Allowance for Corporate Equity
– Overview of existing Equity and Dividend Deduction Regimes and the International Tax Law treatment hereof

1. Background

The debt equity conundrum has been approached by various means in different jurisdictions. The debt bias is a well-documented fact and a global trend in neutralizing the treatment of debt and equity is seen[1]. Relevant measures include means of reducing the appeal for debt financing by way of restricting interest deductibility or reclassifying debt into equity[2]. Another approach includes allowance for equity or dividend deductions. The latter approach stimulates equity investments rather than restricting debt financing. Economic theory advocates such an approach. An increase in the usage of equity- and dividend deduction regimes is seen in recent times where several countries have followed this approach. This tendency necessitates legal clarification of international tax issues raised by such regimes.

This presentation analyzes ACE-regimes and discusses the implications for international tax law of such approaches. This contribution does not address debt-equity hybrid instruments (in concreto debt-like equity), which are considered debt from the perspective of the issuer, and the yield as a consequence hereof is considered deductible interest.

2. Theoretical approaches favoring equity and dividend deductions – Allowance for Corporate Equity (ACE).

Economic theory has developed different solutions with the objective of neutralizing the tax treatment of debt and equity.

The solution proposed to obtain full neutrality is referred to as a Comprehensive Business Income Tax (CBIT), which denies deductibility by firms and treats debt as the current corporate income tax treatment of equity. There are however, no real-world examples of CBIT[3].

A model offered to solve the problems is traditionally referred to as Allowance for the Cost of Equity (ACE) which has been on and off tax reformers' agendas since the 1980's[4]. Since then proponents have repeatedly argued in favor of such a tax. The ACE has a number of interesting properties[5]. The idea of an ACE is to address the difference in the treatment of debt and equity by allowing firms to deduct a notional interest rate on their equity as well. As a consequence the ACE reduces the debt financing bias and reduces the tax motivations for leverage and consequently reduces the need for specific anti avoidance and anti-arbitrage legislation. On the other hand ACE systems may also be seen as a mean to stimulate equity investment in the corporate sector of the country in question. In the present

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1 See for a recent analysis e.g. *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011.

2 See for an overview of possible policy responses *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011, p. 14 et seq. and *Blessing* in Bulletin 2012, p. 209 et seq.

3 See *de Mooij*: Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, 2011, p. 16 and See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.

4 *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 3. A more firm reform proposal was presented by Institute for Fiscal Studies in 1991: A General Neutral Profits Tax, Fiscal Studies Vol. 12, pp- 1-15 (IFS, 1991, *Deveraux & Freeman*) and *Gammie* in ET 1992, p. 238 et seq.: Corporate Tax harmonization: An Ace Proposal. See also Institute for Fiscal Studies, Miirlees Review, Reforming the tax system for the 21st century, Tax by Design, pp. 421-425 and *Blessing* in Bulletin 2012, p. 212. See also See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.

5 *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 4 et seq.

economic environment ACE may be seen as a means of increasing the attractiveness of a capital importing country.

In theory the Allowance for Corporate Capital (ACC) is even more neutral. Under the ACC-model, the interest deduction is abolished and replaced by a deduction for the notional risk-free return on all capital, irrespective of whether it is financed by debt or equity[6]. In the United States, such a system has been proposed several times over the years. The model presently most popular is the "COCA" or "cost of capital allowance" system. This model has been advocated primarily by *Kleinbard*[7].

One of the most recent proposals is seen in Sweden where the topic has been extensively analyzed[8].On 12 June 2014, the Swedish Committee on Corporate Taxation published a proposal to reform the corporate income tax regime. The most important details of the proposal, which should apply from 1 January 2016, are summarized below. The Committee has not found any grounds that motivate a difference in the tax treatment of equity and debt. Moreover, it was found that the previous academic debate regarding the abolishment of the difference in the tax treatment of equity and debt and the distortions caused hereby were not perceived sufficiently serious to lead decision makers to consider there was any call for reform. This has changed due to large scale conversions of equity into debt and the moving of capital into low tax jurisdictions.

The main proposal includes a restriction of interest deduction and other financial costs, where such costs should be restricted to those costs for which there is a corresponding financial income. This means that the net financial costs would no longer be deductible. In this context, the Committee also concluded that the definition of financial costs should be expanded and, inter alia, include the following items: interest, exchange rates differences, losses on financial instruments; and the interest component on rental payments. In addition, the Committee suggested abolishing the current interest deduction restrictions concerning intra-group debts. Furthermore, group companies should be allowed to offset their financial income against financial costs of other group companies. As compensation for the abolition of the deduction for net financial costs, it is proposed to introduce a standard deduction for all financial costs (“a financing allowance”)(including the cost of equity) at a rate of 25% of the taxable profit. As a result, the standard corporate income tax (CIT) rate of 22% would be reduced to 16.5%.

3. Overview of Country Practices: domestic equity- and dividends deduction regimes

As mentioned an increased use of equity- and dividend deduction regimes is seen. ACE-deductions have not only been a theoretical exercise. Accordingly, a number of states have enacted such measures with certain variations.

French companies established prior to 1988 have had the opportunity to deduct from their taxable income 100% of distributed dividends provided the contributions were made in cash. The system was introduced to encourage shareholder equity financing but was limited to a ten year period[9]. The system was amended (reducing the rate of deductibility from 100 to 53,4) in order to correct the imbalance between the actual corporate taxes paid and the total tax benefit including shareholder imputation credit (avoir fiscal).

[6] See *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 17 and Blessing in Bulletin 2012, p. 211.
[7] See Tax Notes, 3 January 2005, at 101; and *Taxes* 1989, at 943.
[8] See SOU 2014:40 Neutral bolagsskatt, - för ökad effektivitet och stabilitet.
[9] See the former art. 214 A C.G.I. commented by *Lazarski* in ET 1988, at p. 264 et seq. and *Jacobs* in Intertax 1989, p. 466.

An ACE system was introduced in Croatia in 1994, followed by Italy in 1997 and Austria in 2000. All these countries have later abolished their ACE-system[10]. Presently variations of ACE systems exist in Belgium, Latvia, Brazil and Italy. Recently, an ACE has been advocated by the Mirrlees Review for the U.K. (Mirrlees and others, 2011). That report emphasizes that a British ACE could bring important economic benefits. A recent tax committee of the Dutch government has also proposed an ACE-regime[11].

Greenland

Greenland allows deduction for all payments. Thus, subject to certain conditions, distributed dividend is deductible for a Greenlandic distributing company.

Brazil - 1996

Since 1996 Brazilian law has contained a favorable regime allowing deductions on equity[12]. Such payments are referred to as "Juros sobre o Capital Próprio" (JCP). Typical English translations of JCP are "Interest on equity capital (IOE), "Interest on Net Equity (INE)" or "Interest over Capital (IOC)". The abbreviation JCP is used in the following.

JCP is considered an alternative to ordinary dividend distributions. As such the JCP system is not an ACE system and the JCP deduction only applies to actual payments. According to domestic Brazilian law JCP is treated as a special type of interest and is treated as interest.

The JCP mechanism allows for a legal entity to opt to pay interest in its own capital calculated by the application of a long term interest rate set by the government ("Taxa de Juros de Longo Prazo") over the entity's equity. JCP paymentscan only be paid up to half of the amount of (whichever is higher): (i) the entity's profits of the current year, before the JCP's deduction; or (ii) the entity's accumulated profits[13]. The JCP deduction requires a formal decision in the paying company. Moreover, the JCP requires a corresponding taxation at the level of the recipient, being a resident or a foreign tax payer (the shareholder). The tax value of the deduction is 34%, however corresponded by a 15% withholding tax.

According to Brazilian law there is no money flow requirement[14]. The payor is allowed to register the JCP payment as a liability or, by shareholders' decision, the declared JCPs can be recapitalized by way of capital increase of the payor company. In either case, the payor can deduct the JCPs, even though no actual payment has been made to the payee, and the payee will be taxed at the same moment the deduction is taken. Thus, regardless of the money flow, the payor's deduction is fully linked to the payee's taxation[15].

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[10] The global practice of ACE systems has been analyzed by *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006. *De Mooij* considers ACE a promising tax policy option in Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Note, may 3, 2011, SDN/11/11.

[11] Ministry of Finance of the Netherlands, 2010, Continuity and Renewal, report of the Studygroup on tax Reform.

[12] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared in European Tax Studies, 1/2010 and *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 10 et seq.

[13] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 4.

[14] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 6.

[15] See *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010, p. 6.

There has been lenghty discussions before the Superior Court of Justice as to the charging of certain contributions on JCP and according to the final ruling it should be treated the same way as interest is and not as dividends.

Belgium – 2005

With effect from tax years since 2007 Belgium introduced Notional Interest Deduction rules (NID)[16]. In essence the rules neutralize the treatment of debt and equity. In terms of foreign investments it seems that the introduction of the NID system put Belgium back on the tax map as a replacement of the Belgian coordination center[17].

The measure permits Belgian tax-resident companies and Belgian branches of non-resident companies to claim a tax deduction for their cost of capital by allowing them to deduct a notional interest at a rate calculated on the aggregate amount of their equity including retained earnings.

The NID is based on the company's share capital plus its retained earnings, as determined for Belgian generally accepted accounting principles purposes and as of the last year-end date.

The NID rate is based on the prior year's average of the monthly published interest rates, which is paid on 10-year Belgian government bonds. The rate is adjusted annually up or down by a maximum of 1 percentage point, and the maximum rate is currently capped at 6.5%. The annual rate is 3% for 2013 and 3.5% for SMEs. The part of the NID deduction that cannot be set off against the profits of the current year can be carried forward for seven years.

No actual cash flow is required under the Belgian NID regime. The NID is a fictitious interest cost on the adjusted equity capital. This can be put as follows: NID = Notional Interest x adjusted equity.

For obvious reasons the Belgian NID regime contains anti-abuse provisions with the objective to ensure that the same equity is not included in the deductible equity of more than one taxpayer.

Latvia - 2009

With effect from 1 January 2009 Latvia introduced a Notional Interest Deduction Regime. According to this regime a "notional interest" is deductible from the taxable income[18]. The calculation is based on the retained earnings from tax periods starting after 31 December 2008 and the annual average weighted interest rate on loans in lats to domestic non-financial companies.

Italy – 2011

Italy also (re-)introduced a Notional Interest Deduction regime on 22 December 2011[19]. The deduction aims to encourage self-financing and alleviate the tax imbalance between Italian companies funded with equity and those funded with debt. The Italian version of the ACE regime stands for "Aiuto alla Crescita Economica". Italy's Minister of Finance issued a decree on 14 March 2012 containing

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[16] See *Gerard* in ET 2006, p. 156 et seq., *Springael* in DFI 2006, p. 47 et seq., *Bombeke & von Frenckell* in DFI 2006, p. 167 et seq., *Quaghebeur* in Tax Notes Int'l June 20 2005, p. 1035 et seq., *Quaghebeur* in Tax Notes Int'l November 12, 2007, p. 627 et seq., *Haelterman & Verstraete* in Bulletin 2008, p. 362 et seq., *Malherbe & Vettori*: Deducting Interest on Equity Capital: Brazilian and Belgian Tax Rules Compared, in European Tax Studies, 1/2010 and Notional Interest Deduction: an innovative Belgian tax incentive- Tax year 2013 – Income 2012, Federal Public Service.

[17] Certain aspects of the Belgian NID regime have been brought before the ECJ in Case C-350/11 Argenta Spaarbank. The ECJ found that the rules were contrary to EU law. See *de Broe* in ECJ developments, 2011, p. 16 et seq.

[18] See *Lasmane & Rumba* in World Tax Advisor 2008, 5 December.

[19] See *Leone & Zanotti* in ET 2012/8 and World Tax Advisor 18 May 2012. Italy also introduced an ACE system in 1997 under the calling name: Dual Income Tax System. See *Klemm*: Allowances for Corporate Equity in Practice, IMF Working Paper WP/06/259, 2006, p. 7 et seq. for an overview of the historical ACE system in Italy.

implementation rules and clarifications with regard to the notional interest deduction introduced at the end of 2011.

Starting with the fiscal year 2011, the ACE rules entitle Italian entities (i.e. companies, individual firms and partnerships, as well as branches of nonresident companies) to a tax deduction computed by applying a notional yield to the increase in their net equity (the "ACE base"). For the first year of application (i.e. 2011), the ACE base is the amount of equity existing at the end of that year less the amount of equity at 31 December 2010 (excluding profits earned in 2010).

In subsequent years, the ACE base is the base carried forward from the previous year: (1) increased by cash contributions and apportionments of profits to capital reserves (exceptions for apportionments to specific reserves that are not available for distribution, increasing capital or covering losses); and (2) reduced by distributions of equity to shareholders, acquisitions of new interests in participated companies and acquisition of going concerns (the March decree provides for additional reductions under specific anti-abuse rules, if applicable). Should the amount of the notional yield (i.e. the ACE deduction) for a year exceed the total net income declared, the excess may be carried forward and increase the amount deductiblefrom income for subsequent tax periods.

The notional yield is fixed at 3% for the fiscal years 2011, 2012 and 2013. After 2013, the notional yield will be determined annually by a Ministerial decree based on the yields on Italian treasury bonds and can be increased by an additional 3% to compensate for higher business risk.

The decree provides specific anti-avoidance rules that place limitations on the ACE base and, consequently, the amount of the ACE deduction. These rules primarily target transactions that lead to a duplication of the tax deduction in the context of corporate groups (more precisely, in transactions involving entities linked by a control relationship). In particular, the following transactions will reduce the ACE base:

- Cash contributions made after the end of the tax year including 31 December 2010 to controlled entities or entities under common control (even if the control relationship is a consequence of the contribution concerned);
- Acquisitions of businesses and/or participations previously owned by controlled entities or entities under common control;
- Increases in relation to the amount shown in the financial statement as of 31 December 2010, in amounts receivable from loans provided to controlled entities or entities under common control;
- Cash contributions received from nonresidents controlled by residents; and
- Cash contributions received from an entity or individual domiciled in a black-list jurisdiction (even if no control relationship exists between the nonresident and the recipient of the cash contribution).

4. International tax issues raised by domestic equity deduction regimes

No international consensus exists regarding the tax treatment of ACE regimes. Traditional ACE regimes, however, should not likely trigger any tax consequences in the state of residence of the investor. One concern if whether dividends payments paid by companies resident in countries allowing ACE deductions would then continue to be creditable against foreign corporate income taxes, in countries that use the credit system. One source reports that experience with the operation of ACE-style relief in Belgium and Croatia, does not suggest that this is a problem[20].

In the specific case of Brazilian JCP payments and similar dividend deduction regimes there is an actual cash flow in the form of dividends payments.

A specific anti-arbitrage regime exists in certain countries including Germany and Denmark with the objective to deny participation exemption regarding such deductible inbound dividend payments[21].

The specific application of this provision with respect to JCP has not been analyzed in Danish law. Consequently, the tax treatment of JCP in Danish law is based on a classification of the payments according to generally applicable tax principles. The uncertainty is obvious since JCP shows traits of dividends and interest. Domestic uncertainty on the classification within Brazil adds to this uncertainty. According to Danish law it seems most correct to classify JCP payments as dividends for domestic tax purposes. This conclusion is based on the very broad notion of dividends in Danish law as any payment from a company to its shareholders which is also broadly interpreted in case law. This classification applies irrespective of any diverging classification according to the law of the source state since it is a generally acknowledged principle that any foreign transaction for Danish tax purposes must be classified on the basis of Danish tax law principles. The currently applicable notion of interest payments moreover requires the existence of a debt obligation in order to qualify as an interest payment. This specific circumstance disqualifies JCP payments as interest payments.

Once JCP payments are classified as dividends the next question is to assess whether the anti-arbitrage provision in SEL § 13, par. 1(2) applies. This provision denies participation exemption when dividends are deductible for the paying company.

Since the enactment of act no. 98 of 10 February 2009 with effect from distributions made on 8-October 2008 or later the Danish participation exemption regime has contained explicit wording on deductible dividends. According to this, the participation exemption does not include dividends, where the dividend paying company can deduct the dividend payment, unless the taxation in other countries is reduced or eliminated according to the parent-/subsidiary directive.

In our opinion JCP payments should be considered deductible dividend payments in this specific context regarding the application of the Danish anti-arbitrage provision in SEL § 13, par 1(2). As a consequence JCP payments from a Brazilian subsidiary to a Danish parent company should be considered taxable dividends according to domestic law. However, as a general principle in international tax law such a result should be in accordance with the existing double tax treaties.

With respect to double tax treaties an international consensus on the classification of JCP-payments for treaty purposes seems to be absent. The relevant provisions in most double tax treaties based on the OECD model treaty would be Article 10 on dividends and Article 11 on interest payments.

I generally favor a tax treaty classification of JCP-payments as dividends. However, in a number of Brazilian tax treaties the definition of interest in article 11(4) deviates from the present OECD model in defining interest as.

> *"The terms "interest" as used in this Article means income form Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt claims of every kind as well as other income*

[20] See Institute for Fiscal Studies, Miirlees Review, Reforming the tax system for the 21st century, Tax by Design, p. 446.
[21] See § 20 Abs. 1, EStG for German tax law and SEL § 13(2) for Danish tax law.

assimilated to income from money lent by the taxation law of the Contracting State in which the income arises.".

It may be argued that this definition includes JCP-payments. Moreover, in a number of cases the Brazilian tax authorities have taken the position that JCP-payments should be classified as interest payments. Thus, JCP-payments are seemingly classified as interest payments for Brazilian tax purposes despite debate on the topic. The view regarding the characterization under tax treaties has not been definitively reviewed by Brazilian courts[22].

In Brazilian commentary it has been submitted that JCP is covered by Article 10 as income derived from shares and, as such and, as such, should generate no doubt as to being included in the conventional concept of `dividends´ (and therefore subject to article 10 of the treaties). The Brazilian tax authorities, however, have been taking the position of considering JCP as being subject to Article 11 of tax treaties. In the case of more recent treaties with South Africa, Belgium, Chile, Israel, Mexico, Peru and Ukrania the Ordinances that regulate the application of treaty rules state clearly that "*in the case of interests, including JCP, subject to Section 11 of the Convention, the withholding tax shall not exceed ..."* Prior to those statements there is no referrence to JCP in the Brazilian tax treaties. In general there has been lenghty discussions before the Superior Court of Justice as to the charging of certain contributions on JCP and the final ruling has been that it should be treated the same way as interest and not as dividends, which suggests that the Brazilian courts would endorse the tax authorities understanding on this matter.

One question is whether JCP deductions can be said to neutralize a potential Brazilian withholding tax with the effect that there is no withholding tax actually paid. Such reasoning must be rejected since there is nothing different in the JCP deduction from a traditional interest payment, where a withholding does not cease to exist simply because the paying company has been allowed a deduction for the interest payment.

Although Brazilian tax law (and more recently, Brazilian tax treaties, with Mexico, South Africa and Israel) draw a distinction between JCP and dividends, several jurisdictions consider that JCP-payments is akin to income deriving from equity and thus can rely on the associated rules, which might be participation exemption[23].

It has been reported that JCP-payments have been classified as dividend payments for Spanish and German tax purposes, whereby the domestic participation regime has been found applicable. In Germany the Tax Court of Nürnberg analyzed the instrument in its decision of December 14, 2010 and concluded that the JCP-payments for German tax purposes would qualify as dividends, since at the end of the day they derive from the investment by the shareholder in the equity of the Brazilian company. The Spanish discussion has been concerned with the question of how the interaction should be between tax treaties and domestic law. In a Spanish case from 2014 the question was analyzed on the basis, that the Spanish tax authorities since 2011 challenged the applicability of the domestic participation regime to JCP-payments. The Spanish High Court "Audencia Nacional" decided on 27 February 2014 that a Spanish parent company will be able to benefit from the Spanish participation regime since the "subject to tax" test would be met and since the JCPs according to the court fit better into Article 10 rather than into Article 11 of the tax treaties. One Spanish commentator has stated that the decision can still be reversed by the Spanish Supreme Court[24]. Despite the current BEPS debate, it

[22] See *Garrigues*: Brazilian interest payments on net equity (Juros sobre o capital próprio): An international perspective, p. 4.
[23] See *Garrigues*: Brazilian interest payments on net equity (Juros sobre o capital próprio): An international perspective, p. 5.
[24] See *Vallada* at http://taxcave.blogspot.dk/2014/03/spanish-decision-on-brazilian-interest.html, dated 25 March 2014.

is argued that JCP and other similar mechanisms contribute to healthier companies, as they provide for some relief in favor of equity financing. Moreover, it is mentioned that, in this case, there is no abuse or mismatches, but simply the use of a mechanism and enjoyment of intended effects provided for by tax legislation.