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I. Introduction - The Debt vs. Equity Conundrum Continues

The question of what constitutes debt and what qualifies as equity for tax purposes has long been a source of debate in the international tax community.[1] Issuers will generally decide on whether to raise capital through the issue of debt or of equity, based primarily on business considerations. To the extent that tax factors into the decision, if debt affords an issuer a deduction for interest without any further withholding tax cost assessed by the source jurisdiction to the recipient, it may prove extremely attractive to both an issuer and an investor.[2] Tax professionals and their clients have worked in the international arena with varying national notions of debt and equity in structuring financial instruments with combined debt and equity features, in order to satisfy investor requirements, while also maximizing their tax efficiency. The purpose of this tax planning has, most often, been the very real commercial or business requirement that most issuers face in securing and accessing capital from arm's length lenders in foreign markets at attractive and economically viable costs.

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1. *See, e.g.*, Shipra Padhi & Shreya Rao, *The Debt-Equity Conundrum*, 7 Int'l Taxation 468, 468 (2012); Tim Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Foundation (2000); Mark P. Gergen, *Making Do in a Mongrel Accrual-Realization Regime*, 50 Canadian Tax J. 212, 214 (2002).

2. As the deduction afforded by many jurisdictions for interest on debt is highly sensitive—especially when the parties involved in the transactions are related, affiliated, or otherwise connected—jurisdictions have put limits on interest deductions to ensure that they are able to tax what they consider to be their fair share of revenues of multinational groups. The varied approaches to these limitations have also been the subject of study, and have been addressed in one of the Action Items of the BEPS project. *See* OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, 18 (2015).

This process has also resulted, however, in the evolution of "hybrid" financial instruments, designed deliberately with equity or debt features to take advantage or "arbitrage" the differences in domestic laws of relevant jurisdictions as they impact the characterization of debt and equity. For example, a hybrid may be treated as debt in a jurisdiction of source, and related payments would then, if they met local domestic law tests in that source jurisdiction, be deductible in computing the income of the issuer. In the jurisdiction of the investor's residence, however, if the same instrument is treated as equity, the receipt may be exempted from tax for the recipient through some type of participation exemption or dividend-received deduction under relevant domestic law. This hybrid mismatch has been the subject of much scrutiny among tax administrations internationally, particularly in recent years, and has now been addressed in one of the Action Items of the G20/OECD Base Erosion and Profit Shifting (BEPS) project, as well as in numerous other research studies and published works.[3]

Derivatives (such as options, futures, forwards, interest rates, currency swaps, and more recently collateralized and synthetic obligations, such as mortgage-backed securities and total return swaps) do not fit neatly into traditional categories of debt or equity, and are treated in some jurisdictions separately for tax purposes as financial claims or obligations (e.g., notional principal contracts). Derivatives and synthetics add a further stress to tax regimes that distinguish between debt and equity but provide no flexibility for addressing these more complex instruments.

II. Canada

The character of a financial instrument for Canadian tax purposes, as debt or equity, is determined under common law principles. These common law principles suggest that, for an obligation to be "debt," it must contain the essential elements of debt as judicially determined under commercial law.[4] There is authority in Canada for the proposition that to have debt, it is necessary to have an obligation of a fixed or liquidated character.[5] Canadian courts have, in the past, been asked to characterize financial instruments as either debt or equity. As a result, there is Canadian jurisprudence that provides guidance as to how a duality of features in a financial instrument has been reconciled by the Canadian courts.[6]

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3. *See, e.g.*, OECD, NEUTRALISING THE EFFECTS OF HYBRID MISMATCH ARRANGEMENTS, 15 (2015) (setting out recommendations for domestic rules designed to neutralize mismatches in tax outcomes that arise in respect of payments under a hybrid mismatch arrangement); *see also* Council Directive amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, 2015 (EC).

4. *See* Backman v. Canada, [2001] 1 S.C.R. 17 (Can.); Will-Kare Paving & Contracting Ltd. v. Canada, [2000] 1 S.C.R. 915 (Can.).

5. *See* Diewold v. Diewold, [1941] S.C.R. 35, 39 (Can.); Noble v. Lashbrook, [1918] 40 D.L.R. 93, 94 (Can. Ont. C.A.).

6. *See, e.g.*, Canada Deposit Insurance v Canadian Commercial Bank, [1992] 3 SCR 558 (Can.). The Canadian courts have been asked, in tax and non-tax contexts, to make

In *Barejo Holdings ULC v. The Queen*,[7] the Canada Revenue Agency (CRA) characterized as debt two "hybrid" derivative contracts, which on their face were styled as Notes (the "Notes") and were valued at $996 million (USD). Justice Boyle of the Tax Court of Canada upheld the position of the CRA.

The two Notes were held by St. Lawrence Trading Inc. (SLT), a BVI-controlled foreign affiliate subsidiary of Barejo Holdings ULC (Barejo Holdings). The Notes were a result of the reorganization of the predecessor of SLT, where certain hedge fund assets (Assets) of the predecessor of SLT were sold to the Bank of Nova Scotia and the Toronto-Dominion Bank (Vendors). SLT used the proceeds to acquire the Notes in affiliates of the Vendors (Issuers) under a Note Purchase Agreement. The value of the Notes was derived from the performance of the Assets (or replacement assets), which were managed by the same management team.

The Term Sheet specified that no interest was payable except for default interest and that the Notes ranked *pari passu* with all unsecured obligations of the Issuers. The Notes did not refer to a principal amount but instead to an issuance amount. The Term Sheet also did not provide for a stated or fixed amount to be payable on the Notes upon maturity or upon an earlier termination event. Instead, each Issuer was obliged, at maturity, to settle the Notes for cash, either by payment of an amount, if any, equal to the net value of the Assets, or by payment of an amount, if any, realized in connection with their actual liquidation. There was also a provision for the calculation and communication of the net value of the Assets on an aggregate and per investment weekly basis, throughout the term of the Notes.[8]

The Canadian *Income Tax Act* ("*Act*")[9] does not provide a specific statutory definition of debt. The tax court's response to the reference question, therefore, took the reader through a treatise on the common law character of debt.[10] It then continued with a statutory review of all possibly relevant

determinations as to the character of financial instruments having features of both debt and equity. The courts have found that the determination is to be made on the basis of which features carry the most weight and are the most persuasive. There is no suggestion in the jurisprudence that there could be a further category of obligations that do not fit neatly, even with the benefit of the established guidance, into either of the traditional categories. This jurisprudence, however, was addressing more conventional instruments, such as convertible debt or preferred shares for the purpose of determining creditor versus shareholder rights and preferences.

7. 2015 TCC 274 (Can. Tax Ct.). The reference question in this case was put to the tax court under Rule 58, Tax Court Rules (General Procedure). This Rule allows the parties, pre-hearing of the substantive issues, to put one or more questions before the court.

8. This value was presumably used during the holding period for determining the managers' fees, bank fees, monitoring compliance with investment restrictions, and potential events of default.

9. R.S.C. 1985, c. 1 (5th Supp.), as amended (Can.).

10. Barejo, 2015 TCC at para. 65 (Can.) (concluding rather surprisingly that "there is not a single all purpose, all encompassing, and all limiting or circumscribing legal definition of debt in Canada.").

terminology in the *Act*, which it concluded supported the characterization of the Notes as debt.

The Court, however, cautioned that its conclusions will not necessarily apply in all cases. In the hearing of any other particular case, the Court may give a somewhat different or more nuanced meaning to the term debt depending upon: (1) the text and context of a particular provision or regime in the *Act*, (2) specific provincial or other applicable laws that are relevant to the interpretation of a contract or the re-characterization of a relationship, or (3) the possible relevance of purpose, objective or intention the application of the provision or the interpretation or characterization of the contract or relationship, among other things.[11]

Justice Boyle believed that his only option was to determine whether the Notes were debt or equity for tax purposes. He identified the debt features of the Notes, such as a stipulated interest rate (which he found to be nil). He also recognized the equity characteristic of the Notes: "[d]istinct from credit or performance risk, the value of the Notes at any time clearly derives from the value of the underlying . . . Assets." Justice Boyle concluded that "the core essentials of debt generally for purposes of the *Act*" are:

(i) an amount or credit is advanced by one party to another party;
(ii) an amount is to be paid or repaid by that other party upon demand or at some point in the future set out in the agreement in satisfaction of the other party's obligation in respect of the advance;
(iii) the amount described in (ii) is fixed or determinable or will be ascertainable when payment is due; and
(iv) there is an implicit, stipulated, or calculable interest rate (which can include zero).[12]

Justice Boyle clarified that all of the core essentials mentioned need not be "perfectly" met. Moreover, other evidence, such as *supportive or contradictory wording* or *intention*, would be a part of the overall weighing process of any debt-equity characterization. "A provision in respect of interest, the use of the term principal or principal amount, and/or security rankings relative to other debt liabilities will generally be indicative of debt."[13]

The Notes, Justice Boyle determined, were debt for purposes of the *Act*. As he describes them,

> "[t]hey are entitled Notes. . . . They have a maturity. . . . Upon maturity there is a payment obligation that relates clearly . . . to the amount for which the Notes were issued. . . . [T]he Notes describe the amount for

11. *Id.* at para. 13.
12. *Id.* at para. 129.
13. *Id.* at para. 131. Based on the decision of the tax court, it would appear that the amount to be repaid may be considered as fixed or determinable and as a debt feature so long as it is or *will be* ascertainable when payment is due, and there will be an implicit, stipulated, or calculable interest rate (which can include zero) where there is a mere mention of interest, even to say simply that none would be paid. The references need not be in the primary instrument to be given weight; they could be included in a prior circular or term sheet or other transactional document.

> which they are issued as a Principal Amount . . . At maturity . . . the amount payable . . . is readily ascertainable . . . . The interest rate is stipulated . . . as . . . zero . . . . The Notes evidence that the parties' intention was that this be treated like any other debt of the issuers. . . . [T]he Guarantors would be liable as if they were the primary debtors. . . . ."[14]

While it is difficult to disagree with the core essentials of debt noted by Justice Boyle in *Barejo*, his application of those core essentials to the Notes and the qualifications he introduced to reach his conclusions are somewhat disconcerting. The Notes that the Issuers issued to SLT were financial contracts, which gave SLT, for consideration, the right potentially to future claims against the Issuers and the Banks. Simply put, these financial contracts did not give SLT rights comparable to either a holder of a portfolio of stock or a holder of traditional debt in the Issuer or in any other entity. SLT was an unsecured creditor, which is not unusual in derivative arrangements. The Notes paid no interest; indeed, they did not mention interest at all, and they did not mention a principal amount. Their focus was on the amount paid by SLT to acquire a claim against the Issuers, which would crystallize and be determinable only on maturity, default, or early termination. These events were not likely to occur unless the market or the financial, tax, or regulatory landscape changed dramatically for fifteen years. At that point, the Issuers would be required to settle the contracts and might possibly, depending on the facts, pay a sum of money. The fact that the financial contracts were styled Notes and that the financial claims were ranked and guaranteed did not change the nature of the rights of the parties under the contracts themselves. The Notes were not "fixed return" instruments, but high risk contractual gambles, both economically and financially. SLT's return was dependent, it is true, on the credit of the Issuer and the Banks, but primarily its exposure was to the financial market or an investment risk.

The definitions of debt in the Canadian jurisprudence are arguably imprecise. If one considers the tax court decision carefully, it would seem to suggest that a financial instrument cannot be one thing at one point in time and another at an earlier or a later point in time. The concept of commercial debt can be, and has been, construed to require that there be an agreement to repay a "fixed amount" determinable at the time of issue and throughout the term of the instrument or arrangement, in order for the obligation to be considered debt at the outset. The agreed amount need not be the same amount as is advanced, but general wisdom would suggest that it should be *some* amount. It remains to be determined if zero or nil, as suggested by Justice Boyle, is an amount for Canadian tax purposes. If so, the potential that no portion of funds advanced will be repayable on maturity and that no interest will be payable on a financial claim should, in the future, still leaves open a debt characterization.

14. *Id.* at para. 133 (emphasis added).

An argument can be made that the decision also supports the proposition that what the parties call a financial instrument and how they reflect its terms and conditions in words (e.g., its form) may be given more weight in an analysis by the Canadian courts than its economics, financial equivalents, or substance.

The tax court decision has been appealed to the Federal Court of Appeal. It should be noted that the standard of review to successfully overturn any findings of fact by the trial judge is that of a palpable and overriding error.[15] It is, nonetheless, to be hoped that the appellate court will use this opportunity to provide some clarity on the core essentials of debt and exercise some levity in addressing Justice Boyle's unusual interpretation and application of those core essentials in this case.

III. India

The famous Indian jurist Mr. Nani Palkhiwala observed that both tax evasion and arbitrary or excessive taxation are reprehensible. He further observed that tax evasion aggravates arbitrary taxation, and arbitrary taxation aggravates tax evasion. To break the vicious cycle, while there must be every attempt to check evasion, there must equally be every attempt to stop whimsical taxation. While these words were said more than three decades ago, the battle continues today in India. In order to minimize tax costs, taxpayers continue to develop ingenious ways to reduce their tax costs while working within the four corners of tax provisions.

A common issue in India relates to capitalizing a company and repatriating its profits in a manner that does not entail significant tax cost. While dividends paid by a company to a shareholder can attract significant tax cost at two levels, the same may not be true for interest payments on borrowed capital.

In India, dividends are not a deductible expense. The amount of a dividend comes from profits which have already been taxed at the corporate level. When the dividend is declared, the company must pay an additional Dividend Distribution Tax (DDT) of 17.304 percent.[16] The dividend is then exempt in the hands of recipient shareholders.[17] Beginning April 1, 2016, however, India added a further tax of 10 percent against any shareholder receiving dividends of Rs.10 lacs[18] or more. Except for certain instances where a holding company and a subsidiary company declare a dividend, there is no credit available for DDT. It, therefore, becomes a net tax cost to the ultimate shareholder, which may increase to as high as 50 percent.

Compare this with a scenario where an investor holds debt. Under the existing provisions of the Indian Act, there would be a withholding tax of 10 percent. The issuer, however, would be eligible to claim a deduction of the

15. Housen v. Nikolaisen, 2002 SCC 33, [2002] 2 S.C.R. 235 (Can.).

16. Income-Tax Act, No. 43 of 1961, INDIA CODE, http://indiacode.nic.in.

17. *Id.* § 10(34).

18. Rs.10 lacs is INR 1 million; The Finance Bill, 2016, Acts of Parliament, 2016 (India).

interest that could possibly produce a corporate tax savings of up to 34.61 percent.

No issue should arise as long as the financial instrument is clearly identifiable as either debt or equity. However, this may not be the case, where an investor acquires debt, but the terms of the debt include features of equity as well. If the debt is recharacterized, the deductibility of interest paid on it will be in jeopardy.

Although thin capitalization rules are not applicable in India and the General Anti Avoidance Rules (Indian GAAR) have yet to take effect, there are instances where Specific Anti Avoidance Rules (SAAR) and Judicial Anti Avoidance Rules (JAAR) may have an impact on this re-characterization.

The Indian Act contains an SAAR that treats loans by a closely-held company to its shareholders that hold more than 10 percent of its shares as a "deemed dividend" to the shareholder.[19] However, the deemed dividend does not attract DDT, but is rather taxed in the hands of the shareholder. Hence, there are two levels of tax—one at the corporate and the other at the shareholder level.

The Indian accounting rules will have a bearing on the characterization of a financial instrument as debt or equity. IND AS-32 addresses the accounting for financial instruments either as a financial liability or an equity instrument.[20] In simple terms, the accounting standard requires that if an instrument qualifies as a financial liability, its fair market value must be ascertained at the beginning of the year, and a necessary provision should be made, after taking into the fair market value of the amount which is to be paid at its maturity.

The Indian Companies Act requires that Indian companies may only issue preference shares that are redeemable (RPS).[21] If the principles stipulated in IND AS-32 are applied, these preference shares may be recognized as a financial liability.[22] As a natural corollary to this characterization, the dividend payable on RPS will be recognized as a charge to profits.[23]

19. Income-Tax Act § 2(22)(e).

20. Ministry of Corporate Affairs, Indian Accounting Standard (Ind AS) 32 (2015). IND AS-32 is the Indian Accounting Standard-32 ("IND AS-32") issued by the Ministry of Corporate Affairs, which establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments from the perspective of the issuer into financial assets, financial liabilities, and equity instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

21. The Companies Act, No. 18 of 2013, India Code (2013).

22. Ministry of Corporate Affairs, *supra* note 20, ¶ 11, at 959 (Where a contractual obligation to deliver cash exists for the repayment of principal, the outflow of cash is unavoidable and hence ought to be treated as financial liability.).

23. *Id.* ¶ 35, at 972 (Interest, dividends, losses, and gains relating to a financial instrument or a component that is a financial liability will be recognized as income or expense in profit or loss.).

Under the Indian Act, there is a provision to pay minimum alternate tax (MAT)[24] on the book profit of a company, as disclosed in its financials. Thus, a dichotomy could arise where a dividend will not be permitted under the normal provisions of the Indian Act, even for purposes of the determination of book profit, as only the ascertained liability is deductible. Nonetheless, it is arguable that the provision for fair market value of the future dividends payable may be regarded as a provision for an ascertained liability, and hence, that amount may be deductible from the book profits for the purposes of MAT. Although this approach may be consistent with the regulatory laws when only fully and mandatorily convertible instruments are not regarded as debt instruments,[25] it is clearly inconsistent with the normal provisions dealing with the deduction of interest on a debt instrument when payments, even on RPS, are regarded as dividends only.

An amendment to the Indian tax laws is clearly required to bring them into conformity with the accounting principles adopted for recognition for financial instruments. In the absence of clear provisions, there is a possibility that the proposed GAAR provision, when effective, will be relied on to recharacterize payments of dividends on RPS. Since, it is the express intention of the Indian government to ensure that India has certainty in its tax laws, inconsistencies such as this should be avoided at all cost.

IV. Italy

Distinctions between debt and equity also exist for Italian tax purposes. When the funding of an Italian corporate entity with debt or with equity is considered, the tax treatment of interest expense (Interest Barrier Rule) and the deduction for notional interest (NID), as well as a quick comparison between the two, may provide some guidance.

24. Income-tax Act § 115JB. MAT is applicable to a company where the income tax payable by that company on its total income as computed under the Indian Act is less than 18.5 percent of its book profit. The company would be required to pay income tax at the rate of 18.5 percent as increased by an applicable surcharge on its book profit ("Book profit" is the net profit as shown in the profit and loss account for a relevant previous year subject to certain adjustments.). The amount of a dividend paid or proposed must be added back in when computing book profit.

25. Foreign Exchange Management (Transfer or issue of Security by a Person Resident outside India) Regulations, 2000, Gazette of India, pt. II sec. 3 (May 8, 2000). "Capital" means equity shares, preference shares, and convertible debentures. The equity shares issued in accordance with provisions of the Companies Act, as applicable, shall include equity shares that have been partly paid. Preference shares and convertible debentures shall be required to be fully paid, mandatorily and fully convertible. "FDI" means direct investment by a non-resident entity/person resident outside India in the capital of an Indian company under Schedule 1 of Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 – ¶ 2.1.12 of Consolidated FDI Policy Circular dated 7-6-2016.

For debt, the Italian interest barrier rule,[26] since 2008, follows the "interest-to-profit approach,"[27] and provides that interest expense is deductible up to an amount equal to the interest income. The balance of any interest expense is deductible up to 30 percent of the gross operating income (Adjusted EBITDA).[28] Any excess of interest expense over the 30 percent of Adjusted EBITDA can be carried forward with no time limit, and can be deducted in future fiscal years to the extent that the net interest expense (in other words, exceeding interest income) of future years is lower than the corresponding threshold. Also, any unused Adjusted EBITDA can be carried forward with no limit and may increase the threshold in future fiscal years.

For equity, the NID, introduced in 2011,[29] mitigates the difference, in terms of tax treatment, between companies funded with debt and companies funded with equity. Under the NID, Italian companies (and Italian-permanent establishments) may benefit from a deduction of a notional yield on the qualifying equity increase accumulated after 2010, computed by applying a defined rate (4.75 percent for 2016, 2.3 percent for 2017, and 2.7 percent for 2018) to that increase. The qualifying equity increase consists of cash contributions from the shareholders, waivers of financial receivables from the shareholders, and retained distributable profits.

In comparing the effect of these rules to decide how to fund an Italian company, the following features should be kept in mind:

- NID is not subject to the Interest Barrier Rule, so it applies to companies with no interest-deduction capacity under that rule;
- both excess interest expense and excess NID may be impaired on a merger with other companies or on the transfer of the controlling stake in the corporate taxpayer; and
- for funding from abroad, interest payments may only be subject to withholding tax, while NID is neutral in this respect.

In 2016, there were two developments that may affect the funding of Italian companies. First, the Italian tax authorities issued important

26. Decreto Presidente della Repubblica. 22 dicembre 1986, n.917, G.U. Dec. 31, 1986, n.302 (It.).

27. For an overview of the different approaches to the matter, *see* Chloe Burnett, *Intra-Group Debt at the Crossroads: Stand-Alone Versus Worldwide Approach*, 6 World Tax J. 1 (2014); Stuart Webber, Thin Capitalization and Interest Deduction Rules: A Worldwide Survey, 60 Tax Notes Int'l 683 (Nov. 29, 2010).

28. Decreto Legislativo 14 settembre 2015, n.147, in G.U. Sept. 22, 2015, n.220 (It.). This adjustment is equal to the difference between ordinary revenues and ordinary costs (excluding depreciation, amortization, and financial leasing instalments). In 2016, it also includes dividends from non-resident subsidiaries in which the Italian company holds more than 50 percent of the voting rights at a shareholders' meeting.

29. Decreto Legge 6 dicembre 2011, n.284, in G.U. Dec. 22, 2011, n.214 (It.). The Italian acronym for NID is Ace (*Aiuto alla crescita economica*).

interpretations on interest expense arising on merger-leveraged-buyout (MLBO) transactions,[30] concerning:

- the legitimacy of the deduction, in the hands of the Italian acquisition vehicle, of any interest expense incurred in the context of a leveraged acquisition;[31]
- the issue of advance tax rulings on the possibility of repealing the exposure to tax loss carry-forward limitations and to interest expense (in excess of the yearly threshold) deduction limitations in case of a merger in the context of MLBO transactions;[32]
- the so-called IBLOR-fronting structures used to grant syndicated loans to Italian acquisition vehicles where a foreign credit support provider grants a loan to an Italian fronting bank that in turn grants a mirror loan to an Italian acquisition vehicle;[33]
- shareholders' loan granted to an Italian acquisition vehicle by a EU company that in turn is back-to-back financed by foreign third party lenders;[34] and
- the re-characterization as equity of a shareholder's loan granted to an Italian acquisition vehicle by a foreign investor whereby, in exceptional circumstances and following the reasoning of the OECD Transfer Pricing Guidelines, the investment should have taken place in the form of equity instead of a loan.[35]

Second, in 2016, Italy became compliant with EU law.[36] As of 2016, a 95 percent exemption from taxable income for investors applies to payments on financial instruments that are linked to the economic results of an issuer (or of other group companies), provided that they are not deductible from the

30. ITALIAN REVENUE AGENCY, CIRCULAR LETTER NO. 6/E (2016), *available at* http://www.agenziaentrate.gov.it/wps/file/nsilib/nsi/documentazione/provvedimenti+circolari+risoluzioni/circolari/archivio+circolari/circolari+2016/marzo+2016/circolare+6e+del+30+marzo+2016/CIRCOLARE+N.+6+-+E+DEL+30+MARZO+2016.pdf.

31. *Id.* This interpretation is quite relevant, as the Italian tax inspectors have often challenged the deduction of interest related to an acquisition loan.

32. *Id.* The relevant ruling requests now become acceptable by definition.

33. *Id.* The fronting bank is now disregarded for withholding tax purposes; in other words, the interest payments to the fronting bank are subject to the Italian withholding tax applicable—or not applicable, as the case may be—as if the relevant interest were paid directly to each foreign credit support provider.

34. *Id.* The EU shareholder's eligibility to the benefits of the EU Interest/Royalties Directive, Directive 2003/49/CE, dated 3 June 2003 will be denied due to its lack of beneficial ownership with respect to the interest income; therefore, the Italian withholding tax becomes applicable—or not applicable, as the case may be—as if the interest were paid directly to each foreign third party lender.

35. *Id.* This recharacterization results in the denial of any deduction for interest accrued on the shareholder's loan, the recognition in principle of the NID on the loan principal amount recharacterized as equity and of the dividend tax treatment on the interest paid to the foreign shareholder. This interpretation has been opposed by Italian scholars based on several arguments.

36. Legge 7 luglio 2016, n.122, G.U. July 8, 2016, n.158 (It.).

income of the issuer.[37] In order to benefit from the exemption on payments from a foreign issuer, an Italian holder or investor must have held at least 10 percent of the share capital of the issuer uninterruptedly for at least one year, and the issuer must have one of the legal forms listed in Annex I of the Directive,[38] must be a EU resident for tax purposes, and must be subject to one of the taxes listed in Annex I of the Directive, without the possibility of benefitting from any exemption regime. With this modification to the existing domestic law, there is full symmetry between the tax position of the issuer and the investor, equivalent to that already existing for dividends. This modification also addresses the concerns of the OECD on hybrid instrument mismatches.[39]

V. Mexico

Mexican tax legislation distinguishes between debt and equity. In general, financing a business through debt provides a relative advantage because the loan can be registered in a foreign currency, avoiding a potential exchange loss, and the interest expense may be deductible to the issuer in computing its income. If equity is issued, there is the risk of an exchange loss and no deduction for dividends. The capital of the issuer company is, however, adjusted for inflation, providing a present value of the investment when there is a future redemption and reimbursement to the shareholder.

Whether the decision is made to use debt or equity to raise funds by a Mexican company will depend only partly on Mexican law. The tax treatment of a foreign investor under the domestic laws of its jurisdiction of residence will also be relevant. Mexican income tax law[40] contains provisions that are intended to neutralize differences in the tax treatment to investors of debt and equity.

Before 2014, dividend distributions of after-tax profits from companies were not taxable by Mexico, regardless of the recipient's residence the year in which the revenues were earned or the distribution occurred. However, as of 2014, an additional 10 percent withholding tax is levied on dividends or profits distributed by entities in Mexico or by permanent establishments of non-residents, to either a Mexican resident individual or foreign resident (individual or legal entity) shareholders. This withholding tax also applies where a permanent establishment remits profits to a home office or to another permanent establishment located abroad.[41] Payment of the tax is affected through withholding by the distributing entity.

37. D.P.R. n.917/1986 (It.).

38. Council Directive 2011/96, 2011 O.J. (L 345) 8, 12 (EU).

39. OECD, *supra* note 3, at 45.

40. Ley del Impuesto Sobre la Renta [ISR], Diario Oficial de la Federación [DOF] 11-12-2013, últimas reformas DOF 30-11-2016 (Mex.).

41. *Id.* art 140, 164.

Interest paid to non-resident creditors is also subject to a withholding tax[42] ranging from 4.9 percent to 35 percent, depending on the nature of the loan, the status of the lender, and, in some cases, the use of the funds. The withholding tax rate of 4.9 percent is applicable when the payment is made to banks, investment banks, and non-bank banks that reside in a tax treaty country. The same preferential rate applies when the payment is made by a Mexican financial institution (in other words, a bank or a special purpose financing entity (SOFOM)). Withholding tax rates are as follows: (1) the 15 percent rate applies to payments to reinsurance companies; (2) the 21percent rate applies when the debt is used by a Mexican taxpayer for the acquisition of fixed assets and the lender is the supplying party; and (3) the 35 percent rate applies in cases not expressly regulated.[43]

In Mexico, corporate taxpayers are required to calculate and recognize the effect that inflation has on their debts and credits on an annual basis.[44] In general, if the average debts during the year is higher than the average credits, the taxpayer will be required to recognize and accrue the inflationary effect of the excess debts. If the average credits during the year is higher than the average debts, the taxpayer will be entitled to a deduction of the inflationary effect for the excess credits. Debt to which the thin capitalization rules apply is excluded from the inflationary calculation.

The Mexican thin capitalization rules address interest paid by a Mexican resident to non-resident related parties, and prevent its deduction to the extent that an issuer's debt to equity ratio exceeds 3:1.[45] In calculating the 3:1 threshold, a Mexican taxpayer must consider all debt that generates interest, regardless of whether the debt was contracted with a non-resident related party. The 3:1 debt to equity ratio can be exceeded in an advance pricing agreement with Mexican tax administration. The thin capitalization rules are not applicable to financial institutions or to financings between related parties for activities related to the construction, operation, and maintenance of infrastructure in national-strategic areas, such as hydrocarbons, oil and gas, and generation of electricity.[46]

There is much debate in Mexico as to whether the non-discrimination clause included in several Mexican tax treaties limits Mexico's right to apply its thin capitalization rules to treaty residents. As an example, article 25, paragraph 4 of the Mexico-USA Tax Treaty provides that interest, royalties, and other disbursements paid by a resident of a Contracting State to a resident of the other Contracting State shall, for the purposes of determining the taxable profits of the first-mentioned resident, be deductible under the same conditions as if they had been paid to a resident of the first-

42. *Id.* art 166.

43. *Id.*

44. *Id.* art 44, 46.

45. DELOITTE, *Taxation and Investment Mexico 2016*, https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-mexicoguide-2016.pdf (last visited Apr. 17, 2017).

46. *Id.*

mentioned State.[47] Thus, the scope of the indirect non-discrimination clause may be to prevent the source Contracting State from denying any deduction of interest paid by its resident to a resident of the other Contracting State, if the interest payment would be deductible if paid to a resident of the source Contracting State. Because thin capitalization rules deny the deduction of interest arising on debt owed to non-resident related parties when that debt exceeds the 3:1 ratio, these rules arguably breach the non-discrimination clause as the same interest paid to a related Mexican resident might be deductible. There are not yet any judicial precedents on the subject.

VI. United States

Historically, the question of whether a financial instrument constitutes debt or equity for U.S. tax purposes has been determined by reference to a multifactor test established by the U.S. courts.[48] The courts have recognized that although "classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income," there are some variations; "[t]oo great a variation," however, will preclude classification as debt.[49]

Detrimental tax consequences may result from a reclassification, including the loss of interest deductions for the issuer, recharacterization of interest and principal payments as dividends, incurrence of higher tax rates on dividends, and the possible disruption of ownership thresholds under the Code,[50] including Section 382 (net operating loss limitations), Subpart F (controlled foreign corporations), and Section 1504 (consolidated return rules).

When evaluating whether an investment takes the form of debt or equity, the courts have focused on a number of factors including the following: (1) whether there is a written, unconditional promise to pay a fixed amount; (2) whether repayment must be made on a specified date (or on demand); (3) the priority of the obligation in relation to borrower's other indebtedness; (4) the capitalization of the borrower and its ability to repay; (5) the availability of third party credit on similar terms; and (5) whether the borrower and lender are related parties.[51]

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47. United States – Mexico Income Tax Convention, Mex.-U.S., Sept. 18, 1992, *available at* https://www.irs.gov/pub/irs-trty/mexico.pdf.

48. *See* Gilbert v. Comm'r, 248 F.2d 399, 406 (2d Cir. 1957); Am. Metallurgical Co v. Comm'r, 112 T.C.M. (CCH), 23 (T.C. 2016).

49. *Gilbert*, 248 F.2d at 637–38 (internal citations omitted).

50. Unless otherwise indicated, all section references are to the United States Internal Revenue Code of 1986, as amended (hereinafter the "Code") and to Treasury Regulations promulgated thereunder.

51. *See* Estate of Mixon v. U.S., 464 F.2d 394, 402-10 (5th Cir. 1972).

This multifactor test has been referred to as "an amorphous and highly unsatisfactory 'smell test.'"[52] It fosters uncertainty as taxpayers, and their advisors attempt to predict the results that could emanate from the patchwork of existing case law.[53] Nevertheless, this test has stopped neither taxpayers from adopting their preferred classifications nor the IRS from challenging those classifications.[54]

Section 385 was first enacted in 1969, authorizing the Treasury Department to promulgate regulations "as may be necessary or appropriate to determine whether an interest in a corporation is to be treated . . . as stock or indebtedness."[55] Initial attempts at creating regulations were highly controversial, and the Treasury Department finally gave up in 1983, leaving Section 385 with little impact until 2016.[56]

On April 8, 2016, the Treasury Department's efforts against "corporate inversions"[57] in the context of the larger backdrop of global coordination on BEPS resulted in the Treasury Department publishing proposed regulations under Section 385.[58] After public comments, the regulations were revised and published as final regulations on October 21, 2016.[59]

The new regulations were promoted as a tool to discourage corporate inversions. Specifically, the Treasury Department believed that, by eliminating earnings-stripping strategies, it would reduce the appeal for a U.S. multinational to undertake an inversion. In reality, however, these new regulations are not limited to situations involving an inversion; they are general anti-earnings-stripping measures that target related party loans between a U.S. borrower and a foreign lender.[60] Furthermore, the targeted loans may arise in the ordinary course of business,[61] or as a result of reorganizations or other structuring.

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52. Stephen A. Lind et al., Fundamentals of Corporate Taxation 140 (7th ed. 2008).

53. *See* James S. Eustice & Thomas Brantley, Federal Income Taxation of Corporations and Shareholders ¶ 4.05 (2017).

54. *American Metallurgical*, 112 T.C.M. (CCH) (T.C. 2016).

55. Tax Reform Act of 1969, Pub. L. No. 91-172, § 415(a), 83 Stat. 487, 613 (1969).

56. *See* T.D. 7920, 1983-2 C.B. 69 (1983); Full Service Beverage Co. v. Comm'r, T.C.M. 1995-126 (1995) (explaining the history of the Section 385 regulations).

57. Corporate inversions are transactions undertaken by U.S.-based multinationals that result in redomestication of the parent company outside of the U.S. Although there can be non-tax reasons for an inversion, significant tax benefits can often be achieved.

58. Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 Fed. Reg. 20912 (proposed Apr. 8, 2016). *See also* U.S. Dep't of Treasury, *Fact Sheet: Treasury Issues Inversion Regulations and Proposed Earnings Stripping Regulations* (Apr. 4, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0404.aspx.

59. Treatment of Certain Interests in Corporations as Stock or Indebtedness, 26 C.F.R. pt. 1 (2016). *See also* U.S. Dep't of Treasury, *Treasury's Issues Final Earnings Stripping Regulations to Narrowly Target Corporate Transactions That Erode U.S. Tax Base* (Oct. 13, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0580.aspx.

60. The US already has earnings-stripping rules under Section 163(j).

61. The Treasury Department included exceptions to help reduce the effect on some ordinary course transactions, such as short-term cash pooling arrangements.

As an opening principle, the regulations reinforce the existing multifactor test by providing that, in general, "whether an interest in a corporation is treated for purposes of the . . . Code as stock or indebtedness . . . is determined based on common law, including the factors prescribed under such common law."[62] The regulations provide two sets of rules under which an instrument that is classified as debt under the multifactor test will nevertheless be treated as equity for federal income tax purposes.

For interests issued on or after January 1, 2018, the parties are required to have appropriate documentation in place before the due date for the U.S. tax return (including extensions).[63] This includes copies of all documents evidencing material rights and obligations of the borrower and lender.[64] Documentation of the kind that the taxpayer uses with unrelated third parties in similar transactions (e.g., evidence of trade payables) will generally suffice, as will documentation that is required by regulators for certain financial and insurance companies.

The regulations require that specific factors be documented.[65] Those factors include: (1) the unconditional, legally binding obligation to pay a sum certain; (2) the holder's rights as a creditor to enforce the obligation; (3) the holder's reasonable expectation of repayment; and (4) an analysis of collateral value, particularly with respect to non-recourse debt.

These rules only apply to expanded groups, which include a public company having total assets in excess of $100 million or having total revenue in excess of $50 million.[66] There are limited exceptions for noncompliance: (1) that is de minimis; (2) when the taxpayer has reasonable cause; or (3) that is ministerial in nature, if remedied by the taxpayer before discovered by the IRS.[67]

If an instrument is considered debt under the multifactor test and otherwise complies with the documentation rules, it will nevertheless be considered equity if the distribution rules apply. Broadly speaking, the distribution rules seek to recharacterize instruments that are issued to a related party in a situation that does not result in any new investment in the operations of the issuer. In general, these rules apply to debt issued after April 4, 2016, by a U.S. domestic corporation to a related party, if the issuer is not an excepted financial or insurance company.[68]

Under these rules, the covered debt is reclassified as stock to the extent issued in connection with a distribution, in exchange for stock of a group member, or in exchange for property in certain asset reorganizations.[69] There is also a "funding rule" that attempts to reclassify debt issued to a

62. Treas. Reg., 26 C.F.R. § 1.385-1(b) (2016).
63. 26 C.F.R. § 1.385-2.
64. 26 C.F.R. § 1.385-2(c)(1).
65. 26 C.F.R. § 1.385-2(c)(2).
66. 26 C.F.R. § 1.385-2(a)(3)(ii).
67. 26 C.F.R. § 1.385-2(b)(2)(i)-(iii).
68. *See* 26 C.F.R. § 1.385-3(g)(3) (covered debt instrument).
69. 26 C.F.R. § 1.385-3(b)(2) (general rule).

related party in exchange for property, if treated as funding an acquisition or distribution during a six year "per se" period.[70] These rules do not apply if the aggregate adjusted issue price of all covered debt instruments is less than $50 million.[71] There are also exceptions for compensatory stock acquisitions, transfer pricing adjustments, and acquisitions in the ordinary course of business by a dealer in securities.[72]

The future of debt/equity determinations in the United States is in a state of flux. Affected businesses are expected to expend considerable effort and funds in compliance costs and restructuring. Furthermore, members of the U.S. Congress and various commentators have questioned the validity of the regulations.[73] It is expected that businesses will spend several years updating their compliance protocols, while the courts determine the lasting effects of these new regulations.

VII. Conclusion

If they illustrate anything at all, the recent developments in regard to debt and equity in the countries included in this report suggest that the debate over what constitutes debt and equity and what tax treatment applies to those interests, as well as to issuers and holders of the much more complex derivatives and other financial products in global markets, is far from finished.

70. 26 C.F.R. § 1.385-3(b)(3) (funding rule); 26 C.F.R. § 1.385-3(b)(3)(iii)(A) (per se period).

71. 26 C.F.R. § 1.385-3(c)(4).

72. 26 C.F.R. § 1.385-3(c) (exceptions).

73. *See, e.g.*, House of Representatives, Committee on Ways and Means, Letter to Treasury Secretary Jacob Lew (June 28, 2016), *available at* http://waysandmeans.house.gov/wp-content/uploads/2016/06/20160628_WM-Reps_Lew_385-Regs.pdf (expressing "surprise" and stating that the proposed regulations are beyond Congressional intent for Section 385).