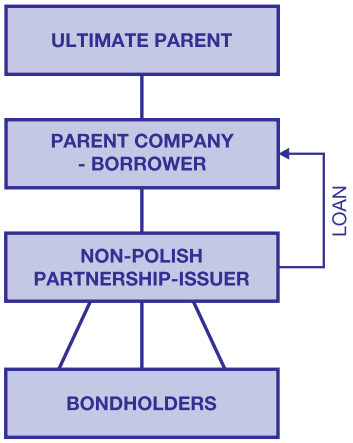
Foreign branch intermediation

This would side step the issue as such foreign branch would not technically be subject to the same capitalisation requirements. This solution would require approval by a tax ruling.



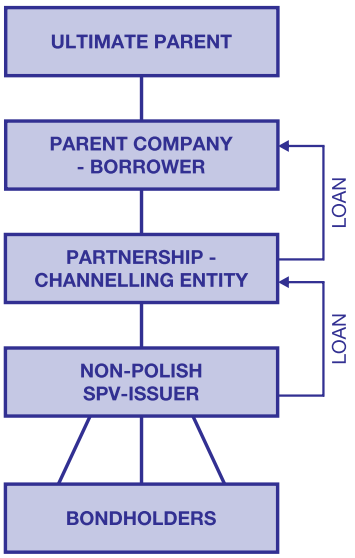
Partnership as an issuer

Loans from subsidiaries that are partnerships do not seem to be restricted by the new regulations, therefore, the issue could be carried out by a foreign tax transparent partnership wholly-owned by the guarantor (this partnership has to have at least two partners, one of whom may be guarantor and second one, holding marginal interest, its wholly—owned subsidiary) instead of a taxable company. We should note that this solution is currently untested and would require approval by a tax ruling.



Partnership channelling

A similarly, wholly-owned tax transparent partnership (again with nominally at least two partners) may also serve as an intermediary in the transfer of funds. The same solution is ultimately achieved, but the drawback which is present here will be the increased complexity of the structure. A tax ruling would again be needed for this structure as it is untested.



Which structure to use?

The best solution to be adopted will depend on the characteristics of the company concerned. For example:

- For entities with a high equity base, compliance with the standard thin capitalisation rules should not prove problematic.
- For entities with a high tax value of assets and a relatively high operating profit (including banks, credit institutions and certain other financial institutions), the alternative model of interest deductibility may be the preferred option.
- For other entities that do not want to simply adopt either new standard rules or the alternative model, all of the solutions presented above have their advantages and disadvantages, so which of them is the most suitable for a given entity is a matter of individual preference.

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Contacts

Grzegorz Namiotkiewicz
Partner

T: +48 22 627 11 77
E: grzegorz.namiotkiewicz@cliffordchance.com

Grzegorz Abram
Counsel

T: +48 22 627 11 77
E: grzegorz.abram@cliffordchance.com

Tomasz Szymura
Counsel

T: +48 22 627 11 77
E: tomasz.szymura@cliffordchance.com

Artur Bilski
Associate

T: +48 22 627 11 77
E: artur.bilski@cliffordchance.com

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Norway House, ul. Lwowska 19, 00-660 Warsaw, Poland

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