

Is the Deduction of Interest on Acquisition Loans Possible? New Developments in LBO Acquisition Structuring in the Netherlands and Switzerland

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The publication intends, based on a hypothetical case, to answer the question what the position of the national legislation and tax authorities is with regard to the deductibility of interest payments in an LBO acquisition. Therefore, possible scenarios about the structuring process in two different countries and its treatment by the tax authorities will be made visible and compared with the position of academics. By considering the legislative changes of 2012 in the Netherlands with regard to the deductibility of interest on acquisition loans and the cantonal differences in Switzerland recent developments will be shown and an outlook will be presented. This comparative analysis fosters in addition the understanding of and the meaning by the authorities of national anti-avoidance rules and the term "tax avoidance".

1 Introduction

The tax law world is changing. Accelerated by the economic crisis, governments and tax authorities try to broaden the tax base more and more. This can be done through different ways and two ways related to recent developments in the Netherlands and Switzerland will be shown. In Swiss tax law the offsetting of debt interest is generally limited compared to the neighbour countries of the EU.¹ On the other hand the tax exemption of the private capital gains for the seller of the company

1 Lissi, A., Wechner, U., "Leveraged Takeovers", International Tax Review (2012), 3.

is usually very advantageous, but limited through the indirect partial liquidation.² By focusing on a Leveraged Buyout (hereafter LBO) acquisition³ the tax consequences in the Netherlands and in Switzerland will be both outlined. Based on a specific case the mechanism, which is working with regard to the deduction of interest in a LBO acquisition, will be made visible and will be further outlined in form of a comparative analysis. The LBO acquisition will be especially compared to the recent legislative changes in the Netherlands relating to the deduction of interest and the treatment of fiscal unities and holding companies.

The change of paradigm in international tax law with regard to the term tax avoidance raises the question, if the principles of tax avoidance are also applicable to LBO acquisitions in Switzerland. Are LBO acquisitions in conformity with the intentions formulated by the OECD in the BEPS report or will they also come under scrutiny?

2 The Case

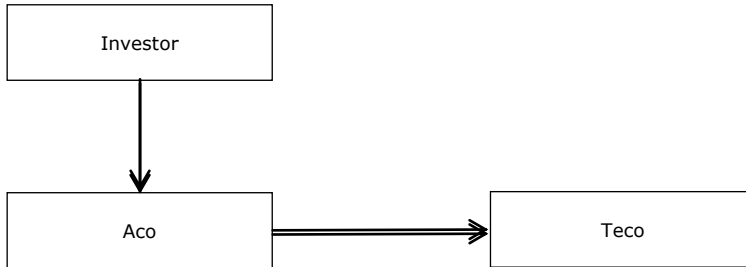
A typical transaction structure of an LBO acquisition entails the following structure. The investor sets up an acquiring company (Aco) with own legal personality with the aim to acquire the target company (Teco) through the acquiring company (Aco). In a second step the investor puts the necessary equity in Aco and usually grants a shareholder loan. Subsequently Aco borrows outside capital from banks as credits. The entire funds or at least a substantial part will then be used to cover the purchase price for Teco. The credits will thereby secured with shares and assets of Teco.

Teco as target company is operating and generating revenues. These revenues are necessary to cover the repayment and interest obligations of Aco. Through a merger of Aco with Teco the revenues of Teco and the repayment and interest obligations of Aco are united. This mechanism is an ordinary LBO transaction.

2 Gmür, M., Hänsenberger, D., "Von der Rechtsprechung bis zur DBA-Praxis im deutschsprachigen Raum", ST 6-7 (2013), 428.

3 Defined in Lissi, A., Zitter, G., "Ausgewählte steuerliche Aspekte der Fremdfinanzierung von Akquisitionen, ASA 81 (2013), 2013, 126.

Figure 1. Base scenario



3 Recent Developments in the Netherlands

New legislation regarding the interest deduction limitation was introduced, as part of the 2012 Budget into the Corporate Income tax act effective 1 January 2012. The new legislation applies exactly to the case above.

The intention of the legislator in introducing this new provision was to counter the erosion of the Dutch tax base resulting from the LBO acquisition structure.⁴ In the early 2000s well-known companies were acquired by private equity investors in the Netherlands. The acquisitions were highly leveraged and due to the offsetting mechanism between Aco and Teco the Dutch tax base regarding Teco was completely eroded. This attracted public attention resulting in pressure to introduce the new rules.⁵

3.1 The new provision

Art. 15ad of the CITA is applicable to interest costs on acquisition loans. Restrictions apply to the set off of interest payable on debt related to the acquisition of a Dutch target company, against the taxable profits of

4 Stoel, E. van der, "Analysis of Proposed Amendments to Dutch Fiscal Unity Rules" TNI (2001), 18.

5 Kok, R., "New Legislation Regarding the Deductibility of Interest on Acquisition Loans", European Taxation (April 2012), 187.

that target company.⁶ Acquisition loans are loans taken out to finance the acquisition or expansion of an interest in a company that is merged with the other company. Interest is a broad term that, in addition to shares, can include participating loans and options as well.⁷ The scope of the provision thereby entails both loans granted by related creditors as well as unrelated creditors. In other words the provision targets LBO by a group and if the provision applies the interest expenses are limited in the group.⁸

3.2 Limitation 1

Interest on acquisition loans can be set off against taxable income of Teco in a merger to the extent that the profits are not attributable to the Teco. Therefore, if Aco has sufficient profits of its own, article 15ad CITA will not limit the deduction of interest. There is a de minimis exemption to the extent that the interest on acquisition loans does not exceed Aco's own profits by more than EUR 1 million. The purpose of the exemption is to remove small and medium-sized enterprises from the scope of application of the provision.⁹

3.2 Limitation 2

If the interest on the acquisition loan is higher than the taxpayers own profits and the de minimis exemption does not save the interest deduction, the interest will still be deductible if the 60% exemption is applicable. The criteria for the application of the 60% exemption is, that the acquisition loan is less than 60% of the acquisition cost and then the interest deduction limitation of Art. 15ad CITA would not apply.¹⁰

6 EY, "International Tax Alert", (June 2012), 2 (retrieved from: [http://www.ey.com/Publication/vwLUAssets/International_Tax_Alert_-_6_June_2012_-_2013_Dutch_budget_proposals_released/\\$FILE/EY_tax_news_2012061204.pdf](http://www.ey.com/Publication/vwLUAssets/International_Tax_Alert_-_6_June_2012_-_2013_Dutch_budget_proposals_released/$FILE/EY_tax_news_2012061204.pdf)).

7 Kok, R., "New Legislation Regarding the Deductibility of Interest on Acquisition Loans", *European Taxation* (April 2012), 188.

8 Ting, A., "Taxation of Corporate Groups under Consolidation", (2012), 250.

9 Kok, R., "New Legislation Regarding the Deductibility of Interest on Acquisition Loans", *European Taxation* (April 2012), 188.

10 Id. 2012, 188.

This becomes visible in an example where this rule is calculated: The 60%, considered to be the acceptable amount of debt, will be lowered by 5 percentage points each year after the acquisition reaching 35% seven years after the acquisition¹¹. As such, in the year in which Aco and Teco merged the acceptable debt was 60% of the acquisition price. In the year thereafter the amount of acceptable debt will be lowered to 55%. Consequently the percentage will be 25% in the seventh year after the merger.¹² Otherwise, if the acquirer has not repaid the debt in the described way, the interest will not be deductible for eight years.¹³

3.3 Similar provision in a fiscal unity

In order to offset the interest related to an acquisition instead of using a merger the Aco could use a fiscal unity to concentrate the debt and the profit making activities in one company¹⁴. Entities included in a fiscal unity are taxed as if they were a single taxpayer for Dutch tax purposes¹⁵. Also in the context of a fiscal unity provisions have been introduced. Because of the similarity, these rules are not described in this article.

3.4 Grandfathering provisions

Interest on acquisition loans related to the acquisition of a company that was in a fiscal unity or merger with the acquiring company before 15 November 2011 will be grandfathered. This means that they can benefit from a special exception from the old rule despite the fact that the new rule is already enacted. As a consequence such interest from an acquisition that took place before 2011 will be tax deductible going forward.¹⁶

11 Id. 2012, 188.

12 Id. 2012, 189.

13 Ting, A., "Taxation of Corporate Groups under Consolidation", (2012), 250.

14 Kok, R., "New Legislation Regarding the Deductibility of Interest on Acquisition Loans", *European Taxation* (April 2012), 189.

15 Kasteren, B. van, Pol, J. van der, "Tax Issues in Consensual Debt Restructuring", *Derivates & Financial Instruments* September/October (2012), 251.

16 Kok, R., "New Legislation Regarding the Deductibility of Interest on Acquisition Loans", *European Taxation* (April 2012), 189.

3.5 Additional restriction on interest deductibility for Dutch holding companies

On 1 January 2013, article 13I of the CITA entered into force with the aim to restrict the deductibility of interest. The purpose of this legislation is to prevent erosion of the Dutch tax base in situations where acquisitions or expansions of existing shareholdings are excessively financed with debt.¹⁷ The goal is to maintain the attractiveness of the Netherlands for Dutch holding companies. Therefore, investments in operational companies are, in principle, excluded from this legislation. This is not the case however, when the acquisition of the participation is structured via the Dutch taxpayer for the purpose of obtaining an interest deduction in the Netherlands (intention test). This rule seems to be relevant mainly for Dutch Holding Companies of Multinational groups.¹⁸

It seems that the Dutch holding companies should be actively involved in the strategic management for their participations to meet the intention test and, as such to ensure that their interest expenses are deductible. Unfortunately, it is currently not clear whether or not reasons other than the headquarter function will be sufficient to meet the intention test. Given that the intention test does not provide much guidance and it is necessary to meet it on a continuous basis, this will clearly bring new challenges to Dutch holding companies.

4 Treatment in Switzerland

In Switzerland the fiscal unity principle does not exist. Each natural or juridical person will be a taxable person. Within a group no fiscal unity can be built and related party transactions have to meet the arms length principle. Therefore the treatment of the deductibility of interest in a fiscal unity does not arise.¹⁹ Instead the deductibility of interest at the merged company has to be examined.

After the merger of Aco and Teco the interest arising from the debt remains a deductible business expense provided that the restrictions on hidden equity capital do not apply. The merger does not change the qualification of the different accounts. Instead within a tax neutral

17 Vis, N., "Restriction on Interest Deductibility for Dutch Holding Companies", *European Taxation* (June 2013), 295.

18 Id. 2013, 295.

19 Simonek, M., Triebold, O., "Akquisitionsstrukturierung bei Leveraged Buy-outs (LBO)", *GesKR* (2013), 358.

merger all the relevant factors are passed over to the newly set up company.

4.1 Requirements for a tax neutral merger

Based on corporate tax law (Art. 61 I DBG) the merger of Aco and Teco does not lead to a realisation of hidden reserves and therefore no income or profit tax liability arises. Certain criteria need to be met:²⁰ The tax liability in Switzerland has to continue to exist and the relevant key factors have to be taken over into the accounts of the merged company.²¹ These general requirements are in practice quite easily met and are not considered to be an obstacle. However, despite the unchanged qualification of the deductible interest as business expenses a majority of the cantonal tax authorities deny the deductibility if the acquiring company Aco has been established with the sole aim to acquire the target company.²²

Some cantons deny the deduction until the debt to finance the acquisition is fully amortised.²³ Other cantons restrict the deductibility within the first 5 years of the merger.²⁴ All these cantons have in common, that the refusal of the interest deductibility is based on the legal reasoning of Swiss tax avoidance.²⁵

20 Simonek, M., Triebold, O., "Akquisitionsstrukturierung bei Leveraged Buy-outs (LBO)", GesKR (2013), 362.

21 Simonek, M., "Verlustverrechnung nach steuerneutraler Fusion", published in Mäusli-Allenspach, Beusch, M., "liber amicorum Martin Zweifel", 2013, 93.

22 Kunz, T., "Holdingstatus: Update betreffend steuerlicher Sonderfragen", StR (2011), 734.

23 This is the case in the cantons Baselland, Berne and Zurich.

24 This practice is applied by the cantons Aargau, Appenzell Innerrhoden, Lucerne, St.Gall, Thurgau.

25 Heuberger, R., "Steuerfragen by Buy-Out und Exit- Transaktionen", published in Gericke, "Private Equity II", 2012, 85, Lissi, A., Zitter, G., "Ausgewählte steuerliche Aspekte der Fremdfinanzierung von Akquisitionen, ASA 81 (2013), 158.

4.2 Tax avoidance practice set out by the Swiss case law

The Swiss Federal Court set out three criteria relevant to qualify an action as tax avoidance:²⁶ First there has to be a substantial tax saving, second the structure of the person liable to tax has to be qualified as wholly artificial arrangement and third there has to be an abusive intent to save taxes.²⁷

In its latest Decision the Federal Court ruled that the criteria of tax avoidance have to be read in the way that only in case of total inadequacy or if the structure goes beyond what can be considered as economically reasonable, it will be applied.²⁸ But the line between a legal tax saving and a structure which is of total inadequacy or if the structure is beyond what can be considered as economically reasonable is difficult to draw.²⁹

Based on the opinions of academics,³⁰ these requirements for tax avoidance are not fulfilled in a ordinary LBO acquisition with a debt push down as the case presented above. It is argued that the case described above is not only for tax purposes but also feasible from company law and contract law viewpoints. Therefore it should not be the case that any regular structure with a tax saving, should be considered as wholly artificial with an abusive intent. Therefore, there is no legal ground to deny the interest deduction of the merger of Aco and Teco. The practice of several cantonal tax authorities should be abandoned since the criteria of tax avoidance are not fulfilled.

4.3 Practical advice

Based on this where by principle no tax avoidance can be identified, but in practice cantonal tax authorities deny the deduction, it is common standard that the structure will not be realised if the cantonal authorities deny this structure and the right of deduction.

26 There are several decision of the Swiss Federal Court of Justice (BGE) 102 Ib 155 E 3a; BGE 107 Ib 315 E 4.; BGE 109 Ia 97 E 4.

27 BGE 102 Ib 155 E 3a; BGE 107 Ib 315 E 4.; BGE 109 Ia 97 E 5.

28 Cf. BGE 138 II 239 E 4.1; Reich, M., "Steuerrecht", 2012, §6 N 20.

29 Lissi, A., Zitter, G., "Ausgewählte steuerliche Aspekte der Fremdfinanzierung von Akquisitionen, ASA 81 (2013), 159.

30 Locher, P., "Rechtsmissbrauchsüberlegungen im Recht der direkten Bundessteuer, ASA 75 (2007), 686.

The legal uncertainty can be resolved by a tax ruling, set up as a request from the taxpayer to the cantonal tax authorities to see if the structure aimed for will be accepted. In this request the taxpayer has to disclose his intentions and will be examined on a case-by-case analysis. The result will not be subject to public disclosure and therefore no similar cases can be cited.

4.4 Alternatives

As a result of this practice, alternative strategies have been developed to eschew the tax avoidance doctrine while securing (at least partially) the same goal:³¹ tax effective deduction of interest.

Cascade Purchase

Cascade purchases are considered in cases where a complex structure is acquired. The acquisition company acquires only a single company within the target structure, which then in turn acquires another company in the structure, etc. This allows for positioning the bank loans in operating companies, whose assets provide sufficient collateral and it allows for interest deduction for profit tax purposes.³² However, this method can lead to very complex and impractical final structures. To simplify the structure, a merger of all the companies in the structure is needed (possible problems: loss on merger and adverse balance).³³

Debt Equity - Swap

After the target company decreases its capital, reserves are distributed to the acquiring company, which in turn repays its acquisition loan to the bank.³⁴ The bank grants a loan to the target company, with the target company's assets serving as collateral, leading to the desired situation of keeping the loan and the security package in the same company and enabling a tax effective deduction of interest by the target

31 Simonek, M., Triebold, O., "Akquisitionsstrukturierung bei Leveraged Buy-outs (LBO)", GesKR (2013), 362 FN 44.

32 Stocker, R., Bader, D., "Push-down of Acquisition Debt: Swiss Tax Law Practice", Bär & Karrer Briefing (June 2013), 1 (retrieved from: http://www.baerkarrer.ch/publications/440.Acquisition_Debt_Push_Down.pdf, 1).

33 Id. 2013, 1.

34 Kasteren, B. van, Pol, J. van der, "Tax Issues in Consensual Debt Restructuring", Derivates & Financial Instruments September/October (2012), 250.

company.³⁵ This strategy is negatively impacted by the fact that there is often only a small amount of distributable reserves in the target company.³⁶ Also, equity rules (thin capitalization) have to be followed as well as cases considered in which an 'indirect partial liquidation' is assumed and taxed accordingly (if the target company is held as a private asset).

Advice

A merger of the acquisition vehicle with the target company often is not an option, especially in the cantons mentioned, after acquiring the target company. Alternative strategies have been developed that strive to achieve the same goal. Which method is best suited for an individual transaction has to be determined on a case-by-case basis.³⁷

5 OECD Position

In case of an extended version with a cross-border structure of the above mentioned case the OECD identified in the BEPS report certain tax advantages which are considered to be aggressive tax planning.³⁸ One of these is to limit base erosion via limitation of interest deduction.³⁹

The debt-push-down technique ensures that subject to applicable limitations interest expenses on the external bank loan are deducted from the target company's operating income through the applicable group tax regimes. L Hold Co is financing T Hold Co through a hybrid instrument. This financing is treated as debt in State T while it is treated as equity in State L to qualify as hybrid instrument. As a consequence, and subject to the applicable limitations, additional interest income will be deducted against the income of Target Co for tax purposes. At the same time, the payment will be treated as a dividend and therefore exempt under the domestic law of State L.⁴⁰ These hybrid instruments

35 Stocker, R., Bader, D., "Push-down of Acquisition Debt: Swiss Tax Law Practice", Bär & Karrer Briefing (June 2013), 1.

36 Id. 2013, 1.

37 Stocker, R., Bader, D., "Push-down of Acquisition Debt: Swiss Tax Law Practice", Bär & Karrer Briefing (June 2013), 1.

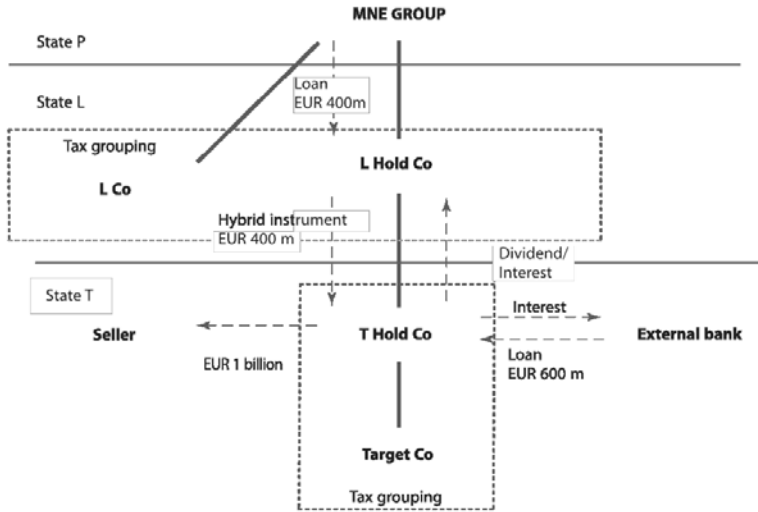
38 OECD, Addressing Base Erosion and Profit Shifting, (2013) (retrieved from: <http://www.loyensloeff.com/nl-NL/Documents/OECD.pdf>, 82).

39 Stocker, R., "Base Erosion and Profit Shifting", IFF (2013), 306, OECD, Action Plan on Base Erosion and Profit Shifting, (2013), 18.

40 OECD, Addressing Base Erosion and Profit Shifting, (2013), 79.

are not a problem in the case at hand, since hybrid mismatches are not at stake.

Figure 2. International scenario⁴¹



However, the interest the company pays on the intra-group loan can also be deducted against the income of other group companies operating in State L (subject to the applicable limitations) via the local tax grouping regime, thus also reducing the tax burden in State L.⁴² This is a scenario addressed in Action 4 of the BEPS Action Plan. This practice cannot be applied in Switzerland due to a lack of the tax grouping regime, whereas in the Netherlands this structure could be implemented. Due to the awareness of the Netherlands they have enacted new legislation limiting the tax benefit and deductibility to a certain amount.

41 Source: OECD, Addressing Base Erosion and Profit Shifting, (2013), 82.

42 OECD, Addressing Base Erosion and Profit Shifting, (2013), 80.

6 Conclusion

By comparing the recent developments in the Netherlands and in Switzerland with regard to LBO acquisition and the deductibility of interest the following differences were identified. Unlike the Netherlands where a fiscal unity and a merger is treated the same way, Switzerland does not provide for a fiscal unity with regard to direct taxes. However, while the Netherlands deny the deduction of interest in a LBO acquisition based on newly enacted legislation, the Swiss cantonal tax authorities deny the deduction by approving a case of tax avoidance. Reasoning that it meets the criteria of tax avoidance set out by the federal court. Due to the very pragmatic approach, it has not been a case where this argument of the cantonal tax authorities has been brought to the federal court. Instead, alternatives to the merger are presented in form of tax rulings and subsequent cascade purchases or debt for equity swaps to guarantee legal certainty and thereby offer a way to guarantee the deductibility of the interest.

Since the deductibility of interest in a LBO acquisition is an issue in both countries they set out as a crucial criteria, what the intention of the taxpayer is. In the Netherlands there is an intention test which is still mainly based on the headquarter function and not yet clearly defined. In Switzerland the line between a legal tax saving and a structure which is of total inadequacy or if the structure is beyond what can be considered as economically reasonable is also difficult to draw. However, the difficulty is reduced due to the opportunity to apply an alternative instead of remaining with the legal uncertainty.

The BEPS report has not yet addressed this uncertainty and differences, but has identified the structure as aggressive tax planning and might also intend to fight it in the next years. Nevertheless in the Netherlands actions are already implemented to guarantee legal certainty in the upcoming years and also Switzerland is not under scrutiny by Action 4 of the Action plan.